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UNIVERSITY OF MIAMI

EMERGING MARKET FAILURE: THE CASE OF MEXICO

By

Eileen M. Scott

A DISSERTATION

Submitted to the Faculty
of the University of Miami
in partial fulfillment of the requirements for
the degree of Doctor of Philosophy

Coral Gables, Florida

May 2000

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Eileen M. Scott

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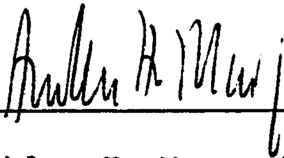

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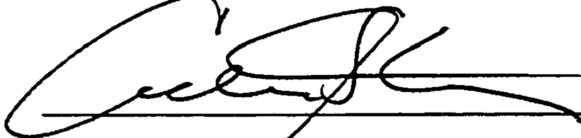

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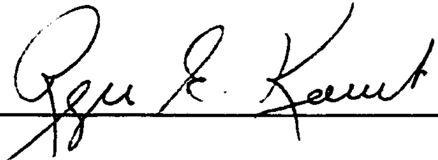

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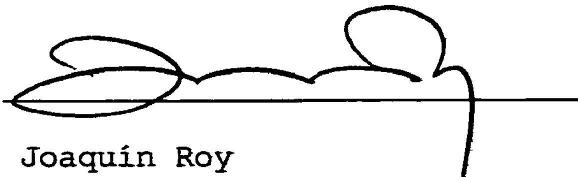

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SCOTT, EILEEN M. (Ph.D., International Affairs)

Emerging Market Failure: The Case of Mexico. (May 2000)

Abstract of a doctoral dissertation at the University of Miami.

Dissertation supervised by Professor Ambler H. Moss, Jr.

No. of pages in text 356.

This dissertation identifies a case of "emerging market failure," represented by the Mexican financial crisis of 1994/95. The hypothesis is that the financial crisis that occurred during the 1990s in Mexico is linked to the one that took place during the 1980s, and that both financial crises are manifestations of a single phenomenon. The two financial crises are strung together by a thread that involves freely-flowing international capital and an economy that is strongly reliant on the international capital market. This study finds that the principal explanation for both crises is located in the interaction of the following: the fundamentals of the Mexican economy that does not generate domestic savings and relies upon the international financial market; a political system that concentrates power at the expense of the democratic political process; and the governmental policies that pursue goals in the short-run at the expense of long-term outcomes.

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In the years since the 1994/95 financial crisis, the international financial system has displayed seemingly contradictory characteristics. In the advanced economies, equity values have been rising to unprecedented levels. Mechanisms for risk management have become increasingly efficient and are being employed on a large scale. Yet for many developing economies, the latter half of the 1990s has been characterized by currency speculation, devaluation, investment capital reversals, and IMF bailouts. This has led some in the academic and policy-making spheres to suggest that individual governments have lost their ability to guide their economies and that there are inescapable forces in a globalized world economy that can destroy even an economy that has followed a sound economic policy path. This dissertation takes an in-depth look at the Mexican case in order to explore this issue. The findings of the study permit a re-framing of the issue of financial crises. It moves beyond the short-term policies and outcomes that occurred in the context of 1994/95, and explores economic policy paths and the fundamentals of the economy and the political system, in the context of evolution in the international economy.

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In particular, I wish to express my sincere appreciation to the members of my dissertation committee. I am grateful to Ambassador Ambler H. Moss, Jr. for his support and guidance throughout my time at the University of Miami. As Dean of the Graduate School of International Studies throughout my course work, as well as my professor, he provided an academic environment in which I was able to develop my research interests and enhance my research capabilities. As Director of the North-South Center, he gave me the opportunity to gain broad exposure to the scholarly and practitioner community in international affairs and inter-American studies. As my dissertation advisor, his expansive knowledge of the field of inter-American affairs, and his clarity and focus strengthened my

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work considerably. Beyond academic guidance, I am grateful to have had the privilege to work under his direction and learn from his example, as a committed and knowledgeable professional and a leader in the field of inter-American affairs and public policy.

I would also like to express my appreciation to Dr. Andy Gómez for the assistance and guidance with which he provided me on my dissertation. He gave me valuable feedback that greatly enhanced my work. He challenged me to think about the way I approached the study and pushed me to clearly and systematically identify the manner in which I arrived at the conclusions that I reached. I am grateful to Dean Roger Kanet, whose broad knowledge and background in international affairs and political science contributed a fresh perspective to my work. He encouraged me to look at the broad issues and understand where my work fits into the field of international studies. I want to express my gratitude to Dr. Joaquín Roy for his conscientious and critical feedback. He compelled me to focus on the specific details that have a large bearing on the overall quality of the work. I am grateful for his display of interest and insightful comments.

I would also like to acknowledge the support of the faculty and staff of the School of International Studies

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and the researchers and staff of the North-South Center. I am indebted to the many individuals who enriched my experience. In particular I would like to thank Steve Ralph, who was a steady source of information and advice throughout my time at the School of International Studies.

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Mexico has been the target, not so much of a rational appreciation of its strengths by international investors, as of a sudden irrational financial infatuation.

-- Paul Krugman, March 1993 in Mexico City

One of the most foolish things said about the international economy these days is that because capital moves so quickly and so freely, government policies have little influence. In reality, precisely because of greatly increased capital mobility, the difference between having the right and wrong government policies has never been greater.

-- Lawrence Summers, 1995

The straw that breaks the camel's back is uninteresting. It's the camel's back that is interesting.

-- Rudiger Dornbusch, 1999

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CHAPTER I

INTRODUCTION

A. The Problem

This dissertation identifies a case of "emerging market failure." The emerging market phenomenon came about in the 1990s, as regulatory and demographic changes in the advanced economies led to an expansive phase in the international liquidity cycle. With large amounts of private capital in the international financial system seeking a place to earn high returns, several developing countries were singled out by international investors as "emerging markets," where they could invest their money and receive better returns than could be attained in domestic markets. "Market failure" refers to a sub-optimal economic situation characterized by market inefficiencies. This dissertation identifies the Mexico crisis of 1994/95 as a case of "emerging market failure," in which domestic economic, political, and economic policy factors come together in a context of a high degree of international liquidity to result in a crisis situation.

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The 1994/95 Mexican crisis has been the subject of a vast interdisciplinary literature that can be summarized as essentially two views. The first says that the crisis was the result of a new stage in the international financial economy in which speculators and other financial actors create self-fulfilling situations and can destroy the economies of even governments that are following a sound economic policy plan. The opposing view says that it was a result of a government that had pursued bad policies and was made to suffer the consequences of those policies by the market.

This dissertation offers a competing explanation. The thesis of this dissertation is that the crisis was part and consequence of a larger phenomenon that began with the debt crisis of 1982. In both crises there were economic and political elements that came together to constitute the trigger of the crises. The ultimate explanation for the crises is located in the particular conjuncture of three elements, the configuration of the Mexican economy, the nature of the Mexican state, and the design of Mexican economic policy. In this context, the globalization of the financial market, in particular large flows of private capital, by itself would not have been able to produce the crisis if the other elements did not exist. Consequently,

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the nature of the problem in Mexico was not private international flows in and of themselves. Rather, the problem that afflicted the Mexican economy in the 1980s and 1990s was foreign debt. In the 1990s this debt was expressed in bond instruments, including short-term dollar-indexed treasury bonds from the Mexican government.

B. Relevance

There has been considerable econometric work examining the causes of the crises of the 1990s, including the Mexico crisis in 1994/95 and the Asia crisis of 1997/98. The Asia crisis shattered illusions about what it means to "get the policies right." Prior to the Asia crisis, it was thought that Mexico and other Latin American countries' problems stemmed from their implementation of policies to attract short-term and portfolio capital in contrast to Asia's heavier reliance on flows of foreign direct investment. However, if portfolio investment is classified separately from short-term capital flows, the magnitude of short-term flows and its share of total inflows are larger in Asia than in Latin America.

In both Mexico and Asia, the short maturity of debt has been identified as a key determinant of the volatility

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of capital flows. Similar to Mexico in 1994, corporations' unhedged currency and interest-rate exposures played a large role in the crisis. Because of high domestic interest rates companies financed their operations through security issues and loans in foreign currency. Hedging their exposures would have led to additional expense because of underdeveloped domestic industry and the need to go offshore, as well as because of the governments' credibility in their commitment to the exchange rate.[1]

In addition, there is no consensus on what constitutes "good" or "bad" capital flows. Conventional wisdom has been that countries that are able to attract a large amount of FDI flows will be in a better situation than those that receive large amounts of portfolio capital. However, examination of the composition of capital inflows has suggested that a high level of FDI and a low level of portfolio flows could signal an underdeveloped financial market and low potential for growth in the economy overall.[2]

---

[1] Alejandro López-Mejía, "Large Capital Flows: A Survey of the Causes, Consequences, and Policy Responses," Working Paper no. WP/99/17, IMF, Washington, DC, 1999, 14.

[2] Zhaohui Chen and Mohsin S. Khan, "Patterns of Capital Flows to Emerging Markets: A Theoretical Perspective," Working Paper no. WP/97/13, IMF, Washington, DC, 1997.

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On the basis of work produced after 1997, it appears that in reality there were more similarities between Latin America and Asia's problems than investors, policy makers, and the business community wanted to recognize.[3] Inter-regional comparison serves a purpose in highlighting similar circumstances and suggesting what works and what does not. However, it has often served to blind economic actors, sometimes by willful ignorance or outright deception, to the macroeconomic and institutional realities of the countries in question.

Crises and the attempt to prevent future ones have prompted a substantial amount of work seeking to identify the key causes. Initial analyses that followed the Mexican and Asia crises pointed to large current account deficits and fiscal deficits as key elements and possible predictors of future crises. These two variables have not held up well

---

[3] Alan Greenspan highlighted this point when he said that "the maintenance of financial stability in an era of global capital markets calls for attention from government." According to Greenspan, it is clear from Mexico and Thailand that the level of information disclosure was too little. Current data on commitments by governments to buy and sell currency in the future and on nonperforming loans will allow investors to make more rational decisions and help avoid sharp reversals. It would help sensitize the economic policy makers to the potential emerging threats to their economic staiblity. Alan Greenspan, speech given at the conference on "Money and Capital Flows in a Global Economy," Cato Institute, Washington, DC, 14 October 1997.

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in multi-country analyses. For example, Frankel and Rose found that because the ultimate use of capital inflows helps determine the sustainability of a current account deficit, there is not a systematic relationship between the size of the current account deficit and a currency crisis.[4] The nature of the current account deficit is directly related to several factors that pertain to the trade in goods and services and the composition of capital inflows. As a result, the uses to which the capital is put, whether or not it is invested in the industrial sector or in the financial sector, makes an important difference in how the current account deficit impacts on the economy as a whole.

With regard to large fiscal deficits, there have been inconsistent findings about how they impact upon currency crises. The fiscal deficit in and of itself does not signify a future crisis. For example, prior to the 1994/95 crisis, Mexico had a surplus in the public budget. Large fiscal deficits are typically related to other factors that are relevant to currency crises, such as rapid expansion in domestic credit and inflation. Thus, it appears that large

---

[4] Jeffrey Frankel and Andrew Rose, "Exchange Rate Crashes in Emerging Markets," *Journal of International Economics* 41, nos. 3-4 (November 1996).

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fiscal deficits, as well as current account deficits, are related to and a reflection of other variables that could serve as signals of future crises but are not of themselves signals of a pending crisis.

Four variables have been identified as possible predictors of currency crises. They are real exchange rate appreciation, growth in domestic credit, banking crises, and the level of international reserves. First, the appreciation of the real exchange rate leaves currencies vulnerable to speculative attacks. This was an important factor in the Mexican crisis, although it did not prove to be a significant contributor in the case of South Korea.[5] Second, rapid growth in domestic credit has proven to be a principal factor in the crises that have occurred in the 1990s. Under a fixed exchange rate regime, only a small fraction of domestic money supply should be backed by foreign exchange reserves. If the expansion of domestic credit exceeds a level appropriate for the economic fundamentals, it can reflect unsustainable macroeconomic policies.[6]

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[5] Ibid.

[6] Jeffrey D. Sachs, Aaron Tornell, and Andrés Velasco, "Financial Crises in Emerging Markets: The Lessons from

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Third, banking crises have shown to be a reliable predictor of currency crises. A banking crisis can undermine confidence in the economy and trigger a currency crisis. The mechanism through which this operates is that prior to a banking crisis, there is typically a lending boom, large capital inflows, and financial liberalization.[7] Finally, a decline in international reserves can signal a coming currency crisis. If there is a fixed exchange rate, a decline in international reserves will lead to a speculative attack on the currency. In a pegged exchange rate system the mechanism through which this has typically worked is that reserves decline because the government makes last-ditch attempts to defend the currency before it finally collapses.[8]

While it would appear that armed with this understanding, it should be possible to predict future crises and avoid the destabilization to the domestic and world economy associated with them. However, simply

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1995," Brookings Papers on Economic Activity, The Brookings Institution, Washington, DC, 1996.

[7] Graciela Kaminsky and Carmen Reinhart, "The Twin Crises: The Causes of Banking and Balance of Payments Problems," International Finance Discussion Paper no. 544, Board of Governors of the Federal Reserve, Washington, DC, 1996.

[8] Ibid.

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identifying warning signals has not proven sufficient to prevent crises. This was the case in virtually every crisis studied. For example, in Thailand the IMF had issued reports to the government more than a year in advance of the crisis warning of the dangerous levels some of the key indicators were reaching. There were political factors involved that prevented the government from acting on the recommendations. Similarly, shortly after the Mexico crisis, the International Monetary Fund embarked on the Data Dissemination Standards Initiative in order to prevent future crises like the one that occurred in Mexico. While this effort has been successful in making information on some developing-country financial sectors available to the international financial community on a voluntary basis, it did not stop the crisis from occurring in Asia.

A large part of the explanation of why the knowledge of predictive indicators of an impending currency crisis is not sufficient to prevent a crisis from happening is because the economic indicators are a signal of underlying political trends and decisions and tendencies in the behavior of economic agents. In East Asia, key elements of the crisis were distorted incentives, lax regulatory standards, poorly-managed financial liberalization, and inadequate disclosure and supervision. These factors result

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in the economic indicators that might signal an impending currency crisis, but they are a result and a reflection of political and societal forces.

It is for this reason that I have undertaken this analysis of the Mexican political economy. The contribution of this case study is to add to the body of work on understanding the reasons behind the economic outcomes that are reflected in economic data on currency crises. The unidimensional economic and financial indicators, such as current account deficits, fiscal deficits, and exchange rates, are not sufficient elements to understand and to prevent financial crises. On the contrary, it is necessary to understand the fundamentals of the economy, the structure of the political system, the process of decision making, and the direction of economic policies, which are outlined in this dissertation.

C. Methodology

When I began the research for this dissertation, my suspicions were that developing countries like Mexico were prone to crises like occurred in 1982 and 1994/95 because of constraints imposed by their position in the world economy. If I had been asked in 1995 what my dissertation

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would address, it would have been that point. What emerged over the course of my research and writing about this issue, with the global backdrop of half a decade of crises, near-crises, and attempts at reform, has been a more nuanced explanation of how the Mexican situation evolved over the course of the 1970s-90s and the implementation of the neoliberal economic model in Mexico. Comparison with other crises, like those in other regions and countries, and with other places where crises did not occur -- through news media reports, academic studies and presentations, and conversations with individuals from the areas affected or not affected -- enabled me to develop a perspective on these issues that takes into account the unfolding of events over time, through successive governments, under the direction of a variety of decision makers, and against a backdrop of a dynamic global financial and economic system.

The picture that I paint in the chapters that follow is based on careful reflection of the unique elements in the Mexican case and also the similarities and differences between Mexico and other countries that experienced or did not experience crises. Consideration of other countries and regions has been important for sketching out the parameters of the issues. However, it is the unique features of the Mexican case that warrant in-depth historical

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interpretation and empirically-based causal analysis. This is so that what occurred there can be understood in all its complexity and analysts and decision makers in Mexico, the United States, and international institutions can make more informed predictions about when it may happen again and design policy to minimize the effects of a crisis in the future.

The literature reviewed represents an overview of the vast literature that exists on the broad topic of financial liberalization and international affairs. Throughout the dramatic changes that have taken place during the 1990s in terms of domestic and international finance and frameworks for understanding them, the issues have been tossed about and reconsidered and are not yet fully understood. Nor is there consensus within the scholarly and/or policy making communities about how to address them. I have presented what I believe to be the key issues and debates that span the disciplines looking at these issues, on which I have been researching since I began my doctoral studies in 1994. I acknowledge contributions made by most of the perspectives discussed, but align myself more closely with those that consider: (1) political processes (as opposed to economic trends or indicators) as key to understanding the crises that have taken place in the 1990s; and (2) the in-

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depth case-oriented method as the appropriate analytical framework for examining these issues.

My contribution to the existing literature on the subject of the 1994/95 Mexico crisis is threefold: (1) I have added a comparative dimension, outlining the threads that run throughout the crisis periods of the 1980s and 1990s and have pinpointed structural weaknesses in the Mexican political economy that enabled the crises to occur in both cases; (2) I have identified the contracting and management of external capital as a key element behind the forces that propelled both crises; and (3) by highlighting the unique elements in the Mexican case, I have shown the analytic usefulness of the case study methodology for explaining these issues and formulating policies designed to address them. Recognizing that an appropriate solution to a problem can only develop on top of a proper diagnosis, I have conducted this study to address the points that I have found missing in explanations of the 1994/95 crisis. On a larger level, the study is intended to serve as a building block for the effective design of solutions to address the issue of how to minimize the destabilizing impact of crises in the global financial system.

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The research design is constituted by case-oriented qualitative research.[9] The study represents a single-country case study that compares two instances of crisis in recent Mexican economic history. The research was conducted to address the following research questions.

1. What has been the effect of external capital on the Mexican economy beginning with the period of industrialization and running through the 1990s? To what extent does the presence of external capital explain the emerging market failure that occurred in 1994/95?
2. What degree of interplay existed between the owners of Mexican manufacturing companies and the banking sector and the domestic policy and decision makers over the period of the 1960s through the 1990s? To what extent do the policies implemented during this period contribute to the emerging market failure of 1994/95?

The thesis of this dissertation is that the 1994/95 crisis in Mexico was part and consequence of a larger phenomenon that was expressed in the Mexican debt crisis of 1982. The explanation for the crisis does not lie only in

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[9] Charles C. Ragin, *The Comparative Method: Moving Beyond Qualitative and Quantitative Strategies* (Berkeley, CA: University of California Press, 1987), 35.

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the international financial system, which designated Mexico as an "emerging market." It also lies in the characteristics of the Mexican economy and the domestic policies that were implemented. These policies were a result of the interplay between a small sector of the Mexican business and banking community and the political decision makers. To develop and examine this thesis, the following economic, political, and economic policy variables have been considered.

Economic: ability of the domestic economic system to finance investment; manufacturing sector competitiveness; and degree of financial sector concentration.

Political: time horizon of political leaders; degree of state autonomy; and degree of citizen participation in political decision making.

Economic Policy: orientation toward foreign capital; degree of economic policy autonomy from political issues; and degree of dissonance between investor view of economy and fundamentals.

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The research was conducted over the course of 1996-98 in the United States and Mexico. The writing was conducted over several months in 1998, with updates and revisions made from 1998-1999. The field research consisted of gathering data from primary sources. The primary information was "triangulated" with information from reports, articles in journals and magazines, and academic and popular books.[10]

In the United States, I obtained information from the International Finance Corporation (IFC), the International Monetary Fund (IMF), the United Nations, the U.S. Federal Reserve Bank, the U.S. General Accounting Office, the U.S. Department of Commerce, and the World Bank. In Mexico, I gathered information from the *Banco de México* (Central Bank), the *Bolsa de Valores de México* (Stock Exchange), the *Instituto Nacional de Estadística, Geografía e Informática*-INEGI (Institute of Statistics, Geography, and Data Processing), and the *Secretaría de Hacienda y Crédito*

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[10] Triangulation is a process of validation employed in qualitative data analysis. It is a method of analytic induction that involves seeing or hearing multiple instances of a finding from multiple sources and modes of evidence. It is a way to build a verification process into the data-gathering process. Matthew B. Miles and A. Michael Huberman, *Qualitative Data Analysis: A Sourcebook of New Methods* (Beverly Hills, CA: Sage Publications, 1984), 234-235.

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Público (Secretariat of Finance and Public Credit). The data consisted principally of information on financial and trade flows, including equity and bond flows, depository receipts, derivatives, foreign debt, service on the foreign debt, and data on the Mexican economy.

Also in Mexico I conducted research at academic institutions including Flacso, *Colegio de México*, the *Universidad Autónoma de México* (UNAM), and *Centro de Estudios Monetarios Latinoamericanos* (Cemla), where I gathered information about political and economic events related to the financial crisis. Information from other sources in Mexico includes that from various issues of newspapers and magazines, including the *Diario Oficial de la Federación*, *Excelsior*, *El Financiero*, *La Jornada*, *Proceso*, *Reforma*, and *El Universal*. Information from the international financial press comes from sources including the *Wall Street Journal*, the *Financial Times*, and the *Economist*. Data was also collected from databases including Bloomberg Financial Markets and Datastream.

In New York I conducted interviews with representatives of the investment banking community, such as Michael Wilson, who spoke with me about how investment

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decisions were made and the factors that go into the evaluation of a country's risk and return profile. In Mexico I interviewed representatives of social and political movements, such as Alfonso Torres, from the *Barzón* movement, and Alberto N., from the EZLN. They provided me with information about their particular experiences and perspectives on the crisis and how it impacted them. They spoke to me about what their movements were seeking to achieve and why they believed their political action was necessary and appropriate.

A considerable part of the analysis, data processing, and writing was conducted during the time that I was a graduate student affiliate at the David Rockefeller Center for Latin American Studies at Harvard University. I had the opportunity to interact and speak with some members of U.S. academia who are involved with and/or shape discussion on these issues, such as Rudiger Dornbusch, Sebastian Edwards, Jeffrey Sachs, Jeffrey Frankel, Kenneth Froot, Felipe Larraín, Carmen Reinhart, and Andrés Velasco. Similarly, I had exposure to members of the Mexican business community, such as Carlos Slim, the Mexican academic community, including Jorge Castañeda, Enrique Krause, and Lorenzo Meyer, officials of the Mexican government, such as Francisco Gil Díaz, former Vice Governor of the *Banco de*

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México, and Javier Arrigunaga, Director General of Fobaproa, and politicians like Adolfo Aguilar, Mexican congressman.

The kind of research conducted in this study relies heavily on interpretation and inference to provide explanation and causation. This is one of its main strengths because its flexibility "enriches the dialogue between ideas and evidence."[11] A main argument of this dissertation is that the case-oriented approach provides an appropriate way to examine the issues of relevance to understanding what happened in Mexico in 1994/95, and to drawing inferences about what will happen in the future. The method employed enabled me to provide a fine-grained explanation of the 1994/95 crisis that represents a deviation from prevalent explanations in the literature.

The limitations imposed by the method pertain to the degree of interpretation and inference involved in the research design. While one of its main strengths, it is also a weakness. This is because it cannot be encapsulated into a neat and simple study that can be applied as a template to the analysis of other situations or countries. This is a tradeoff involved in employing a single-country

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[11] Ragin, *The Comparative Method*, 49.

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case study as opposed to a multi-country quantitative approach. While the latter method is analytically useful in instances where there are easily-defined variables and a large number of cases, the case-oriented approach provides a greater degree of flexibility that highlights the unique elements of a situation and avoids generalizations that may obscure important aspects of the issue.

Intertwined with the issue of interpretation and inference is the limitation imposed by the researcher's biases. As mentioned previously, I undertook this study expecting to find that developing countries are at a disadvantaged position in the global financial system and are constrained in their policy options. To mediate against this bias, I consciously sought out counter-balancing arguments to the perspective in order to remain analytically objective. As a result of the research and analysis conducted, I reached a different finding that challenges the view that domestic policy is weakened in the face of international capital mobility.

From this perspective, in Chapter II, I review recent literature on the globalization of finance and its relationship to developing countries. The literature is divided into three categories. The first pertains to

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financial liberalization and capital inflows into developing countries. The literature addresses key issues regarding why the international financial system opened and what actors were important in its opening. It also looks at elements of the international economy and the developing countries' economies that are responsible for capital inflows. The second category addresses international relations and power structures. It builds on themes of uneven distribution of power in the international political economy. While this work provides the backdrop against which the implications of the capital surges of the 1990s should be considered, in general it stops short of explaining why the experiences of different countries vary given similar external conditions. The third category of work on policy options and political-institutional structures attempts to provide pieces of the puzzle in answering this question. Work in this area emphasizes the distinct features of individual countries and seeks to understand how the effects of the international economy interact with these individual features.

In Chapter III, I provide an overview of the world economy and international capital flows in the 1990s. I discuss the world economic context against the backdrop in which the international financial system was liberalized. I

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review the cyclical behavior of international capital flows, focusing on the 1990s with the "emerging market" phenomenon. I provide an overview of the private capital instruments, including portfolio investment and international bond finance, that have constituted large international flows in the 1990s. Emphasis is placed on the key emerging markets in the Western Hemisphere and Asia, where the lion's share of the flows have been directed.

This chapter shows how the international environment has changed from the 1960s to the 1990s. It shows how cyclical behavior in the world economy is reflected in the magnitude of the flows and the direction of international capital. It also shows how the nature and composition of financial flows has changed throughout the decades. During the 1960s, the multilateral financial institutions were the primary suppliers of funds to developing countries. In the 1990s, this had changed to the point that private sources became the principal suppliers of capital. This chapter highlights the new instruments that were used in the international capital markets in the context of financial globalization. The use of these instruments provides a precarious environment for the developing countries that have availed themselves of the flows. It was in this context, where Mexico was one of the key emerging markets,

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that the crisis of 1994/95 occurred. Although it has been suggested that the crisis was part of a new phenomenon in which international financial speculators exercise control over domestic financial policies, I argue that the crisis in Mexico was much more basic and local than that.[12] It represented part of a process that began in the 1970s as a result of domestic policy and economic orientation, the political system, and policies regarding the use of foreign savings to finance the domestic economy.

In Chapter IV, I analyze the main elements that interacted and provoked the Mexican debt crisis of the 1980s. The focus is on the orientation of the Mexican economy, which passed from the import-substitution model in the 1960s and 1970s to a free-market economic model in the 1980s and 1990s. This process coincided with booming oil prices on the international market in the late 1960s and 1970s, a highly liquid international financial market, and

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[12] One investor who has been singled out in this fashion has been George Soros. Soros himself has said that "financial markets don't deal in known quantitites. The future cannot be known because markets determine it and sometimes outcomes do not correspond to expectations." He said that "financial markets are like a wrecking ball." George Soros, 30 November 1998, Harvard University, Kennedy School of Government.

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the policies employed by Mexico to use foreign savings to finance the operations of the domestic economy.

Also, I examine the main characteristics of the Mexican political system based on a corporatist arrangement between the state and society. In addition, I analyze the structure and functioning of the Mexican financial system. A key finding is the linkage between the state and the institutions that comprise the Mexican financial system, which is in the hands of a small group of individuals who hold economic power in the country. These elements allowed Mexican policy makers to lead the country to high levels of foreign debt without accountability. The result of this accumulation of debt made the Mexican economy vulnerable to changes in the international financial environment and primed the Mexican economy for the debt crisis of the 1980s. It also set the stage for the crisis that would follow in the 1990s.

In Chapter V, I examine the crisis of the 1990s through the analysis of the new orientation of Mexican economic policy, which began at the end of the administration of President Miguel de la Madrid and developed through the administration of President Salinas de Gortari. This analysis focuses on the new free market reform project that was transposed on top of the economic

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system that emerged from the crisis of the 1980s. In this regard, I also examine the reconfiguration of the Mexican financial system, which shifted the center of gravity of the banking sector from the hands of the state to the private sector. I look at the reaccommodation of the groups holding economic power through the financial system of the 1990s and their approach to the international environment in order to face the new level of competitiveness that integrated financial markets require.

In this chapter I also look at the profile of the Mexican state in the process of market reform and how this constitutes a constraint for the development of the market system. I examine the role of the business community as a main actor in the process of building Mexico into an emerging market and outline its role in the events that culminated with the collapse of the currency and the dramatic reversal of capital flows. The failure of the emerging market is analyzed through the implications of portfolio equity and debt and the new instruments in the capital and money markets that were employed during the Salinas administration. The relationship between the domestic financial market, linked to the international financial market, and the domestic industrial sector of the Mexican economy is examined. This analysis shows the

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weakness of the "successful" growth of the Mexican economy during the early 1990s, and highlights the weakness of the fundamentals of the economy in their insertion into the international economy. This discussion provides the basis from which to view the future of the Mexican political economy.

Finally, the chapter discusses the bailout package that was put in place by the international financial community to resolve the Mexican financial crisis. This analysis is presented within a context of the new role of the international institutions and actors that govern the global economy and draws relevance for the future trends in this area.

In Chapter VI, I present the conclusion of the dissertation in which I outline the elements that suggest that the crisis of 1982 and 1994/95 were part of the same phenomenon. This problem lies in the incapacity of the economy to generate domestic savings and its strong reliance on the international capital market. The conclusion outlines the interaction of three elements, the fundamentals of the economy, the political system, and the policies, that in the period 1980-95 placed the country in the cycle of taking loans in order to pay off debt.

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CHAPTER II

LITERATURE REVIEW

International capital flows hold the potential to enhance the efficiency of the global trade and financial system by channeling resources from capital-rich countries to those in need of financial resources. Flows of financial capital can contribute to much-needed development financing. However, periodic episodes of turmoil and the threat of systemic crisis have characterized the post-Bretton Woods era of global financial liberalization and raise the question of whether international flows of investment capital help or hurt developing countries.

Technological advances coupled with increasing financial market liberalization have enabled the development of new financial instruments that have the capacity to hedge risk. Such developments can provide a basis for an efficient global capital market that can enhance trade and financial transactions and provide developing countries throughout the world with access to capital. However, these advances also hold the potential to

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threaten nascent financial systems and jeopardize recent economic reforms and progress toward economic development.

Proponents of the free market believe that the international financial system will best function if left to its own mechanisms.[13] Although the occasional financial correction may be painful, such corrections are necessary to keep the system working at its highest level of efficiency. The market will penalize bad policies, and this punishment will keep the market working efficiently. From this perspective, recent financial crises have resulted from the implementation of poor policies. Intervention from

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[13] This view is attributed to the classical liberal economic tradition. In Adam Smith's *Wealth of Nations*, he lays the foundations for this tradition in his formulations concerning the self-regulation of the market and individual self-interest in pursuit of profit. He argues against intervention in the functioning of both the internal and international markets and asserts that profit will direct investment and will encourage the growth of capital stock and achieve the public good. Smith said, "...every individual who employs his capital in the support of domestic industry, necessarily endeavors so to direct that industry that its produce may be of the greatest possible value." See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, ed. Edwin Cannan (New York: The Modern Library, 1937).

This belief in market efficiency and self regulation has led the proponents of liberal economic policies to advocate market deregulation and liberalization in order to stimulate higher investment and growth and to enable savings to be directed to the most efficient and productive investments.

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international financial institutions or capital controls imposed by domestic governments are unnecessary and will introduce distortions in the market.

An opposing viewpoint is that regulation is necessary to "throw sand in the wheels" of international finance.[14] If the international financial system is left to function on its own with no intervention from international or domestic

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[14] This view derives from the Keynesian perspective. In his *General Theory* Keynes rejects the classical liberal economists' idea of the self-regulating market. For him, the government plays an important role in stimulating the economy because an unregulated market will not fully exploit a country's productive capacity. Keynes was equally skeptical about the financial markets' ability for self-regulation. He makes the distinction between "speculation" and "enterprise." The former refers to the activity of forecasting the psychology of the market. The latter refers to the activity of forecasting the prospective yield of assets over their whole life. He states that "[a]s the organisation of investment markets improves, the risk of the predominance of speculation" also increases. While "[s]peculators may do no harm as bubbles in a steady stream of enterprise...the position is serious when enterprise becomes the bubble on a whirlpool of speculation." This, according to Keynes, would render a nation's development a "by-product of the activities of a casino" and would not serve the economic interests of the country. Keynes advocates a government tax on speculative transactions in order to mitigate against the predominance of speculation over enterprise. John Maynard Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt, Brace, 1936), 158-159.

Building upon this idea, James Tobin advocates an international transfer tax on transactions across currencies. James Tobin, "A Proposal for International Monetary Reform," *Eastern Economic Journal* 4, nos. 3-4 (July-October 1978): 153-159.

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forces, it will indiscriminately punish or reward economies without regard to the underlying fundamentals. International financial regulation and capital controls will tame the unruly financial market that is detached from the real, productive economy.

Paul Krugman's seminal article on current account crises in 1979 prefaced the financial turbulence of the decades to follow.[15] He argued that currency crises were the result of poor economic fundamentals regarding a country's currency regime. On the basis of the crises of the 1990s in Europe and Mexico, "second-generation" models emerged.[16]

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[15] Paul Krugman, "A Model of Balance-of-Payments Crises," *Journal of Money, Credit, and Banking* 11, no. 3 (August 1979).

[16] Guillermo A. Calvo and Enrique G. Mendoza, "Petty Crime and Cruel Punishment: Lessons from the Mexican Debacle," *American Economic Review* 86, no. 2 (May 1996); Guillermo A. Calvo and Enrique G. Mendoza, "Mexico's Balance-of-Payments Crisis: A Chronicle of a Death Foretold," *Journal of International Economics* 41, nos. 3-4 (November 1996); Barry Eichengreen, Andrew K. Rose, and Charles Wyplosz, "Speculative Attacks on Pegged Exchange Rates: An Empirical Exploration with Special Reference to the European Monetary System," Working Paper no. C95/046, Center for International and Development Economics Research (CIDER), University of California, Berkeley, CA, 1995; Maurice Obstfeld, "Models of Currency Crises with Self-Fulfilling Features," Working Paper no. 5285, National Bureau of Economic Research (NBER), Cambridge, MA, 1995; Timothy J. Kehoe, "Are Currency Crises Self-Fulfilling? Comments," in *NBER Macroeconomics Annual 1996*, ed. Ben S. Bernanke and Julio J. Rotemberg (Cambridge, MA: MIT Press, 1996).

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These models suggested that while the possibility of a crisis is determined by the fundamentals, there is a self-fulfilling element to currency crises that is triggered by panic.[17] For example, Sachs, Tornell, and Velasco argue that the fundamental conditions of the Mexican economy could not account for the extent of the crisis that occurred there.[18] After the Mexican government ran down gross reserves and ran up short-term dollar debt, self-fulfilling expectations became decisive in generating a panic that exacerbated the extent of the crisis.[19]

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[17] According to Jeffrey Sachs, there is a crisis of global government. The international financial rules of the game do not promote stable flows, and "bad things happen to good countries." He says that this is a failure of thinking in Washington that does not get better because no one wants to admit it. Jeffrey Sachs, 30 November 1998, Harvard University, Kennedy School of Government.

[18] Jeffrey Sachs, Aarón Tornell, and Andrés Velasco, "The Mexican Peso Crisis: Sudden Death or Death Foretold?" Working Paper no. 5563, National Bureau of Economic Research (NBER), Cambridge, MA, 1996.

[19] According to Andrés Velasco, if there is a lot of capital mobility and governments are not willing to step in and do uncomfortable things, currency crashes will be based on things that are not fully understood, like perceptions and moods. He says that there is nothing irrational about this process on an individual level. The problem is at the level of collective action. In this type of event, it is coordination among investors triggered by a random event that focuses expectations on a negative. This is true if and only if the government is perceived as being unwilling,

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With these self-fulfilling elements present in the international financial system, the question arises as to why developing-country governments have enacted policies to attract flows of financial capital. Some have suggested that the role of the financial system has been over-emphasized in economic literature pertaining to economic growth and productivity. However, others have argued that the financial sector, rather than being an entity detached from the "real," productive sector of the economy, contributes to growth, capital accumulation, and productivity improvements.[20]

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indecisive, or political weak. Andrés Velasco, 12 November 1997, Harvard University, Kennedy School of Government.

[20] Ross Levine and Sara Zervos, "Stock Markets, Banks, and Economic Growth," *American Economic Review* 88, no. 3 (June 1998); Ross Levine, "Financial Development and Economic Growth: Views and Agenda," *Journal of Economic Literature* 35, no. 2 (June 1997); Ross Levine, "Stock Markets: A Spur to Economic Growth," *Finance & Development* 33, no. 1 (March 1996); Valerie R. Bencivenga, Bruce D. Smith, and Ross M. Starr, "Transactions Costs, Technological Choice, and Endogenous Growth," *Journal of Economic Theory* 67, no. 1 (October 1995); Michael B. Devereux and Gregor W. Smith, "International Risk Sharing and Economic Growth," *International Economic Review* 35, no. 3 (August 1994); Maurice Obstfeld, "Risk-Taking, Global Diversification, and Growth," *American Economic Review* 84, no. 5 (December 1994); Robert G. King and Ross Levine, "Finance and Growth: Schumpeter Might be Right," *Quarterly Journal of Economics* 108, no. 3 (August 1993).

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Behind these inflows of capital is the process of globalization, which entails a shift toward open international financial and exchange rate policies, as well as privatization and deregulation of national capital markets. There are two concurrent, interrelated aspects of the process. One of these aspects relates to financial transactions occurring on a transnational scale that transcend territorial boundaries. The other of these aspects pertains to national institutions and conditions that interact with international capital flows within individual countries. These issues, which are equally important to understanding the process of financial globalization and its impact upon the political economies of the developing countries, are addressed to differing degrees by the literature pertaining to the globalization of finance. Basic themes from the classical liberal, Keynesian, and Marxist perspectives are recurrent throughout the literature and policy debates concerning the globalization of finance and increased capital mobility.[21]

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[21] The Marxist perspective derives from the concept of finance capital, developed by Rudolf Hilferding in 1910. Finance capital is conceived as the final phase of capitalist development. Finance capital represents bank capital, which is capital in the form of money that is transformed into industrial capital when invested in industry. Rudolf Hilferding, *Finance Capital: A Study of*

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Elements from each of these perspectives can be identified in the contemporary work that is discussed below.

A. International Capital Inflows and Policies

Attempt to understand the changes that have occurred since the beginning of the 1990s begins with inquiry into why the international financial system opened up and why capital began to flow to developing countries after a long lapse. A subject of discussion has been the causes behind

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the Latest Phase of Capitalist Development, ed. Tom Bottomore, trans. Morris Watnick and Sam Gordon (Boston: Routledge & Kegan Paul, 1910), 225.

According to Lenin, finance capital "...exacts enormous and ever-increasing profits from the floating of companies, issue of stock, state loans, etc., tightens the grip of financial oligarchies and levies tribute upon the whole of society for the benefit of monopolists." Lenin asserted that the high rate of profit obtained from the issue of securities contributes to the development and consolidation of the financial oligarchy. This polarization is also international in the sense that in 1910 four countries, England, France, the United States, and Germany, accounted for 80 percent of the world's finance capital. Lenin believed that uneven development and poor conditions for the majority of the populations in capitalist countries are inherent in the nature of the capitalist mode of production and that the export of capital affects and accelerates the development of capitalism in the countries to which it is exported. Rudolf Hilferding, *Finance Capital: A Study of the Latest Phase of Capitalist Development*, ed. Tom Bottomore, trans. Morris Watnick and Sam Gordon (Boston: Routledge & Kegan Paul, 1910), 136, 144.

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financial liberalization in the international economy. The key question behind work in this area surrounds the issue of why capital controls have been lifted over the past two decades. The answer is expected to provide an understanding of the nature of the process of a loosening of capital controls and what may be its future course.

The analyses are concerned with the international financial system in which the advanced economies are key players and decision makers. Changes in international production and financial intermediation wrought by advances in technology and communication are seen as important elements in the process inciting the actions of private firms and governments. Changes in the global environment in national policies and institutions are identified as responsible for the increasing liberalization of the international financial system in the post-war period. Key issues regarding why the system opened and what actors were important in this opening, with varying emphasis placed on market forces, state autonomy, and organized societal interests are addressed in the literature.

Goodman and Pauly emphasize the market forces behind the decisions of the advanced industrial states to abandon capital controls. They claim that the shift toward capital decontrol in the industrial countries in the 1980s and

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1990s was driven by changes in the structures of international production and financial intermediation. These changes made it easier and more urgent for private firms to effectively pursue strategies of evasion and exit from controls. At the same time, the utility of controls for governments declined and their perceived costs increased. The authors' comparative analysis considers both generic types of external pressure and distinctions in domestic structures.[22]

In contrast to Goodman and Pauly's market-based explanation, Sobel focuses on the role of the states of the major industrial powers in the deregulation of domestic markets and the liberalization of external controls. Taking a politically-based approach that focuses on the role of the state in the process of liberalization, Sobel explains it through considerations at the domestic level.[23] His analysis highlights the role of domestic politics and institutions in driving international developments. For Sobel, the most significant consideration is the

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[22] John Goodman and Louis Pauly, "The Obsolescence of Capital Controls? Economic Management in an Age of Global Markets," *World Politics* 46, no. 1 (October 1993): 51.

[23] Andrew C. Sobel, *Domestic Choices, International Markets: Dismantling National Barriers and Liberalizing Securities Markets* (Ann Arbor: University of Michigan Press, 1994).

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competition between organized interests within national political economies. The effects of this "inside" factor "spilled over" into the "outside" international environment.[24]

Helleiner also takes a politically-based approach, but he places emphasis on an autonomous state. Helleiner refutes explanations that view globalization as a direct product of unstoppable technological and market forces and discount the role played by states and government policies.[25] He applies Ruggie's concept of "embedded liberalism" to explain the shift from a system of open trade but closed capital markets following World War II to the present system characterized by both open trade and open capital markets.[26] Through his analysis, he

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[24] Sobel refers to structural interpretations of globalization as "outside-in" explanations in which the principal stimulus for change comes from outside the domestic political economy. As noted by Benjamin Cohen, the terms "outside-in" and "inside-out" have been borrowed from Kenneth Waltz's 1979 *Theory of International Politics*. Benjamin J. Cohen, "Phoenix Risen: The Resurrection of Global Finance," *World Politics* 48, no. 2 (January 1996): 274.

[25] Eric Helleiner, *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca: Cornell University Press, 1994).

[26] Ruggie uses the term embedded liberalism to describe the liberalism that was restored after World War II, which, he

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demonstrates that the post-war order was based upon a compromise between international interests and the need to protect the welfare state. He suggests that the relaxation of capital controls reflects deliberate choices on the part of government leaders in the United States and Great Britain and that this relaxation was not inevitable. This interpretation suggests that the move toward liberalization was a deliberate choice on the part of the major governments and not an unstoppable tendency propelled by the mobility of capital and technological advances.

The literature that examines the reasons for the present condition of financial globalization addresses key issues regarding why the system opened and what actors were important in this opening. Each of the authors discussed above place varying degrees of emphasis on market forces, state autonomy, and organized societal interests. Each

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states, was different than that which had previously existed. Embedded liberalism represents a compromise between safeguarding the quest for domestic stability without triggering the mutually destructive external consequences of the inter-war period. "Unlike the economic nationalism of the thirties, it [was] multilateral in character; unlike the liberalism of the gold standard and free trade, its multilateralism [was] predicated upon domestic interventionism." John Gerard Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," *International Organization* 36, no. 2 (Spring 1982): 393.

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addresses to a certain degree the interplay between international developments and domestic considerations and the manner in which they are affected by their interaction.

Taking a more narrow focus than the broadly-based work described above, the reasons behind capital flows into developing countries have been the subject of economic inquiry. Work in this area has been conducted from an economic perspective using predominantly quantitative means to analyze data on such factors as interest rates and capital flows over time. The work in this area considers domestic factors and international elements as the reason behind capital inflows into developing countries. Considerable emphasis is placed on the international factors.

Reviewing economic literature on the theme of capital inflows into developing countries, Fernández-Arias and Montiel argue that it is necessary to understand the reasons behind the inflows in order to be able to project the expected evolution of the inflows and to choose appropriate instruments and design effective public policy to respond to the inflows. They identify domestic factors at the project level, domestic factors at the country level, and exogenous factors. Domestic factors at the project level include structural and macroeconomic policies

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that increase the attractiveness of domestic investment and that open the domestic financial market to foreign investors. Domestic factors at the country level include debt-equity swaps and policies that affect the level of domestic absorption relative to income. Exogenous factors that affect the external opportunity cost of funds include foreign interest rates and recessions abroad and bandwagon effects in international capital markets.[27]

Hernández and Rudolph's work provides support for the consideration that domestic factors play a significant role in explaining private capital flows. They differentiate between high-capital-inflow recipient countries and low-capital-inflow recipient countries. They show that savings as a percentage of GNP for the former group is twice as high as that for the latter. They also suggest that both the private and the public sectors in the high-capital-inflow countries save more than in the low-capital-inflow countries. In addition, high-capital-inflow countries evidence a larger degree of stability in terms of inflation, exchange rate, and political risk. The high-

[27] Eduardo Fernández-Arias and Peter Montiel, "The Surge in Capital Inflows to Developing Countries: Prospects and Policy Response," Working Paper no. 1473, World Bank, Washington, DC, 1995, 57-59.

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capital-inflow countries are more "creditworthy" because they have lower degrees of indebtedness, a higher reserves ratio, and better-performing export industries than low-capital-inflow countries.[28]

Similarly, Chuhan, Claessens, and Mamingi argue that the surge in capital flows into developing countries is driven by domestic "pull" factors. They conclude that domestic factors are at least as important as external factors in attracting flows to Latin American countries, and in East Asia they are three to four times more important.[29]

In contrast, Gavin, Hausmann, and Leiderman suggest that capital flows are largely driven by external factors.[30] They note a correlation between international interest rates and capital flows into Latin America and suggest that

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[28] Leonardo Hernández and Heinz Rudolph, "Sustainability of Private Capital Flows to Developing Countries: Is a Generalized Reversal Likely?" Policy Research Working Paper no. 1518, World Bank, Washington, DC, 1995, 8-9.

[29] Punam Chuhan, Stijn Claessens, and Nlandu Mamingi, "Equity and Bond Flows to Asia and Latin America: The Role of Global and Country Factors," Working Paper no. 1160, World Bank, Washington, DC, 1993.

[30] Michael Gavin, Ricardo Hausmann, and Leonardo Leiderman, "Macroeconomics of Capital Flows to Latin America: Experience and Policy Issues," Working Paper no. 310, Inter-American Development Bank (IDB), Washington, DC, 1995.

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in the period 1970-94, the turning point of each major phase of the capital flows cycles corresponds to movement in world interest rates.[31] The authors also find a correlation between capital flows to Latin America and current account balances in the industrial countries. They assert that inflows to the region are high when external deficits are low in the industrial countries and that a reverse pattern is evident when external deficits are high. Their study does not suggest that domestic policies are irrelevant in determining capital inflows into the region; they found that capital inflows were greater in countries with a strong policy environment. They suggest that there are important linkages between the international financial environment and the domestic environment that require appropriate understanding and preparation.

Also focusing on the correlation between capital flows and international interest rates, Fernández-Arias suggests

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[31] Empirical work undertaken by Fernández-Arias and Montiel also supports the conclusion that foreign interest rates have played a dominant role serving as a "push factor" in driving capital inflows and determining their magnitude. However, they point out that domestic considerations, such as the creditworthiness of the recipient country, also played a role in determining the timing and destination of the new phase of capital inflows. Fernández-Arias and Montiel, "Surge in Capital Inflows," 60, 74.

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that during the period 1970-94, changes in international interest rates led to fluctuations in capital flows through two reinforcing channels pertaining to the attractiveness of developing countries to foreign investors and their creditworthiness. The author recognizes cross-country differences and states that external factors, such as the terms of trade, and internal factors, such as structural reform, explain differences between individual cases. He puts forth the idea that the "return gap effect" and the "creditworthiness effect" are a result of changes in international interest rates that result in fluctuations in capital flows. The former refers to the notion that international investment flows from low to high return economies. When international interest rates are low, mobile capital will flow to high-risk, high-return emerging markets. With regard to the "creditworthiness effect," Fernández-Arias breaks with the conventional thinking that suggests that country creditworthiness is largely independent of external factors and that a country's ability to pay reflects its internal resources and circumstances. He suggests that long-term international interest rates are key factors in determining a country's ability to pay, in that they represent the applicable discount rates. He asserts that when international interest

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rates decline, the ability to pay and creditworthiness increase. He states that the lower a country's creditworthiness, the greater will be the impact of a change in international interest rates.[32]

The work reviewed above on the causes of capital inflows addresses consistent themes regarding elements of the international economy and the developing countries' economies that are responsible for the inflows. The authors all address the "push-pull" debate on capital flows with attention to varying factors, including geographical location, policy history, consumption and savings behavior, and international interest rates. While some of the work lends support to the idea that capital has been attracted on the basis of domestic "pull" factors, it appears to be counterbalanced with support for an exogenous "push" factors explanation. In this case, it appears that it is not one or the other and that both elements determine capital inflows. Moreover, certain elements are more relevant in some countries or regions than in others.

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[32] Eduardo Fernández-Arias, "External Financial Shocks and Macroeconomic Instability: Diagnosis," *Development Policy* (Office of the Chief Economist: Inter-American Development Bank) June 1995, 7.

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B. International Relations and Power Structures

The effect of changes in international financial flows on global structures of power in the international economy and regimes of accumulation is examined by theorists concerned with the political influence of mobile capital in the international system. A considerable proportion of the work addressing these issues emphasizes external factors and convergence toward an international standard in policy and institutional design. It contains elements of structural, historical, economic, and political perspectives and suggests an absolute loss or greatly reduced degree of policy autonomy for individual states, particularly in developing countries. Individual countries are viewed as parts of a system in which a few powerful core countries shape the parameters of the functioning of the international financial and monetary system. An underlying theme is that the present stage of financial liberalization represents a recurrent phenomenon in a cyclical pattern of historical change and signals the emergence of a new regime of accumulation in the global political economy. From this perspective, the present phase of financial liberalization is placed within a broad context within which a developing country, despite the

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specificity of its own political, cultural, and economic institutions, represents but one small part of an order characterized by a systemic dynamic and a cyclical pattern of change. This body of work sketches the broad parameters for understanding the international financial system and the position of the developing countries impacted upon by the increased mobility of financial capital.

Broadest in scope among these works, Arrighi employs a comparative analysis of four similarly structured "long centuries."[33] The most recent of these centuries is the "long twentieth century," which represents the conclusion of a single historical process defined by the rise, full expansion, and demise of the U.S. system of capital accumulation on a world scale. Each of these long centuries constitutes a particular stage of development of the modern capitalist world system. The comparison is intended to yield conclusions regarding the dynamic and future outcome of what he terms the present world economic crisis that began in the 1970s. The work conceives of "finance capital" not as the "highest stage of capitalism" as had Lenin, but rather as a "recurrent phenomenon that has marked the

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[33] Giovanni Arrighi, *The Long Twentieth Century* (London: Verso, 1994).

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capitalist era from its earliest beginnings in late medieval and early modern Europe."[34]

With an approach that also examines structures of accumulation and expansion in historical cycles in the capitalist global economy and that attempts to provide an understanding of what is seen as a present state of crisis in the world political economy, authors in the volume edited by Kotz, McDonough, and Reich provide an analysis through the perspective of Social Structures of Accumulation (SSA). The SSA is defined as the complex of political, cultural, and economic institutions that supports the process of capital accumulation at the national and international levels.[35] The central premise of the approach is that a long period of relatively rapid and stable economic expansion requires an effective SSA to promote growth and stability. There are events that constitute definite turning points in the construction of SSAs. At these turning points, the foundations of the institutions that comprise the SSA are set in one design

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[34] Ibid., ix.

[35] David M. Kotz, Terrence McDonough, and Michael Reich, "Introduction," in *Social Structures of Accumulation: The Political Economy of Growth and Crisis*, ed. David M. Kotz, Terrence McDonough, and Michael Reich (New York: Cambridge University Press, 1994), 1.

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rather than another. The SSA will eventually decay, and a period of stagnation and instability will follow until a new SSA is built in its place.

The concept of the SSA places the current situation of financial liberalization in a context of the social and institutional forces that condition the external environment. The authors suggest that even though investment decisions that influence capital accumulation are conducted by individual firms on the basis of individual behavior, investment in capitalist economies is mediated by social and institutional forces that represent factors that are determined by collective social activities and are external to individual capitalists. From this perspective, recent changes in the global economy "...are best understood not as a symptom of structural transformation but rather as a consequence of the erosion of the social structure of accumulation which conditioned international capitalist prosperity during the 1950s and 1960s."[36]

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[36] David M. Gordon, "The Global Economy: New Edifice or Crumbling Foundations?" in *Social Structures of Accumulation*, 292.

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Gordon notes that while flows of productive capital have become increasingly selective and increasingly oriented toward a few preferred havens throughout the world, financial flows are becoming increasingly more liquid to the point that they are flowing around the world. He suggests that the global economy is becoming increasingly *closed* for productive investment because production and investment decisions are increasingly dependent upon a range of institutional policies and activities and a pattern of differentiation and specialization among the developing countries. In this sense, he states that what exists today is a declining mobility of *productive capital* because production and investment decisions are less influenced by pure market signals about short-term cost and price fluctuations.

The interplay between international developments and domestic considerations and the manner in which they are affected by their interaction are also key to work from this perspective, which suggests that market forces and political decisions in a few core countries in the global economy determine the degree of openness of the system. Consequently, economic policy making and the flows of capital into emerging markets are portrayed as exogenously determined and potentially reversible. In relation to

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policy choices for individual governments, globalization is seen as a structural constraint on the national governments of all states.

Susan Strange examines the structural power of capital mobility to determine the parameters of international discourse and the impact of increased capital mobility on transnational capital relative to national capital and labor within the structure of the international financial system. In *Casino Capitalism* she explores what is viewed as crisis in the global political economy, which she suggests is a result of key decisions and non-decisions of the countries controlling the global monetary and financial system.[37] In *States and Markets*, she expands upon this theme and identifies four sources of "structural power" in the international system: finance, knowledge, communications, and military. Structural power, in contrast to relational power, which refers to the power to enforce decisions, is the power to set the agenda and determine the parameters of international discourse. It is through this type of structural power that the major powers within the global economy, principally the United States, were able to give

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[37] Susan Strange, *Casino Capitalism* (Oxford, England: Basil Blackwell, 1986).

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shape to the international monetary and financial system. The result has been increased financial volatility and capital mobility that threaten to undermine social, economic, and political norms.[38]

Building on similar themes, Gill and Law maintain that the emerging international financial structure may legitimize a new global regime of transnational accumulation. They say: "the impact of increased capital mobility...has worked to the advantage of large-scale transnational capital, relative to national capital...and to labor, especially in the core capitalist states...These changes can be interpreted as signs of the emergence of a new regime of accumulation.[39]

Andrews treats the topic of capital mobility from the perspective of Kenneth Waltz's structural realism. He states that along with increased capital mobility across international borders come increased constraints on the macroeconomic policy options of national governments. He suggests that international capital mobility can constitute

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[38] Susan Strange, *States and Markets: An Introduction to International Political Economy* (Oxford, England: Basil Blackwell, 1988).

[39] Stephen Gill and David Law, "Global Hegemony and the Structural Power of Capital," *International Studies Quarterly* 33, no. 4, (December 1989): 486-88.

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a Waltzian third-image attribute of the international system.[40] Andrews advances a capital mobility hypothesis, which says that "financial integration has increased the costs of pursuing divergent monetary objectives, resulting in structural incentives for monetary adjustment."[41] He believes that globalization has progressed to the point that capital mobility must be regarded as an exogenous feature of the international system.

Cerny focuses on the political effects of open capital markets and what he calls "embedded financial orthodoxy."[42]

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[40] By this he means that the degree of capital mobility systematically alters state calculations and behavior by rewarding some actions and punishing others. Kenneth N. Waltz, *Theory of International Politics* (New York: McGraw-Hill Publishing Company, 1979), 73-74.

[41] David M. Andrews, "Capital Mobility and State Autonomy: Toward a Structural Theory of International Monetary Relations," *International Studies Quarterly* 38, no. 2 (June 1994): 203.

[42] Cerny states that rather than a system of "embedded liberalism," what exists today is a system of "embedded financial orthodoxy." By this he means that the process of financial transnationalization has altered the scope and substance of governmental intervention. Keynesian demand management policies have given way to monetary policy as the main instrument of macroeconomic control, while at the same time becoming blunted as policy instruments. As a result, governments are forced to measure performance according to criteria acceptable to the financial markets in order to retain the confidence of the transnational financial community. Philip G. Cerny, "The Deregulation and Re-regulation of Financial Markets in a More Open World,"

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He maintains that the "competitive re-regulation" of financial markets has resulted in the development of the "competition state," vying for access to international capital and the right to regulate it. He notes that it is not only the erosion of the financial power of the state, but also the way that distinct national currencies themselves are increasingly becoming inextricably locked into wider financial trends and structures, that has come to be of central interest. He concludes that certain states, those that fit the model of the "competition state," may be in a better position vis-a-vis the international financial system. However, "the power of all states to manage their economic affairs will be structurally constrained by the emergence of an 'integrated, 24-hour global financial marketplace.'" With regard to what financial globalization signifies for democracy, Cerny states that "deregulation is an ongoing process which increasingly puts the financial economy in a position of hegemony over the real economy at both the international and national levels, undermining not only policy autonomy but the very bases of state authority and

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In *Finance and World Politics: Markets, Regimes, and States in the Post-Hegemonic Era*, ed. Philip G. Cerny (Aldershot, England: Edward Elgar, 1993), 67.

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democratic legitimacy."[43] He suggests that financial globalization holds consequences for the nature of political structures and processes in terms of the state, public policy, and democracy.

In a similar vein, Schor introduces the idea that as a result of the integration of financial markets across national boundaries, economists, financiers, and policy-makers have adopted a distinctly anti-Keynesian view that she calls "global neoclassicism."[44] Under a system dominated by global neoclassicism, financial globalization subordinates national economies to international markets. The global neoclassicist view is that international financial regulation and discretionary macroeconomic policy are futile and that the flow of capital across borders cannot and should not be controlled. The convergence of ideas described by Schor makes it nearly impossible for an individual government, caught in a "classic prisoners'

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[43] Philip G. Cerny, "International Finance and the Erosion of State Policy Capacity," In *Globalization and Public Policy*, ed. Philip Gummett (Brookfield, VT: Edward Elgar, 1996), 91.

[44] Juliet B. Schor, "Introduction," in *Financial Openness and National Autonomy: Opportunities and Constraints*, eds. Tariq Banuri and Juliet B. Schor (Oxford: Clarendon Press, 1992), 4.

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dilemma," to pursue interest rate, currency valuation, or macroeconomic policies which deviate from the "dictates of the international market."[45]

Hurrell and Woods suggest that the process of globalization creates new forms of structural power in which institutions play an important role. They suggest that conditionality is becoming more visible at regional levels, where the uneven nature of globalization is particularly obvious. They state that in order to participate in existing arrangements like the European Union or NAFTA, countries must adapt their policies and converge with required domestic political and economic standards. In doing so, countries take part in a process that reinforces and perpetuates the power of those who control the conditions and timing of admission.[46]

Also using the dimension of inequality among nations' position in the global economy, Akyüz suggests that increased financial openness and the dismantling of barriers to capital flows have served to reinforce links among the financial markets of national economies. He

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[45] Ibid., 1-2.

[46] Andrew Hurrell and Ngaire Woods, "Globalization and Inequality," *Millennium: Journal of International Studies* 24, no. 3 (winter 1995): 461-462, 466.

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states that financial openness reduces the degree of policy autonomy because it weakens the national policy influence on national goals and raises the external influence. He maintains that the degree of policy autonomy has declined everywhere, but where it has declined most of all has been in the small and/or less developed countries that have a high degree of financial openness. He further asserts that although policy autonomy has diminished for the governments of the major world economies, the global effects of their policies have increased considerably.[47]

Like Akyüz, Harris states that the impact that internationalized financial markets and global institutions have on some countries is greater than others.[48] This inequality is reflected in that developing countries often do not have the capacity to choose policies different from those required to maintain markets' confidence[49].

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[47] Yilmaz Akyüz, "Taming International Finance," in *Managing the Global Economy*, eds. Jonathan Michie and John Grieve Smith (New York: Oxford University Press, 1995), 75.

[48] Laurence Harris, "International Financial Markets and National Transmission Mechanisms," in *Managing the Global Economy*, 208-209.

[49] Ibid., 212.

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All of this work builds on similar themes of uneven distribution of power in the international political economy. Not only do the less powerful not have the ability to shape the discussion among international institutions, they are unable to design even their own policies. This is made worse by liberalized flows of financial capital, which restricts policy choice by threatening reversal. Recent experience in Asia with the IMF lends support for these ideas. However, they stop short of explaining why the experience of different countries varies, given similar external conditions. The works discussed below attempt to provide pieces of the puzzle in answering this question.

C. Policy Options and Political-Institutional Structures

Another branch of the literature on the effects of globalization on policy options acknowledges the constraining effects of financial globalization but suggests that national governments still maintain the power to formulate national economic policies. Work in this area suggests that international capital mobility does not constitute an absolute constraint on national governments. The works take account of the social and political implications of international capital mobility and address

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the interaction of the domestic and international political economies. Those writing from this perspective emphasize the extent of diversity among national financial structures and cross-national differences in the impact of globalization.

Pauly states that fears concerning nation-states' "losing their sovereignty" in the international arena have incorrectly identified the nature of the problem. According to him, these fears have resulted from a failure to account for the social and political implications of expanding international capital mobility. Pauly states that capital mobility constrains states, but that it does not do so in an absolute sense. He rejects the idea that international capital flows constitute an exogenous structure that irrevocably binds societies or their states. He says that while a collective movement away from capital decontrol may be undesirable, it remains possible.[50] He emphasizes the extent to which diversity in national financial structures

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[50] Louis W. Pauly, "Capital Mobility, State Autonomy and Political Legitimacy," *Journal of International Affairs* 48, no. 2 (winter 1995): 373, 385.

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persists, despite the increasing international mobility of capital.[51]

By analyzing the politics of international capital mobility, Frieden addresses general conceptual issues regarding the interaction of the domestic and international political economies. He argues that while financial capital is extremely mobile across borders, other types of investment, such as sector-specific capital, are much less mobile. According to Frieden, within this context, international capital mobility restricts national economic policies but does not eliminate the possibility for autonomous economic policy making. He analyzes the differential impact of capital mobility on various socioeconomic groups and generalizes about the effects of these differences on national economic policy debate.[52] He

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[51] Louis W. Pauly, "National Financial Structures, Capital Mobility, and International Economic Rules: The Normative Consequences of East Asian, European, and American Distinctiveness," *Policy Sciences* 27, no. 4 (November 1994).

[52] Frieden employs a "sectoral," as opposed to "class-based" approach, in which workers in a particular industry have crosscutting interests. This is because they are at the same time workers, whose long-term interests are similar to those of other workers, and workers in a particular industry, whose short-term interests are similar to those of managers and shareholders in their particular industry. Under such a framework, politics consists principally of competition among various sectors of the economy, although

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argues that over the long run, international financial integration tends to favor capital over labor. In the short run "financial integration favors capitalists with mobile or diversified assets and disfavors those with assets tied to specific locations and activities such as manufacturing and farming."[53] He also argues that international capital mobility tends to remake political coalitions as a result of its impact on the effects of national policies.

With a similar focus on domestic alliances and coalitions, Maxfield investigates how international financial integration affects the politics of economic policy making in industrializing countries. She examines how international financial integration interacted with domestic structures in Mexico and argues that macroeconomic policy patterns and the policy alliances that shape them are crucial intervening variables between international financial markets and the state's capacity for economic management.[54] In addition, she says that historical

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long-term class interests sometimes play a role. Jeffry Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," *International Organization* 45, no. 4 (autumn 1991): 438.

[53] Ibid., 426.

[54] Policy currents or alliances are defined as "loose coalitions of public and private sector actors brought

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continuities in national economic policies reflect the relative institutional and organizational power of competing policy alliances. Maxfield's analysis suggests that financial policy reflects both the interests and the power of the domestic alliances and their alliances with international political and economic interests.[55]

Using a similar conceptualization of the impact of international processes upon domestic politics, Keohane and Milner analyze the impact of what they refer to as internationalization by exploring the impact of interdependence on politics within countries.[56] They focus on the idea that domestic politics within individual countries can no longer be understood without an

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together by the desire to push for or against a particular policy." Sylvia Maxfield, *Governing Capital: International Finance and Mexican Politics* (Ithaca, NY: Cornell University Press, 1990), 29.

[55] In this case, she refers to "bankers' alliances." They are coalitions of public and private sector financiers sometimes joined by other public sector actors or business elites. Ibid., 71, 93.

[56] Internationalization is defined as an exogenous reduction in the costs of international transactions that can be empirically measured by the growth in the proportion of international economic flows relative to domestic ones. Helen V. Milner and Robert O. Keohane, "Internationalization and Domestic Politics: An Introduction," in *Internationalization and Domestic Politics*, eds. Robert O. Keohane and Helen V. Milner (New York: Cambridge University Press, 1996), 4.

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understanding of the nature of the linkages between national economies and the world economy, and changes in such linkages. They suggest that internationalization has a strong effect on domestic politics. However, the effects of internationalization take different forms as a result of variation in institutional and political-economic conditions in different countries. They suggest that there are three specific pathways by which changes in the world economy, particularly rising capital mobility, can alter domestic politics. They create new policy preferences and coalitions, they trigger domestic economic and political crises, and they undermine government control over macroeconomic policy.[57]

Frieden and Rogowski discuss the ways in which economic integration affects domestic politics, policies, and institutions. Using a framework based in international trade theory, they generate propositions regarding the preferences of key groups within societies. The authors focus on the policy preferences of socioeconomic actors and argue that internationalization affects the policy

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[57] Helen V. Milner and Robert O. Keohane, "Internationalization and Domestic Politics: A Conclusion." in *Internationalization and Domestic Politics*, 243.

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preferences of actors within countries in broadly predictable ways based on the economic interests of the actors.

They posit a distinction between observable flows of goods, services, and capital and the exogenous easing of international exchange that the flows reflect. From this perspective, the *potential* for international movements of capital, in response to shifts in interest rates or changing expectations about exchange rates, can have strong effects on national economic conditions and policies even if no capital movement takes place. For this reason, their work focuses not on international flows, but on the *sources* of such flows. They suggest that the easier international economic transactions in general, the greater the social cost of sustaining economic closure for any one country, and the greater the social impact of global economic trends on any one country, regardless of the degree of economic openness of the country in question. They suggest that issues related to the world economy will grow more salient in all countries, and that political dynamics will grow

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more coordinated cross-nationally as international exchange becomes exogenously easier.[58]

Garret and Lange focus on the institutions involved in policy-making and address the institutional context that conditions the incentives facing interest groups and politicians. They suggest that political outcomes cannot be predicted simply on the basis of economic interests. The authors challenge scholarship that they assert pays little attention to the relationship between preference change and policy outcomes and to the mechanisms by which they may be related. They refer to the implicit political model of this view as "economic pluralism," which sees policy outcomes as a function of economic actors' market power and their propensity for collective action.[59] The result of economic

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[58] Jeffry A. Frieden and Ronald Rogowski, "The Impact of the International Economy on National Policies: An Analytical Overview," in *Internationalization and Domestic Politics*, 32.

[59] As described by Garrett and Lange, the "economic pluralist" approach views policy outcomes as a function of political conflict shaped by the preferences of different actors, weighted by their market power and their propensity for collective action. While this approach has the benefit of parsimony, it lacks attention to the institutions that configure the environment in which actors engage in political action. Geoffrey Garrett and Peter Lange, "Internationalization, Institutions, and Political Change," *International Organization* 49, no. 4 (autumn 1995): 628-629.

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pluralism is the assumption that the effects of internationally generated changes in the constellation of domestic economic preferences will be quickly and faithfully reflected in changes in policies and institutional arrangements within countries.[60] They assert that institutions are an element missing from this type of analysis. To make up for this shortcoming, they offer an institutionalist analysis that examines how and why institutions mediate in the relationship between internationally-induced changes in the policy preferences of domestic actors and political outcomes. They argue that important variations in domestic political outcomes can only be explained by supplementing an analysis of preferences and preference change with attention to the institutional context of politics.[61]

Haggard and Maxfield examine the relationship between economic interdependence and balance of payments crises to policy reform. They suggest that there are international systemic pressures at work and that the increasing integration of developing countries into the world economy

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[60] Geoffrey Garrett and Peter Lange, "Internationalization, Institutions and Political Change," in *Internationalization and Domestic Politics*, 49.

[61] Ibid., 75.

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has constrained government choices with respect to international financial policy. The balance of political forces is tilted in a more internationalist direction and a greater political voice is afforded foreign investors in the domestic policy process. Also, balance of payments crises create international pressure for financial market opening.[62] They suggest that the latter is more frequently the proximate cause for financial market opening. They find that crises strengthen internationalist forces within the government and in the economy and suggest that episodes of capital account opening are motivated by efforts of political leaders to reassure domestic and foreign creditors and investors.[63]

In contrast to perspectives that view financial globalization and increased capital mobility as an absolute constraint on the macroeconomic policies of developing countries, the studies outlined above view diversity in historically-shaped national financial structures and institutions as a critical factor in determining the manner

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[62] Stephan Haggard and Sylvia Maxfield, "The Political Economy of Financial International in the Developing World," in *Internationalization and Domestic Politics*, 211.

[63] Ibid., 234.

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in which globalization will impact upon an individual country. Although the authors also recognize the constraining effects upon policy of international systemic pressures, they emphasize the distinct features of individual countries and seek to understand how the effects of the international economy interact with these individual features. These authors bring to the discussion the role of national policy and institutional arrangements in the formulation of economic policy. This appears to be the key to understanding why and how divergent outcomes result across countries facing similar external circumstances.

In terms of what the present situation signifies for democracy, Grabel suggests that reliance on portfolio investment inflows introduces the mutually-reinforcing problems of "compromised policy autonomy" and "increased risk potential" into developing-country economies. She addresses the issue of globalization and constraint on national policies and concludes that due to its particular nature, portfolio capital imposes constraints to the effect that "portfolio investors may become the ultimate arbiters of national macroeconomic policy, to the detriment of

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economically vulnerable, disenfranchised groups."[64] From this perspective, developing countries whose economic crises have the potential to impact upon the advanced economies are likely to receive assistance from foreign governments and multilateral institutions. However, this type of assistance "introduces a further *ex-post* constraint on policy autonomy."[65]

Grabel presents a categorization of types of capital inflows into developing countries and their impact upon national policy autonomy and increased risk potential. See Figure 2.1 below.

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[64] Ilene Grabel, "The Contradictions of Portfolio Investment in the Global Economy," *World Development* 24, no. 11 (November 1996): 1764.

[65] Ibid.

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Figure 2.1: Constraints on Policy Autonomy of Capital Inflows into Developing Countries

Type of Inflow	[illegible]	[illegible]	[illegible]
Foreign Aid	LDC government	Donor government(s)	• Aid conditionality • Threat of withdrawal
Commercial Loans	LDC governments, state-owned enterprises, local banks	Foreign commercial banks	• *ex-ante* conditionality • threat of withdrawal • *ex-post* conditionality
Direct Foreign Investment	Firms in Host LDC	Foreign owners	• control over national resources, plant and equipment, technology, and employment opportunities, • Threat of withdrawal, • Use of foreign policy tools to protect interests of owners
Portfolio Investment	Governments, state-owned enterprises, banks, private firms	Portfolio Investors	• *ex-ante* and *ex-post* constraints on macroeconomic, exchange rate, and social policies

Source: Adapted from Ilene Grabel, "Marketing the Third World: The Contradictions of Portfolio Investment in the Global Economy," *World Development* 24, no. 11 (November 1996): 1766, and, to a lesser degree, Leslie Elliott Armijo, "Theorizing about Foreign Capital and Democracy," in *Financial Globalization and Democracy in Emerging Markets*, ed. Leslie Elliott Armijo (New York: St. Martin's Press, 1999), 13.

Her analysis highlights the variation among different types of capital flows and provides insight into how mobile capital impacts on political systems.

Similarly, Armijo analyzes the implications of foreign capital inflows into newly-democratizing developing

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countries. She presents a stylized analysis that relates the type of foreign capital, ranging from foreign aid to government through portfolio flows to private sector, and implications for different gradations of democracy, ranging from political democracy with incumbent authoritarians through economic democracy. She finds that most forms of capital flows hold positive implications for democracy in the formal, procedural sense. However, as she moves along the democracy continuum through democracy that incorporates a degree of national economic policy autonomy to democracy that ensures a minimum of economic equality for all citizens, "economic democracy," she finds a large number of instances of foreign capital having negative implications for democracy.[66] In most cases, the implications of the

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[66] Roberts Clark notes the irony that increased global financial integration has aided democratization in developing countries by strengthening the position of democratizing elites to transform key government institutions, yet has at the same time been responsible for a decline in the degree to which national policy makers can control their economies. In short, he says that "democratizing elites are more likely to gain a seat at the policy-making table, but they are likely to be disappointed at what this new position affords them." Using Armijo's criteria, then, while the globalization of finance has assisted in procedural democracy, it works against the incorporation of national policy autonomy into democracy. William Roberts Clark, "Democratization and the Loss of National Policy Autonomy: The Domestic Political Implications of Global and Regional Financial Integration" (paper presented at the XIX International Congress of the

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inflows are contingent factors such as donor behavior, investor behavior, or the incumbent government.[67]

Armijo suggests that poorly institutionalized or weakly-consolidated democratic governments expose themselves to risks by accepting large portfolio flows. Portfolio flows can superficially serve to support a democratic government. However, if financial crisis ensues, as is often the case with volatile portfolio flows, the type of political regime that the incumbent administration represents can be discredited.

D. Conclusion

Underlying capital mobility and financial liberalization is the process of globalization. This term has become somewhat of a catchall phrase that at once embodies many concepts and at the same time leads to little new in the way of understanding the complex set of political and economic phenomena that have been underway in

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Latin American Studies Association, Washington, DC, September 28-30, 1995), 20.

[67] Leslie Elliott Armijo, "Theorizing about Foreign Capital and Democracy," in *Financial Globalization and Democracy in Emerging Markets*, ed. Leslie Elliott Armijo (New York: St. Martin's Press, 1999), 29.

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the international financial system in recent years. Yet clearly there have been qualitative changes in the nature and character of international economic relations in recent years that represent not just the continuation of a steady trend but a shift to a new level upon which the global economy operates. This has been due not to the liberalization of international economic policies, which had been highly liberalized by the end of the 19th century, but rather to the dramatic changes introduced by technological advances and what they signify for economic policy and global economic activity.

There is no definitive answer to the question of what these changes mean for national economic policies. However, at a minimum it can be said that new considerations are introduced into the decision making calculus that are brought to bear on the political decision makers, particularly those dealing with international capital flows.[68] This has been addressed throughout the literature surveyed above from a variety of approaches. The new sources of funds to developing countries are volatile, and

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[68] Miles Kahler, *International Institutions and the Political Economy of Integration* (Washington, DC: The Brookings Institution, 1995.)

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the recipient governments must maintain the confidence of their financial sector. This imposes pressures on policy makers to adopt necessary measures that are politically difficult to take. This reduces the margin for policy error because of the large flows of volatile funds.

As seen in the discussion above, identifying these new considerations and how they impact upon domestic politics has been the focus of scholarly work from the disciplines of both international relations and comparative political studies. Yet as the distinctions between the "international" and the "domestic" become more blurred at the margins of the global economy, the division between these two disciplines has also come to be less clearly demarcated.

Cerny suggests that the process of globalization in the financial system has undermined the differentiation between the international, national, and sub-national levels of analysis that have traditionally predominated the field of international relations theory. This is because globalization is at one time a transnational, international, and domestic process.[69] This makes the job of the analyst all the more challenging by introducing

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[69] Cerny, "International Finance," 93.

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simultaneous interactions among what is transnational, international, and domestic.

The above review contributes to the understanding of the impact of increased financial globalization, capital mobility, and flows of investment capital into developing countries. It demonstrates that additional work is needed in order to understand the implications of these changes for strengthening the political systems in developing countries. Theoretically, it suggests that there are contributions yet to be made regarding the issue of globalization and how policy and institutional arrangements are impacted upon and impact upon the processes associated with increased globalization. From an empirical standpoint, it suggests the necessity for detailed study of the policy and institutional legacies of individual countries in order to understand the implications for national economies and the global financial system of financial crises triggered by flows of investment capital.

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CHAPTER III

EMERGING MARKETS IN THE WORLD ECONOMY

A. World Economic Trends

During the period 1960-70, the world economy experienced unprecedented prosperity. Global GDP increased by roughly 4.9 percent per year. World exports increased by 7 percent yearly. This strong expansion of trade, especially among the advanced economies, had a dynamic influence on the world economy. Positive growth in the world economy was a result of several factors, including the existence of international order with an explicit code of behavior and a strong set of international institutions that enhanced cooperation among the economies of the world. This situation was also characterized by international monetary stability. Another element that contributed to growth in the world economy was domestic economic policies that were devoted to the promotion of a high level of demand and employment in the industrial economies. Also, continued advances in technological progress in the

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industrial countries had a favorable effect on the global economy.[70]

At the beginning of the 1970s, the world economy began to slow and inflation began to accelerate. This situation occurred as a result of several factors, among the most important of which were: the collapse of the post-war fixed exchange rate system in 1971, which was the principal anchor for economic policies in the previous period; and the effect of the OPEC oil shocks of 1973 and 1979-80, which caused massive price increases, as well as terms of trade losses and balance of payments problems. As a consequence, growth in the world economy declined.

After the 1982 international debt crisis, the world economy faced a new challenge in the form of hyperinflation that pushed countries to pursue policies focused on achieving price stability. The power of the OPEC cartel was broken by the development of new energy resources, which allowed the price of oil to drop significantly in subsequent years. During this time period, a set of monetary arrangements was developed. The countries of Western Europe had created a new zone of monetary stability with fixed but adjustable pegs in

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[70] Angus Maddison, *Monitoring the World Economy 1820-1992* (Paris: Development Centre of the Organisation for Economic Cooperation and Development-OECD, 1995).

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the European Monetary System. In contrast, the United States, England, and Japan had open floating rates. Also, during this period the governments of the main industrial economies applied a set of policies, which came to be known as neoliberal policies that involved deregulation, privatization, and trade and financial liberalization.[71]

The economic ideology that spread across developing countries in the wake of the 1980s debt crisis entailed a dramatic change in economic orientation and the institution of policy reforms. The overall goal of the reforms was to achieve microeconomic efficiency and macroeconomic stability, and thereby accelerate growth and industrialization. A series of policies was adopted to remove exchange and interest rate distortions, deregulate markets, liberalize trade and finance, dismantle direct controls over prices and resource allocation, and privatize state-owned enterprises. Progress toward these goals varied within and across regions.

The world economy grew by 2.4 percent in the 1990s. In the latter half of the decade, the world economy was characterized by turbulence, particularly in the financial markets. The global economic situation resulted in a reduction

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[71] Ibid.

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of international capital flows and a slowdown in world trade growth. Despite the slowdown at the end of the decade, the 1990s was a decade of growth for some developing countries. For example, China grew an average of 10.7 percent per year in the period 1990-98; India, 6 percent; Brazil, 3.1 percent; Mexico, 2.9 percent; Argentina, 4 percent; Turkey, 4.6 percent; Poland, 4.8 percent; South Africa, 1.8 percent; and Nigeria, 2.5 percent.[72]

B. Cycles of International Capital Flows

When the price of oil increased dramatically as a result of the oil crisis in the mid-1970s, the oil-producing countries received a substantial inflow of capital. At the same time, oil-importing advanced-economy countries suffered from the increase of oil prices and entered a period of recession. These circumstances propelled the international banks to seek markets to allocate the resources. At the same time, the developing countries competed among each other for capital, principally in the form of foreign loans. As a result of this conjuncture of circumstances, there was a wave of

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[72] World Bank, *Global Economic Prospects and the Developing Countries, 1998/99: Beyond Financial Crisis* (Washington, DC: World Bank, 1998), 194.

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capital inflows to developing countries from the mid-1970s through the early 1980s. The wave ended with the debt crisis that began in 1982 when Mexico declared its inability to make payments on its foreign debt. During this period, capital inflows into developing countries averaged roughly $30 billion, twice what they had been in previous years.

For the developing countries, the debt crisis signified a decline in capital inflows to the level of approximately $10 billion on yearly average. This period of decline lasted until the end of the decade. The situation changed at the beginning of 1990, when international financial flows into developing countries resumed, reaching a yearly average of about $90 billion.

The increased inflow of capital into developing countries coincided with a recession in the advanced economies and low interest rates in the advanced economy financial markets. At the same time, policy makers in the developing countries were promoting policies designed to attract foreign capital. These policies were inspired by a need for funds to complete structural reform projects that entailed the privatization of economic activity previously in the hands of the state,

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economic liberalization, and deregulation of the domestic financial markets.

The structure of capital flows to developing countries changed over the course of the three decades from the 1970s through the 1990s in several ways. First, foreign direct investment increased as a percentage of total financial flows to developing countries, even though the overall amount of foreign financing experienced periods of ebbs and flows. During the 1990s foreign direct investment displayed a strong presence in developing countries as a result of international firms relocating operations in developing countries. An estimated $50 billion in foreign direct investment flowed into Latin America and Caribbean region in 1997. In comparison with the early part of the decade, by the end of the decade, in Latin America foreign direct investment shifted away from traditional mining and energy sectors and toward services and manufacturing. This was particularly the case in automobile production in Argentina, Brazil, and Mexico.[73] This was part of a general regionally-determined trend by which FDI flows were

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[73] Ibid., 187.

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moving away from resource-based investments to efficiency-seeking, industry specific flows.[74]

Second, flows of portfolio investment and international bond financing, which had been inconsistent prior to the 1990s, became key elements of capital flows to developing countries. Between 1990 and 1997, the average yearly flow of portfolio investment and international bond financing to all developing countries increased by $27 billion. These flows signified an increase of developing country indebtedness through the bond markets. They also represented a new presence of foreign investors in the stock markets in developing countries, especially in Asia and Latin America.

C. The Emerging Market Phenomenon

Throughout the 1990s, the developing countries became attractive vehicles for international investors. Developing country governments were persuaded to adopt economic reform policies because the markets rewarded them with inflows of

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[74] United Nations Conference on Trade and Development (UNCTAD), *Transnational Corporations, Market Structure and Competition Policy, 1997* (New York: United Nations, 1997), 163-177.

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capital.[75] At the same time, the markets were willing to continue to supply steady streams of capital because they were encouraged by movement toward policy reform in developing countries.[76] Total resource flows into developing countries increased by 110 percent from 1990 to 1994. This pattern continued through 1997, when there was an increase of 206 percent in total resource flows over those in 1990.[77] The enhanced interest of international investors in the developing countries accompanied their new definition as "emerging markets."[78] The term is used in a variety of ways, ranging from a loose definition considering all stock markets in developing countries to be "emerging," to one that meets criteria such as having securities that trade in a public market, being of

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[75] Michael Wilson, a Manhattan investment banker, told me that in the early 1990s there was a dramatic growth in Latin American emerging markets. Investors were putting their money into Mexican asset funds looking for high returns, without knowing much about the country, its economy, or its future. For the investors, the important thing was that the government had the backing of the U.S. government. New York, May 1997.

[76] Paul Krugman, "Dutch Tulips and Emerging Markets," *Foreign Affairs* 74, no. 4 (July/August 1998): 36.

[77] World Bank, *Global Development Finance, 1998* (Washington, DC: World Bank, 1998), 3.

[78] The term "emerging market" dates back to 1981, coined by a former IFC official trying to entice investment in what had been called the "Third World Equity Fund." James A. White, "Pioneering Manager Picks Third World Stocks," *Wall Street Journal*, 19 June 1991, sec. C.

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interest to global institutional investors, and having reliable sources of data.[79]

The surges in capital inflows that resulted from the emerging markets phenomenon negatively affected the real exchange rate and the current account, and created temporary inflation in some countries. Some developing country governments employed several methods to restrict capital inflows. Similarly, governments enacted policies to address the volatility brought about by inflows of portfolio capital. They are detailed in Figure 3.1.

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[79] International Finance Corporation, *Emerging Stock Markets Factbook* (Washington, DC: International Finance Corporation, 1997); Arjun B. Divecha, Jaime Drach, and Dan Stefek, "Emerging Markets: A Quantitative Perspective," *Journal of Portfolio Management* 19, no. 1 (September 1992): 41.

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Figure 3.1: Means of Restricting Capital Inflows

Direct Methods

- Ceilings on banks' foreign borrowing
- Minimum reserve requirements on foreign loans
- Ceilings on foreign direct investment
- Tobin's interest-rate equalization tax*

Indirect Methods

- Foreign exchange intervention: sterilized & nonsterilized
- Fiscal adjustment
- Liberalization of the current account and of capital outflows
- Floating the exchange rate

Methods to Counteract Volatility

- Restrictions on capital outflows
- Lifting restrictions on outflows
- Opening the current account
- Maintaining long-term fiscal and monetary targets
- Exercise of greater discretionary power over the allocation of resources on the part of the central bank

*Tobin's interest-rate equalization tax requires foreigners to pay a tax on the interest payments they receive from funds invested abroad.

Source: Taken from Vittorio Corbo and Leonardo Hernández, "Macroeconomic Adjustment to Capital Inflows: Lessons from Recent Latin American and East Asian Experience," *The World Bank Research Observer* 11, no. 1 (February 1996): 68-69.

During the period 1990-98, there was a change in the structure of capital flows to developing countries. In 1990, 57 percent of capital that flowed into developing countries was in the form of official development finance, grants or

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loans, and 43 percent was constituted by private flows. Of this 43 percent, foreign direct investment was the principal component, with 24 percent of total private flows; portfolio capital represented only 3 percent of total private flows. This structure changed dramatically throughout the decade.

By 1997, the main source of capital flows into developing countries was no longer official flows, which represented 15 percent of the total. The principal component was private flows, which represented 85 percent of total capital flows to developing countries. Within this 85 percent, foreign direct investment and portfolio investment and international bond financing increased, representing 40 percent and 29 percent, respectively, of the total private capital into the developing countries. The remainder consisted of commercial bank loans and other private loans.

A key change in the structure of capital flows to developing countries was the emergence of portfolio investment and international bond financing as one of its most dynamic components. From 1990 to 1997, these flows increased from $3.3 billion to $86.3 billion (an increase of 2,515 percent). Within this category, the most dynamic component was debt flows, which increased from $100 million to $53.8 billion (53,700 percent) between 1990 and 1997. Equity flows increased from $3.2 billion to $32.5 billion (960 percent). Portfolio

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investment and international bond flows have characteristics that are distinct from other forms of international capital flows to developing countries, foreign direct investment, commercial bank loans, and official development financing, both in terms of the benefits that they can bring to developing-country economies and the risks that they present, as was illustrated by financial crises that occurred in Mexico, East Asia, and Russia in the decade of the 1990s.[80]

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[80] According to James Dean, short-term portfolio capital flows are susceptible to "reverse free-rider" behavior on the part of investors. He says, "if an individual investor sees other investors pulling out, that alone is an incentive for him to pull out, irrespective of the merits of the investment itself." According to Dean, the free-rider barrier to reinvesting short-term portfolio capital is difficult to overcome because "perceived shortfalls become actual shortfalls, and perceptions of liquidity crises become self-fulfilling." James Dean, "Why Left-Wing Moralists and Right-Wing Academics are Wrong about Asia," *Challenge* 41, no. 2 (March-April 1998): 49.

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Table 3.1: Net Long-term Resource Flows to Developing Countries, 1990-97 ($ billions)

	1990	1991	1992	1993	1994	1995	1996	1997
Official Development Finance								
Grants	29.2	35.1	30.5	28.4	32.7	32.6	29.2	25.1
Loans	27.2	27.6	23.3	25.1	12.9	21.4	5.4	19.2
Subtotal (official)	56.4	62.7	53.8	53.5	45.6	54.0	34.6	44.3
Private Flows								
Debt flows	0.1	7.4	8.3	31.8	27.5	23.8	45.7	53.8
Equity investment	3.2	7.2	11	45	32.6	32.5	45.8	32.5
Foreign direct investment	23.7	32.9	45.3	65.6	86.9	101.5	119	120.4
Commercial banks	3.8	3.4	13.1	2.8	8.9	29.3	34.2	41.1
Other private	11.1	2.7	12.4	9.4	4.7	2.0	2.3	8.3
Subtotal (private)	41.9	53.6	90.1	154.6	160.6	189.1	247.0	256.1
Total Net Resource Flows	98.3	116.3	143.9	208.1	206.2	243.1	281.6	300.4

Source: World Bank, *Global Development Finance, 1998* (Washington, DC: World Bank, 1998), 3.

Unlike foreign direct investment, which is not traded in liquid markets and generally reflects the long-term strategies of multinational corporations, portfolio investments can be quickly moved from one market or country to another, regardless of the long-term position of many institutional investors in their portfolio decisions.[81] Another difference between foreign direct investment and portfolio investment lies in the control exercised over the operations of the firm. In the case of foreign direct investment, there is a minimum of 10-25 percent ownership. In contrast, portfolio investment

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[81] Punam Chuhan, Gabriel Pérez-Quiros, and Helen Popper, "International Capital Flows: Do Short-Term Investment and Direct Investment Differ?" working paper no. 1669, World Bank, Washington, DC, October 1996.

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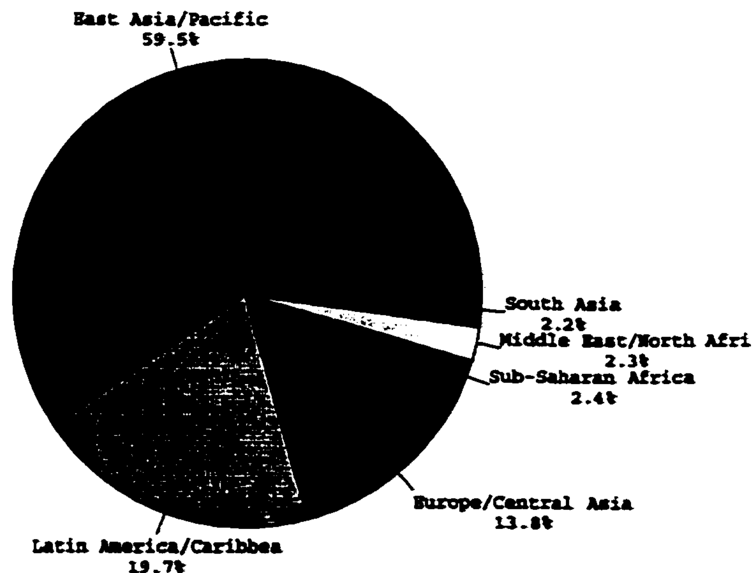
pertains to investment that involves a lower degree of ownership.[82]

Figure 3.2: Net Foreign Direct Investment in Developing Countries, 1995 ($ billions)



Source: World Bank, *World Debt Tables: External Finance for Developing Countries*, vol. 1 (Washington, DC: World Bank, 1996), 17.

Throughout the 1990s, the most significant source of capital inflows to developing countries was constituted by

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[82] Morris Goldstein, "Determinants and Systemic Consequences of International Capital Flows," Occasional Paper no. 77, International Monetary Fund (IMF), Washington, DC, 1991, 68.

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private flows. Yet their allocation was not uniform among the developing countries. In the period 1990-96, the majority of private capital flows went to Asia, which encompassed several of the key emerging markets of the 1990s. In 1990, Asian countries received 56 percent of the total private flows; they received 52 percent in 1996. In 1990, private capital flows to the region totaled $27.5 billion; in 1996, they reached $98.3 billion, which represented a 257 percent increase over the period 1990-96. The crisis that befell the region in 1997 resulted in a slowdown or reversal of these flows to the point that the Asian region received only $28.8 billion in 1997, 20.7 percent of total private flows to developing countries.

The countries in the Latin America and Caribbean region experienced a high degree of dynamism among the emerging markets. Their share of total private flows to developing countries increased from 29 percent in 1990 to 43 percent in 1996, increasing from $14.1 billion in 1990 to $81.8 billion in 1996 (480 percent).

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Table 3.2: Net Private Capital Flows to Developing Countries by Region, 1990-97 ($ billions)

	1990	1991	1992	1993	1994	1995	1996	1997
Africa	-1.9	1.2	0.2	3.7	9.2	10.5	5.4	14.0
Asia	27.5	32.2	20.9	54.3	64.3	91.2	98.3	28.8
Middle East and Europe	9.2	65.9	31.3	30.3	13.4	7.7	4.2	8.7
Western Hemisphere	14.1	25.5	55.9	63.1	46.5	38.2	81.8	87.5
All Developing Countries	48.9	124.8	108.3	151.4	133.4	147.6	189.7	139

Source: International Monetary Fund, *World Economic Outlook* (Washington, DC: IMF, 1998).

Within these regions, private capital flows to developing countries were concentrated among a few, mainly East Asian and Latin American countries. In 1990, 12 countries represented 83 percent of total private flows to developing countries. By 1996, the degree of concentration remained high, although it had declined. The top 12 countries represented 72.5 percent of total flows.[83] As of 1997, 140 of the 166 developing countries accounted for less than 5 percent of total private inflows.[84]

In 1990, the main recipient country of private capital flows was Mexico, with 18.4 percent of total private capital flows to developing countries. Mexican participation in total

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[83] World Bank, *World Debt Tables: External Finance for Developing Countries*, vol. 1 (Washington, DC: The World Bank, 1996), 5.

[84] World Bank, *Global Development Finance, 1998*.

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private flows declined in 1996, to represent 11.5 percent. However, the amount of capital that Mexico received increased from $8.2 billion in 1990 to $28.1 billion in 1996 (243 percent). Mexico's role as a key emerging market accompanied its policies to attract international capital. Capital flows returned to Mexico following the 1994 crisis.

China was the most significant recipient of private capital flows in the decade. In 1990, China received $8.1 billion in private capital; in 1996, it received $52 billion, an increase of 542 percent. During this period, China enacted policies to attract capital inflows, and international investors capitalized on the opportunity to gain a position in China's large consumer market.

Other key emerging markets in East Asia were Malaysia, Indonesia, and Thailand. During the period 1990 to 1996 the amount of private capital flows to these three countries increased from $9.5 billion to $47.2 billion, representing a 395 percent increase. However, the Asian financial crisis of 1997-98 has negatively impacted on this pattern. Private capital flows to Indonesia, South Korea, Malaysia, the Philippines, and Thailand declined by roughly $84 billion in 1997.

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Other key emerging markets in the decade were Brazil and Argentina, whose participation in attracting private capital increased dramatically in the 1990s. In 1990, Brazil received $500 million in private capital; in 1996, $14.7 billion (an increase of 2,840 percent). Argentina, which in 1990 had an outflow of $200 million, received $11.3 billion in private capital inflows in 1996, an increase of 5,750 percent. These inflows are partially explained by the large-scale privatization projects that were undertaken throughout the decade.

Table 3.3: Net Private Capital Flows to Developing Countries, 1990-96

Country	1990	1991	1992	1993	1994	1995	1996
China	8.1	7.5	21.3	39.6	44.4	44.3	52
Mexico	8.2	12	9.2	21.2	20.7	13.1	28.1
Brazil	0.5	3.6	9.8	16.1	12.2	19.1	14.7
Malaysia	1.8	4.2	6	11.3	8.9	11.9	16
Indonesia	3.2	3.4	4.6	1.1	7.7	11.6	17.9
Thailand	4.5	5.0	4.3	6.8	4.8	9.1	13.3
Argentina	-0.2	2.9	4.2	13.8	7.6	7.2	11.3
India	1.9	1.6	1.7	4.6	6.4	3.6	8
Russia	5.6	0.2	10.8	3.1	0.3	1.1	3.6
Turkey	1.7	1.1	4.5	7.6	1.6	2	4.7
Chile	2.1	1.2	1.6	2.2	4.3	4.3	4.6
Hungary	-0.3	1.0	1.2	4.7	2.8	7.8	2.5
All Developing Countrie	44.4	56.9	90.6	157.1	161.3	184.2	243.8
Percentage share of top 12 countries	83.6	76.8	87.4	84.1	75.4	73.3	72.5

Source: World Bank, *Global Development Finance, 1997* (Washington, DC: World Bank, 1997).

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D. Private International Capital Instruments

There are several instruments employed in international portfolio capital transactions. Some are equity instruments, which signify foreign investment in domestic assets, and others are debt instruments, representing a promise to pay on the part of domestic institutions. Derivative instruments, which derive their value from underlying financial instruments, can be both equity and debt based.

1. Equity Markets

Portfolio equity investment takes the form of direct purchases of shares on domestic stock markets, equity funds, and American or Global Depository Receipts (ADRs or GDRs). Throughout the 1990s, portfolio equity investment constituted an average of 13 percent of total net resource flows to developing countries, and 18 percent of total private flows to developing countries. In 1997, $32.5 billion in portfolio equity flowed into developing countries, representing 13 percent of the total private flows to developing countries.

Key players in this market are institutional investors, such as insurance companies, investment companies, and pension

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funds, seeking the diversification benefits that come from investing in the assets of countries whose returns are not correlated with advanced-economy stocks markets.[85] Thus, the principal players in the portfolio equity market are seeking diversification and high yield, and have a short-term perspective on investment in the country. For this reason, portfolio equity flows are sensitive to changes in the macroeconomic situation of the country and are susceptible to herding behavior on the part of investors.

Despite the risks for developing countries, in the 1990s policy makers instituted policies to attract these flows, including loosening regulatory policies on domestic exchanges. Changes in the international regulatory environment also encouraged these flows, including changes that facilitated shares of developing country enterprises to trade on international exchanges.

Throughout the 1990s, flows of portfolio equity to developing countries displayed erratic behavior. From 1990 to 1993, equity flows grew from $2.6 billion to $45.6 billion (a

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[85] By the early part of 1995, there were more than 150 dedicated Latin America funds. Their significance was such that even a small reallocation in favor of Latin America increased the amount of capital flows to the region by billions of dollars. "The Miracle Unmasked," *The Economist*, 9 December 1995, S5.

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1,649 percent increase). They declined to $20.9 billion in 1995 (a 54 percent drop from 1993). Equity issues in emerging market economies in 1997 totaled $24.8 billion.[86] These capital inflows into developing countries were concentrated in Latin America and Asia.

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[86] International Monetary Fund, *World Economic Outlook, October 1998* (Washington, DC: International Monetary Fund, 1998), 61.

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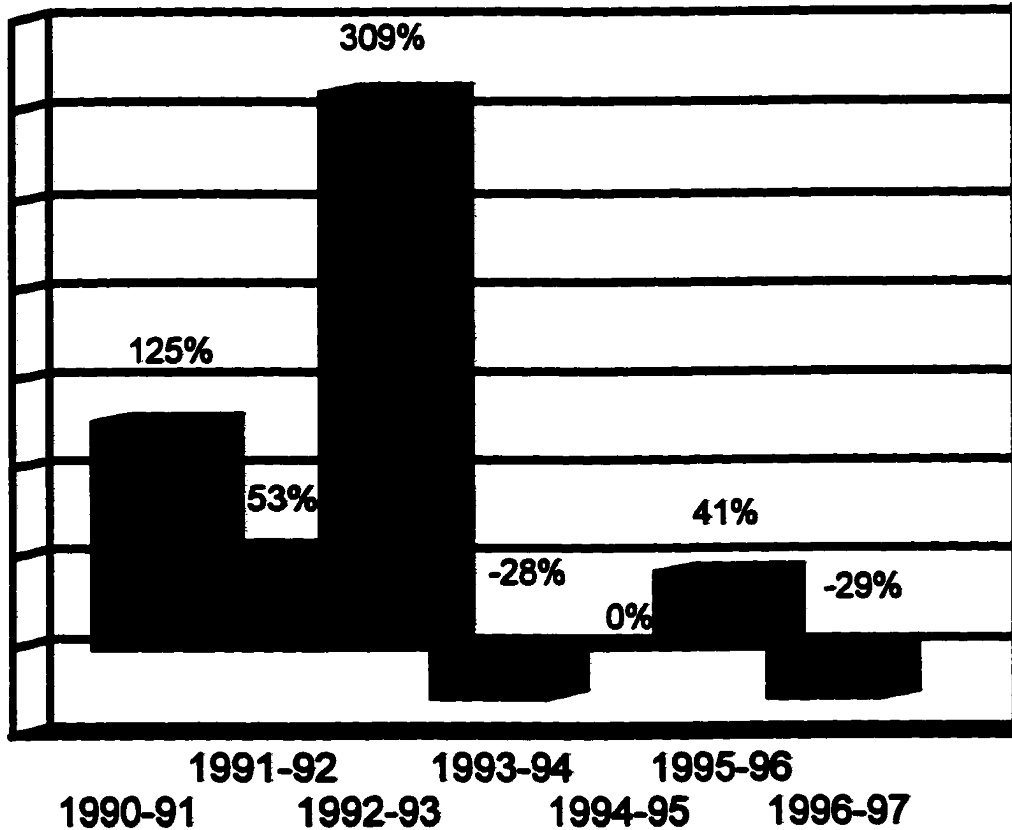
Figure 3.3: Yearly Change in Portfolio Equity Flows, 1991-97



Source: World Bank, *Global Development Finance, 1998* (Washington, DC: World Bank, 1998), 3.

Throughout the decade, portfolio equity flows were highly concentrated in three countries in Latin America, Argentina, Brazil, and Mexico, which in the period 1990-95 accounted for 80 percent of the flows to Latin America, and four countries in South and East Asia, Indonesia, South Korea, Malaysia, and

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Thailand, which received 75 percent of the flows to the region.[87]

Table 3.4: Gross Portfolio Equity Flows to Developing Countries by Region, 1990-95 ($ millions)

Region/Country	1990	1991	1992	1993	1994	1995
Latin America/Caribbean	896	5,757	8,048	25,149	13,160	6,200
Africa	-	-	144	144	938	501
West Asia	-	-	-	-	26	13
South and East Asia	1,676	419	4,266	17,854	14,920	12,363
China	-	653	1,194	2,278	3,915	1,297
Mediterranean	35	-	-	178	1,059	500
Total, Developing Countries	2,607	6,829	13,652	45,603	34,018	20,874

Source: World Bank, *World Debt Tables, 1996* (Washington, DC: World Bank, 1996).

The trend toward equity inflows into developing countries coincided with the process of liberalization of domestic financial markets, state reform, and privatization of state-owned companies. This was true especially for Latin America. In the first three years of the decade, an average of 66 percent of the total equity inflows to developing countries was concentrated in Latin America.

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[87] United Nations, Department of Economic and Social Information and Policy Analysis, *World Economic and Social Survey* (New York: United Nations, 1996), 72.

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The Mexican financial crisis of 1994-95 affected the Latin American equity markets, which up until that point had experienced rapid and substantial growth. In the first quarter of 1995, Latin American markets declined by 30 percent. New portfolio equity issues fell from a quarterly average of $5 billion in 1994 to $500 million in the first quarter of 1995. Argentina and Brazil felt the immediate impact of the crisis. Within the region, the countries whose stock markets were least affected by the crisis were Chile and Colombia.[88] Equity markets experienced a recovery in 1996, when more than $16 billion flowed into Latin America and the Caribbean. Three countries, Brazil, Mexico, and Peru, accounted for roughly 85 percent of the inflows.[89]

In the period 1990 to 1995, Latin American and Caribbean regional market capitalization increased by 397 percent. It represented roughly one-fourth of the emerging equity markets but only 2 percent of global stock market capitalization, which was largely comprised of advanced-economy stock markets.

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[88] This was because of capital controls already in place in these countries at the time of the crisis. World Bank, *World Debt Tables*, 14-15.

[89] World Bank, *Global Development Finance, 1997* (Washington, DC: World Bank, 1997).

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Table 3.5: Latin America/Caribbean Stock Market Capitalization 1990-95 ($ millions)

Market	1990	1991	1992	1993	1994	1995
Argentina	3,268	18,509	18,633	43,967	36,864	37,783
Barbados	280	307	259	328	518	497
Bolivia					24	97
Brazil	16,354	42,759	45,261	99,430	189,281	147,636
Chile	13,645	27,984	29,644	44,622	68,195	73,860
Colombia	1,416	4,036	5,681	9,237	14,028	17,893
Costa Rica		311	475	434		
Ecuador			69	1,620	3,499	2,627
Honduras		40			49	338
Jamaica	911	1,034	3,227	1,469	1,753	1,391
Mexico	32,725	98,178	139,061	200,671	130,246	90,694
Panama			226	419	698	831
Peru	812	1,118	2,630	5,113	8,178	11,795
Trinidad and Tobago	696	671	510	485	663	1,138
Uruguay	38	44	368	251	170	183
Venezuela	8,361	11,214	7,600	8,010	4,111	3,655
Regional Total	78,506	206,205	253,644	416,056	458,277	390,418
All Emerging Markets	611,278	854,808	883,456	1,586,797	1,912,451	1,895,709
All Advanced-Economy	8,782,267	10,435,686	9,949,721	12,377,034	13,241,841	15,892,174
World Total	9,393,545	11,290,494	10,833,177	13,963,831	15,154,292	17,787,883
% of Emerging Markets	12.8	24.1	28.7	26.2	24.0	20.6
% of World Total	0.8	1.8	2.3	3.0	3.0	2.2

Source: Compiled from information in International Finance Corporation, *Emerging Stock Markets Factbook* (Washington, DC: International Finance Corporation, 1996), 16-17.

In 1996-97, the stock markets of the Latin American region displayed a tendency toward a greater degree of market deepening. The International Finance Corporation's Latin American index showed a 44 percent increase in the 12-month period ending September 1997. Despite the systemic effects of the financial crisis that befell East Asia in late 1997,

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portfolio equity flows to Latin America for 1997 increased by 11 percent over the previous year.[90]

a. Direct Purchases on Domestic Markets

In the early part of the 1990s, a significant amount of capital flowed into emerging stock markets, particularly in Latin America. The gross inflow for 1991 and 1992 amounted to nearly $12 billion. However, share prices in emerging stock markets are volatile, and for this reason, they appeal to a particular risk-taking class of speculative investors.

Because of the volatility associated with speculative capital in developing country markets, there have traditionally been restrictions imposed on foreign participation in domestic stock markets. Such measures as restrictions on foreign share purchases, the maintenance of separate classes of shares for foreigners, and foreign unit trusts as the only vehicles allowed for foreign investment in domestic markets have been employed by developing countries. Rules, restrictions, and tax considerations have been imposed

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[90] In contrast, total net portfolio equity flows into East Asia dropped 86 percent from 1996 to 1997, from $14 billion to $2 billion. World Bank, *Global Development Finance, 1998*, 12-13.

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on stock purchases of locally-traded shares in emerging market countries, as illustrated in Figure 3.4.

Figure 3.4: Restrictions on Foreign Purchase of Locally Traded Shares in Emerging Markets as of 1994

Region/Country	Considerations
Asia	
East Asia and Pacific	
China	Foreign investors limited to Class B shares; clearing and account fees; stamp duties
South Korea	12% withholding tax on dividends; 10% ownership limits; stocks are traded at premiums on secondary market; deposit requirements may raise commission costs
Malaysia	20% withholding tax on dividends
Thailand	15% capital gain, 10% withholding tax on dividends; ownership limits for foreigners may mean premiums or restrictions
South Asia	
India	Only institutional investors allowed
Pakistan	Complicated settlement; capital gains taxes for private investors; custodians must file Pakistani taxes; withholding taxes on dividends as high as 30%; stamp duties 1.5% of face value
Latin America/Caribbean	
Brazil	Only institutional investors allowed
Chile	One-year waiting period for repatriation of investment. 35% withholding taxes on dividends; 35% capital gains tax
Colombia	Only institutional investors allowed
Mexico	Foreigners not allowed to purchase certain share classes; ownership limits
Peru	Stock exchange and value-added taxes
Venezuela	Complicated taxation; foreigners can't invest in broadcast companies

Source: Adapted from Robert Rosenstein, "Attention Foreign Shoppers," *Forbes*, 18 July 1994, 225.

The imposition of such controls on speculative capital inflows is designed to offset the potential for macroeconomic destabilization posed by a surge in capital inflows. Their

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effectiveness depends upon a variety of political and institutional factors, including their design, the structure of the domestic financial system, and the efficiency of the regulatory institutions.

The enactment of capital controls impacts upon the volume of capital inflows and their composition.[91] Yet they entail a tradeoff. For example, in the 1990s Chile was often cited as an example of successful capital controls that discouraged volatile capital inflows into the economy. However, as a consequence, real interest rates were maintained at a high level, which resulted in financial market segmentation as large firms borrowed abroad to avoid high domestic interest rates. In addition, domestic firms lost access to investment capital.[92]

During the 1990s, direct investment in emerging stock markets was largely concentrated in East Asia and Latin

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[91] Reinhart and Smith suggest that the key to successful capital controls is removing them once the effects of external shock have dissipated. Their beneficial effects can be reversed if temporary measures do not remain temporary or are not perceived as such. Carmen M. Reinhart and R. Todd Smith, "Temporary Capital Controls," Working Paper no. 34, Center for International Economics, University of Maryland, College Park, MD, 1997.

[92] "The Perils of Global Capital," *The Economist*, 11 April 1998, 52; "Of Take-Offs and Tempests," *The Economist*, 14 March 1998, 88.

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America. There was significant direct investment in domestic equity markets in several East Asian countries. Three Latin American countries, Brazil, Mexico, and Peru, accounted for more than 90 percent of direct purchases by foreigners in domestic stock markets.

b. Equity Funds

Emerging market equity funds represent another component of portfolio equity investment in emerging markets. In these funds, foreign investors pool their resources and invest in global, regional, and country funds.[93] This is the most volatile type of equity investment because it enables investors to rapidly shift their investments in and out of a country.[94]

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[93] Masood Ahmed and Sudarshan Gooptu, "Portfolio Investment Flows to Developing Countries," *Finance & Development* 30, no. 1 (March 1993): 11.

[94] The degree of volatility entailed by equity funds depends on the extent of financial integration of the developing country. According to the World Bank, there are three stages: (1) In the early stages of financial integration, foreign participation in the form of boutique investment funds means that investors are seeking selective opportunities in specialized markets. Therefore, fund investment is based on detailed knowledge and entails a lower degree of volatility. (2) In the newly emerging stage, investor participation broadens, beginning with country funds, and then to regional funds and global emerging markets funds. At this stage, fund

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Over the period 1992-97, the number of dedicated emerging market hedge funds increased from 5 to 57, with assets of $682 million and $7.1 billion, respectively.[95] While the rate of direct investment in local securities markets slowed in 1995, the proportion of institutional investors in emerging markets remained high throughout 1995.[96] Roughly $34 billion went to domestic stock markets through pension funds, mutual funds, hedge funds, and other investment vehicles in 1996.[97]

c. American Depository Receipts and Global Depository Receipts (ADRs and GDRs)

In order to meet the needs of investors wanting to mitigate against the exchange-rate risk of direct investment on a developing country stock exchange, some developing

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managers tend to be less specialized, and funds are less dedicated. As a result, there is a relatively high risk of herding behavior. (3) As markets become more mature and integrated, the effect of less dedicated flows and less specialized fund managers is offset by a larger volume of quality information. Thus, this stage is less volatile than the previous stage. World Bank, *Private Capital Flows to Developing Countries: The Road to Financial Integration* (Washington, DC: World Bank, 1997), 134.

[95] World Bank, *Global Development Finance, 1998*, 17.

[96] World Bank, *World Debt Tables*, 104.

[97] World Bank, *Global Development Finance, 1997*.

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countries directly floated stock issues on advanced-economy stock markets. However, due to substantial reporting requirements and high fees, several countries used the American Depository Receipt (ADR) as an alternative. To enact the transaction, a commercial bank, acting as an intermediary for the developing-country enterprise, receives a special issue of shares of the enterprise and issues dollar-denominated ADRs that can be traded on the stock market. As of 1996, ADRs constituted more than 5 percent of all trading volume on the major U.S. exchanges.[98]

Similar to ADRs are Global Depository Receipts (GDRs). The GDR provides issuers access to the international investment community through the simultaneous issuance of securities in multiple markets. They are issued inside and outside of the United States on both public and private exchanges.[99]

In the 1990s, ADRs issued by developing-country enterprises were concentrated among a few countries. For example, of 47 international equity issues by developing

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[98] Michael Allen, "ADR Investment Can be a Walk on the Wild Side," *Wall Street Journal*, 27 June 1996.

[99] International Finance Corporation, *Emerging Stock Markets Factbook* (Washington, DC: International Finance Corporation, 1996), 270.

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countries in the period 1990-92, there were 26 from Mexican firms, 7 Korean, and 3 or less from all other issuers, including Argentina, Brazil, Chile, China, India, the Philippines, and Venezuela.[100] In 1994, roughly 57 percent of portfolio equity flows were financed by equity issues, principally through ADRs and GDRs. Although this figure declined in the following year, they accounted for 47 percent of total portfolio equity flows.[101]

In the decade of the 1990s, for some Latin American countries trading in ADRs equaled or exceeded share trading in home markets. This was the case in Argentina, where in 1995 ADR stocks totaled $15.7 billion, more than three times the total amount traded on the Buenos Aires stock exchange. In 1995 Mexican ADR stocks totaled $54.4 billion, roughly one and one-half times all stock trading in Mexico City. Similarly, in Chile, ADR stocks totaled $11.6 billion, just over total trading in Santiago.[102]

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[100] United Nations, Department of Economic and Social Affairs, *World Economic Survey* (New York: United Nations, 1993), 111.

[101] World Bank, *World Debt Tables*, 103.

[102] International Finance Corporation, *Emerging Stock Markets Factbook, 1996*, 9.

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2. Debt Markets

Emerging debt markets are composed of several instruments: international bond financing, commercial paper, and certificates of deposit. In the period 1990-93, non-bank private debt flows constituted 19 percent of all private capital flows, increasing from $3 billion in 1990 to $38 billion in 1993. Non-bank private debt flows declined in 1994 to $32 billion, coinciding with rising U.S. interest rates. However, they increased again in 1995 to $34 billion.[103] International bond issues, which constituted more than 90 percent of non-bank private debt flows, reached $95 billion in 1997, despite a falloff at the end of the year due to the financial crisis in Asia. Certificates of deposits and commercial paper issues each totaled $3 billion for the year.

a. International Bond Finance

Flows from international bond financing increased from $100 million in 1990 to $53.8 billion in 1997. Of this, corporate debt borrowers (as opposed to sovereign or sub-sovereign borrowers) raised $36 billion in 1997. Developing-

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[103] World Bank, *World Debt Tables*, 9.

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country borrowing on the international financial markets was principally concentrated among a few countries. In 1995, 13 countries raised $1 billion or more on the international bond market, which represented 73 percent of the funds raised by the developing countries as a whole. Of these thirteen countries, ten were in South or East Asia. Despite this concentration, however, in 1995 there were 43 countries that either floated bond issues or borrowed from international bank facilities.[104]

Beginning in the mid-1990s there was a declining share of bonds issued by public-sector borrowers. Table 3.6 shows the distribution of sovereign borrowers, public-sector borrowers, and private-sector borrowers from 1992 through 1995.

Table 3.6: Developing Country International Bond Issues by Type of Borrower (% of Total)

	1992	1993	1994	1995
Sovereign	23	26	22	33
Public Sector	30	27	23	22
Private Sector	47	47	55	44

Source: International Monetary Fund, *World Economic Outlook* (Washington, DC: IMF, 1998).

[104] United Nations, *World Economic and Social Survey*, 71.

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In addition, they were issued in currencies other than the U.S. dollar, particularly the Japanese yen, and to a lesser degree, the deutsche mark. This was differentiated largely by region. In Asian countries, the principal currency was U.S. dollars. In the Western Hemisphere, the share of yen and deutsche mark issues rose significantly in the latter part of the decade. In European developing countries, the majority of issues were denominated in Japanese yen.[105] By the early part of 1997, Argentina and South Africa had issued local-currency denominated bonds on international markets.[106]

Latin American bond issues increased from $2.7 billion in 1990 to $28.6 billion in 1993, representing an increase of 937 percent. In the early part of the decade, the leading country was Mexico, which in 1990 issued 90 percent of the Latin American bonds. By 1993 this figure had declined to 40 percent of Latin American issues. The decline in non-bank private debt flows in 1994-95 strongly affected Latin America. While the region accounted for 42 new bond issues in the first quarter of 1994, totaling $6.3 billion, only three new developing

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[105] David Andrews and Shogo Ishii, "The Mexican Financial Crisis: A Test of the Resilience of the Markets for Developing Country Securities," Working Paper no. WP/95/132, International Monetary Fund (IMF), Washington, DC, 1995.

[106] World Bank, *Global Development Finance, 1998*, 4.

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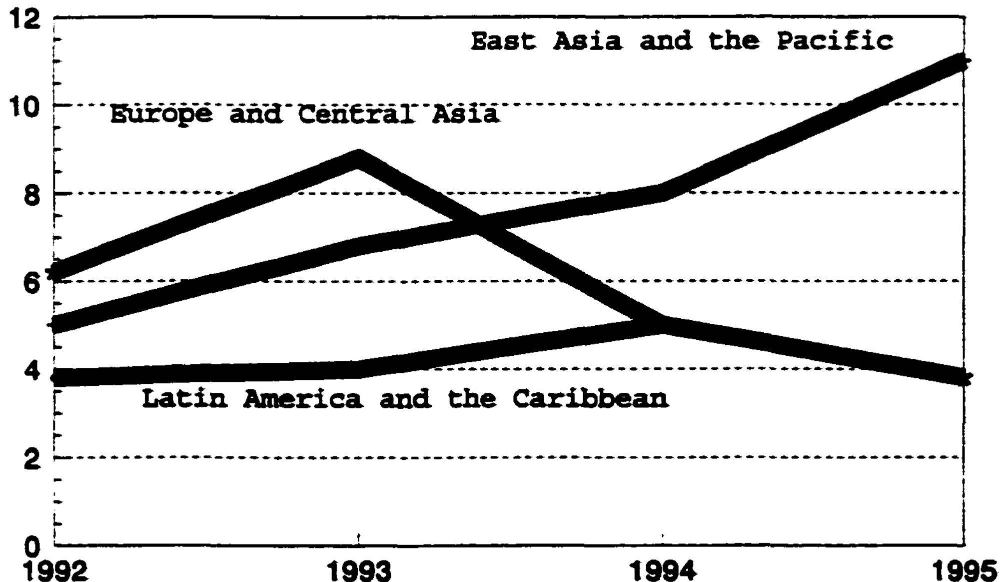
country issues were launched in the same period of 1995, totaling $360 million. Two thirds of the latter figure went to one country, South Korea. Following this decline, Latin American borrowers returned to the market, but their debt was issued at higher spreads and with shorter maturities than other developing country regions.

Figure 3.5: New Borrowing Terms as of 1995



Source: World Bank, *World Debt Tables: External Finance for Developing Countries*, vol. 1 (Washington, DC: World Bank, 1996), 9-14.

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New bond issues in Latin America recovered in 1996 to $21.9 billion, with Mexico representing 34 percent of the Latin American total. The other leading issuers were Brazil (29 percent) and Argentina (27 percent). Other countries that entered the international bond market, particularly after 1994 were Peru, Barbados, and Costa Rica.[107]

Table 3.7: New Western Hemisphere Bond Issues on the International Market ($ millions)

Country	1990	1991	1992	1993	1994	1995	1996
Argentina	21	795	1,619	6,308	5,266	8,413	5,986
Bolivia	-	-	-	-	10	-	-
Brazil	-	1,837	3,695	6,465	4,066	7,017	6,266
Chile	-	200	120	322	100	475	612
Colombia	-	-	-	567	1,099	890	1,452
Costa Rica	-	-	-	-	50	-	-
Ecuador	-	-	-	-	-	10	-
Mexico	2,477	3,782	6,333	11,338	6,831	7,633	7,516
Panama	-	50	-	-	1,248	324	
Peru	-	-	-	30	100	48	-
Trinidad & Tobago	-	-	-	-	150	71	-
Uruguay	-	-	100	140	199	211	-
Venezuela	262	578	966	3,438	-	357	85
Total	2,760	7,242	12,833	28,608	19,119	25,449	21,917

Source: Sistema Económico Latinoamericano (SELA), *Revista Capítulos* 47 (July-September 1996).

[107] World Bank, *World Debt Tables*, 100.

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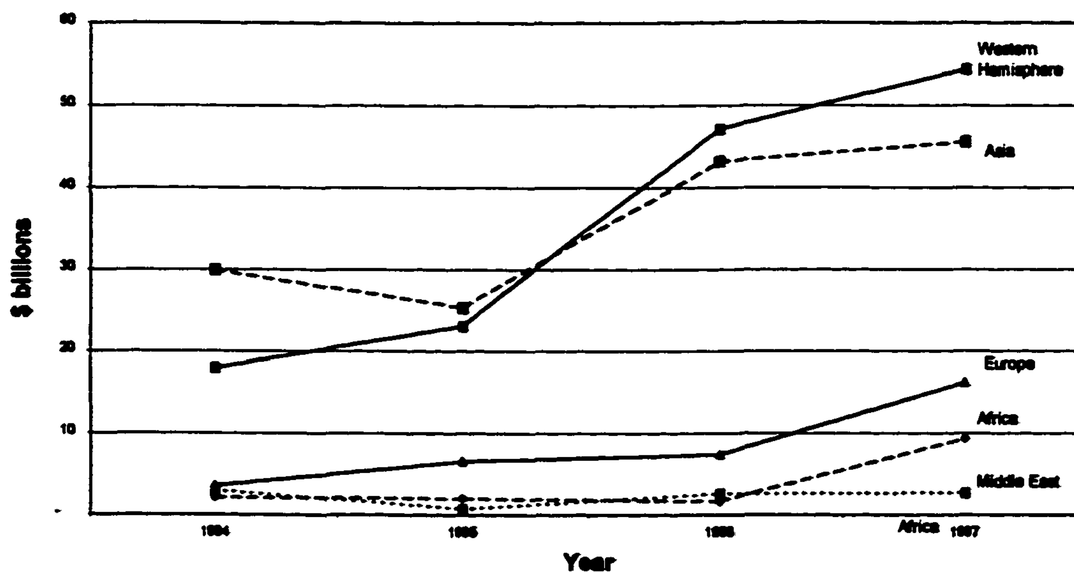
Figure 3.6: Emerging Market Bond Issues by Region, 1994-97 ($ billions)



Source: International Monetary Fund, *World Economic Outlook* and *International Capital Markets, Interim Assessment* (Washington, DC: IMF, December 1998), 27.

In 1997, Latin America and the Caribbean accounted for 60 percent of developing country non-bank private debt flows. A large proportion of this was attributable to the exchange of Brady bonds for $12.3 billion in unsecured global bonds by Argentina, Brazil, Ecuador, Panama, and Venezuela. [108]

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[108] World Bank, *Global Development Finance, 1998*, 112.

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b. Commercial Paper and Certificates of Deposit

Throughout the 1990s, commercial paper and certificates of deposit constituted less than 20 percent of the total non-bank private debt instruments and less than 10 percent of total portfolio investment. In 1989, commercial paper represented 67 percent of the total flows generated by the two instruments. By 1993 this figure had declined to 47 percent. In 1990 the flows generated by certificates of deposit totaled $647 million, and they increased to $1.8 billion in 1993. The use of certificates of deposit predominated in East Asia, while issues of commercial paper were more frequently employed in Latin America, particularly in Brazil and Mexico.[109]

3. Other Instruments: Derivatives

Derivative instruments derive their value from underlying financial instruments. Although they can be either equity or debt based, foreign exchange and interest rate derivatives are more relevant than equity derivatives in an emerging market context. This is because they are used to hedge against the currency and interest rate fluctuations to which market

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[109] World Bank, *World Debt Tables*, 100.

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participants are exposed.[110] There are three categories of derivative instruments. Futures and Forwards (Repos) are agreements in which a buyer and seller agree to complete a transaction at a predetermined time in the future at a price that is agreed upon at the time that agreement is made. Options and Warrants constitute the right to purchase or sell a particular underlying instrument, such as a stock, stock index, bond, bond index, commodity, currency, or futures contract, at a specified price for a stipulated period of time. Swaps involve an exchange of cash flows.

The global financial derivatives market grew dramatically in the 1990s. For example, between 1990 and 1995 the volume of derivatives exchange-traded instruments grew from $2.3 trillion to $9.2 trillion, which represents a 301 percent increase.

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[110] World Bank, *Global Development Finance, 1998*, 16.

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Table 3.8: Derivatives Trading, 1990-95 ($ billions)

	1990	1994	1995
Exchange-traded instruments	2,290	8,863	9,185
Interest rate futures	1,455	5,757	5,863
Interest rate options	600	2,624	2,742
Currency futures	17	40	38
Currency options	57	56	43
Stock market index futures	69	127	172
Stock market index options	94	238	327
OTC instruments	3,450	11,303	17,990
Interest rate swaps	2,312	8,816	...
Currency swaps	578	915	...
Other swap-related derivatives	561	1,573	...

Source: International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues, World Economic and Financial Surveys* (Washington, DC: International Monetary Fund, 1996).

As of the mid-1990s, more than 80 percent of trade in derivatives worldwide occurred in U.S. and European markets.[111]

An increase in emerging-market derivative activity on international exchanges and in the over-the-counter structured markets accompanied the growth of portfolio investment in emerging markets.[112] For example, trading volumes for

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[111] World Bank, *World Debt Tables*, 16.

[112] According to the International Finance Corporation, by the end of the 1990s, there were derivative markets in eight emerging markets, with over 15 exchanges. Other countries, such as Mexico, whose derivatives market MexDer entered the pre-operative stage in March 1998, were in the process of developing derivative exchange markets. The third most liquid futures exchange in the world was Brazil's *Bolsa de*

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developing-country debt derivatives on the U.S. over-the-counter market increased from $15.3 billion in 1992 to $57.4 billion in 1993.[113] In Latin America, growth in derivatives was largely constituted by purchases of Brady Bond options.

Investors benefit from purchasing derivatives because it enables them to gain exposure in emerging markets but reduces the degree of transaction costs and risk. For example, because of settlement costs, stamp taxes, and other local-market costs, equity swaps are generally less expensive than purchasing or selling stocks directly on an emerging market exchange. Similarly, purchasing a Brady Bond option involves a lower degree of risk than purchasing the Brady Bond itself.

However, there are risks associated with emerging market derivative products. They include limited local financing at certain maturities, restrictions on foreign investment and repatriation of corporate profits, and the possibility that the agreement may not be fulfilled because of regulatory changes or political or economic upheaval in the emerging-

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Mercadorias e Futuros (BMF), which traded up to 30,000 contracts a day. Mariana Crespo, "Emerging Markets: Cautious Investors Seek Safety," *Euromoney*, June 1996; International Finance Corporation, *Emerging Stock Markets Factbook, 1996*, 12; "En la etapa pre-operativa entra el mercado de derivativas en México," *El Universal*, 13 March 1998.

[113] World Bank, *World Debt Tables*, 16.

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market country. For this reason, there are elements built into derivatives products designed for emerging markets that are somewhat different than those used in advanced economies.[114]

E. Conclusions

This chapter has analyzed several elements characteristic of the evolution of the world economy from the 1960s to the 1990s. It has shown that international capital flows have behaved in a cyclical fashion. In the 1990s there was a change in the magnitude and orientation of these flows, as well in the key actors behind them. During the 1990s, a new phenomenon developed, the appearance of the emerging markets. They were constituted by roughly 12 countries where 70-80 percent of the private capital flows to developing countries was concentrated. Within the context of financial globalization in the 1990s, flows to developing countries increased dramatically. The new institutional context of the international financial market was accompanied by the deepening of domestic financial markets in a few developing countries, including Mexico. This process involved the

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[114] Crespo, "Emerging Markets".

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development of new sets of regulations and institutions to manage the flows of capital.

The chapter provides a background for understanding how Mexico, as one of the key emerging markets, experienced a financial crisis triggered by the dramatic reversal of international capital flows. This might suggest that the crisis was part of a new phenomenon in which international financial speculators exercise control over domestic financial policies. However, as will be demonstrated in the following chapters, the crisis that occurred was built on the stock of debt that Mexico had been accumulating for several years. It represented part of a process that began in the 1970s as a result of domestic policy and economic orientation, the political system, and policies regarding the use of foreign savings to finance the domestic economy.

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CHAPTER IV

THE ECONOMIC AND POLITICAL CONTEXT OF THE MEXICAN EMERGING MARKET

A. Economic Design

Throughout most of the twentieth century, Mexico has evidenced low levels of domestic investment. Capital resources were scarce because of the financing of several domestic armadas that fought against foreign military interventions. In the absence of a substantial amount of domestic capital, during the roughly 30 years of the dictatorship of José de la Cruz Porfirio Díaz (1876-1910) the country opened to international trade and foreign investment in order to achieve economic growth. The coalition that supported this policy included members of the military, politicians, landowners, members of the business community, miners, and traders. They were allied with foreign interests who benefited from abundant labor and low wages.

The social tensions that arose during this period were brought about by a concentration of power and income, as well as by the nature of the political system of President Díaz.

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These tensions were the principal causes for the outbreak of the Mexican revolution, which began in 1910 and lasted until 1921. The revolution originated in a conflict between, on one side, a coalition of peasants and nascent industrial groups of workers and domestic business entrepreneurs and, on the other side, an export elite principally dominated by foreign capital. In the end it was the former group that emerged victorious. With the triumph of the Mexican revolution, the nexus of power changed from a traditional export-sector governing coalition to a new alliance formed by the government and industrial business sector. This new coalition later supported the policy of import-substitution industrialization.

The revolutionary governments institutionalized organizations with strong popular support that helped President Lázaro Cárdenas (1934-40), to consolidate and maintain a domestic coalition with nationalist ideology. The ideology was conceptualized by the government, public-sector employees, entrepreneurs, workers, and peasants and enabled the government to carry out agrarian reform against the landowners. An important sector of the peasantry benefited from these reform measures. In addition, President Cárdenas nationalized the petroleum industry, which had been principally in the hands of British and Dutch companies. The British and the Dutch became political allies for World War I

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and the competition among the advanced economies that followed the Great Depression.

Despite the nationalistic sentiment surrounding President Cárdenas, the scarcity of domestic capital and technological resources limited the possibility for the country to achieve autonomous development. This increased the need for the country to again open to foreign investment, a policy that had been rejected in this period. President Miguel Alemán Valdés (1946-52), began a period of increasing capital stock that relied upon the support of the private sector, allied with government officials, the leaders of the labor sector, and foreign capital. The economic policies instituted in this period were designed to advance the process of industrialization in the country based on import substitution.

The multinational corporations and their domestic partners and, to a lesser degree, the domestic industrial financial groups and the large domestic agriculture firms had the most substantial resources of the coalition in terms of capital and technology. They generated a significant amount of profit and power. As a result, income became further concentrated, and small and mid-sized domestic businesses were displaced. In attempt to remedy this situation, the government instituted policies to subsidize the low wages of the domestic industrial sector by maintaining low food prices and by

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distorting the terms of trade of agricultural products in relation to industrial goods. However, this reduced the income of the peasants and those who were excluded from the political decision making process. The use of capital intensive industry did not generate adequate sources of employment to accommodate population growth and rural-to-urban migration. Small-scale industrial production resulted in low levels of vertical integration, inefficiency, and reliance on imported inputs, and a consequent loss of foreign exchange.

At the same time, the circles of core political decision making became increasingly narrow. As a consequence, the "revolutionary coalition" gave way to a situation in which the peasants, workers, and some groups within the professional middle class were excluded. This resulted in heightened social tensions. The precarious economic situation and the political and social tensions led Presidents Luis Echeverría Álvarez (1970-76) and José López Portillo (1976-82) to implement economic policies of an expansive populist nature that were financed mainly with petroleum exports and foreign borrowing.[115]

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[115] Gloria M. Delgado de Cantú. *México: estructuras política, económica y social* (México: Alhambra Mexicana, 1996), 159-182.

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1. Inward-Oriented Development

In the period 1960-70, Latin America experienced economic growth. However, it was not at the same level of Western Europe, Southern Europe, and Asia. One of the reasons for this is that Latin America did not have the same incentives to change its policies as had European leaders due to Marshall Plan assistance.

The Latin American economy performed poorly beginning in 1973. Most Latin American governments were indifferent to the OPEC oil shock and felt that they could accommodate high rates of inflation through large-scale borrowing on the international market. The Latin American governments continued to implement expansionary policies through international borrowing at negative real interest rates.[116] This continued until the debt crisis, which began in 1982.

The economic orientation of the Mexican economy had been based on the model of import-substitution industrialization (ISI) since 1929 and continued through the end of the 1970s. Following these five decades of continued import substitution, the import share of total supply fell from 56 to 21 percent between 1929 and 1970. Throughout this period there was steady

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[116] Maddison, *Monitoring the World Economy*.

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and sustained growth of the economy and per capita income. GDP growth averaged 7 percent and 3 percent per capita. Exchange rates and prices were relatively stable, savings increased, and the domestic market was strengthened. Between 1960 and 1971, industrial output doubled. Manufacturing grew in importance from 20.3 percent to 23.7 percent of GDP between 1960 and 1971, while farming, livestock, and oil and mining declined from 20.2 percent in 1960 to 14.7 percent in 1970.[117]

The main objectives of Mexican economic policy during this period were to increase private sector savings and capital accumulation, maintain price stability and a fixed parity with the dollar, and increase real wages.[118] These policies facilitated one of the highest rates of industrial growth in the region. Mexico achieved this growth with one of

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[117] René Villarreal, "The Latin American Strategy of Import Substitution: Failure or Paradigm for the Region?" in *Manufacturing Miracles: Paths of Industrialization in Latin America and East Asia*, ed. Gary Gereffi and Donald L. Wyman (Princeton, NJ: Princeton University Press, 1990), 308.

[118] Edward F. Buffie, "Mexico 1958-86: From Stabilizing Development to the Debt Crisis," in *Developing Country Debt and the World Economy*, ed. Jeffrey D. Sachs (Chicago, IL: University of Chicago Press, 1989), 142.

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the lowest rates of domestic inflation among other import substituting economies.[119]

During this period one of the pillars of the political regime was organized labor. Throughout the successful period of growth in Mexico, there was a permanent social pact in operation that provided the regime with a political base and made for a smooth functioning of the economy. The pact with labor allowed wages to rise in line with or slightly below the rate of productivity increase. Official unions thus removed a major source of inflation from the Mexican economy. Profits and wages both increased steadily. However, it has been argued that these gains were achieved through an oligarchic union leadership that was unresponsive to the membership and the co-

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[119] Robert R. Kaufman, "Economic Orthodoxy and Political Change in Mexico: The Stabilization and Adjustment Policies of the de la Madrid Administration," in *Debt and Democracy in Latin America*, ed. Barbara Stallings and Robert Kaufman (Boulder, CO: Westview Press, 1989), 110-11. Although this period is often characterized as inegalitarian, this is disputed by Buffie who asserts that there is little hard evidence that the distribution of income worsened during this period, which was called "stabilizing development." He states that there is evidence that regardless of how the overall distribution changed, the poor benefited substantially in absolute terms from the high rate of economic growth. According to one study, the percentage of families living in poverty declined from 45 percent in 1958 to 30 percent in 1969. Buffie, "Mexico 1958-86," 144.

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optation of the top union leadership into the ranks of the ruling party.[120]

Throughout the 1960s and into the 1970s, the government supported the development of the consumer goods industries oriented toward domestic markets. High protective tariffs and other import barriers were imposed. The share of imports subject to licensing requirements increased from 28 percent in 1956 to more than 70 percent in the 1970s. The share of total output from agriculture and other primary activities declined, while industry's share increased from 22 percent in 1950 to 29 percent in 1970. The government promoted industrial expansion through public infrastructure investment.

Despite the success of this program in terms of non-inflationary economic growth, the trade and pricing policies applied during this period resulted in relative price distortions. Even though imported capital equipment was cheap for manufacturers, the prices of the goods they produced increased. Imports of inputs increased, exported manufactures lagged, and agricultural exports stagnated. The current account deficit increased by 2.5 percent of GDP between 1967 and 1972.

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[120] Ian Roxborough, "Organized Labor: A Major Victim of the Debt Crisis," in *Debt and Democracy*, 102-3.

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In the mid-1960s, Mexico began to borrow regularly from the international financial markets, borrowing $2.3 billion from private financiers, $1.5 billion from public agencies, and $675 million from other sources between 1965 and 1970. Throughout the 1970s and into the early part of the next decade, Mexico was one of the world's largest borrowers on international financial markets. The largest proportion of borrowing was done by the public sector, including the central government, the public utilities, and state-owned enterprises. The borrowing was channeled into state public investment projects, private investment in industry, expansion of the private financial system, and expansion in federal government social service provisions.[121]

Throughout this period, the policies of the government can be characterized by the following elements: (1) the key element of development was the domestic market; (2) the domestic market was based on durable goods production, which was carried out by domestic industry; (3) commercial banking was one of the leading business sectors; (4) the relationship between the state and the business community was based on the establishment of mechanisms to provide stability for the

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[121] Jeffry A. Frieden, *Debt, Development, and Democracy: Modern Political Economy and Latin America, 1965-85* (Princeton, NJ: Princeton University Press, 1991), 183.

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financial system; (5) fiscal policy was oriented to limit the participation of the state in the industrial sector; and (6) the government would provide foreign currency to cover the trade deficit generated by the needs of domestic industry, particularly with regard to capital-goods imports. As a result of the combined efforts of sectors of the government, the domestic banking sector, and the international financial community, economic policies during this period had a particular orientation, which was to pursue financial stability above all else.

2. Expansion of the State Role

Throughout the 1970s, the Mexican economy remained centered on the domestic market. Industrial output doubled, and a more diverse array of manufactured goods emerged, such as in the automobile industry. During this period there were higher levels of direct industrial support from the public sector for oil and steel and increasing exports. There was also a large supply of foreign exchange based on oil exports and a greater availability of external credit. During this period, the import substitution process began to stagnate and

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the share of imports in total supply increased from one-fifth in 1976 to one-fourth by 1981.[122]

During the presidential administration of Luis Echeverría, economic policy underwent a dramatic change. The role of the state in directing and regulating economic activity and promoting equity and prosperity was expanded. Reforms undertaken in the early 1970s included land reform, increased investment in health and education, greater latitude for independent labor unions, and electoral reform.[123] The government instituted fiscally expansionary policies. Throughout Echeverría's administration, government employment doubled, and the share of total public sector spending in GDP increased from 20.5 percent to 30 percent, mostly in the state-owned enterprise sector. From 1971 to 1975, real current expenditure by public sector enterprises grew at an average annual rate of 18 percent.[124] By 1982, the overall level of public expenditure was one of the highest in the region.[125]

The fiscal imbalance produced during this period was financed through foreign borrowing and oil revenues. The

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[122] Villarreal, "Latin American Strategy," 308-9.

[123] Kaufman, "Economic Orthodoxy and Political Change," 111-12.

[124] Buffie, "Mexico 1958-86," 145.

[125] Kaufman, "Economic Orthodoxy and Political Change," 112.

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public-sector deficit increased from 2 percent of GDP in 1970 to 7 percent of GDP in 1976. The share of public-sector spending financed by debt increased from 32 percent in 1971 to 50 percent in 1977. Despite increasing inflation, the government maintained fixed exchange rates. A lack of competitiveness in the domestic industrial sector served to discourage new investment and encourage capital flight.

Highly liquid international financial markets provided resources that were augmented by oil revenues that became available toward the end of the period due to new oil discoveries. New groups were incorporated into the political system through the expansion of direct state intervention in economic and social life.

The availability of low-cost foreign financial resources loosened fiscal discipline. Government agencies that had traditionally imposed a relatively orthodox fiscal and monetary policy lost political ground. "Developmentalists" in ministries and state firms advanced politically. The struggle between orthodox policy proponents in the Ministry of Finance and the *Banco de México* (the Mexican central bank) and the developmentalists eroded policy coherence and effectiveness. The rapid expansion of the public economy as a result of

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capital inflows into Mexico diminished the executive branch's ability to manage its administrative structure and heightened tensions with members of the upper-income sectors.[126]

As a result of growth in the public economy, economic dependence on oil revenue, and continued access to foreign credit, the Mexican economic system became vulnerable to the unfavorable economic conditions of the early 1980s. This unfavorable system was characterized by rising interest rates and falling oil prices.

Also during this period, imbalance in the trade and current account balances was resolved through oil export revenues. Income from oil exports amounted to $32.5 billion in the 1976-81 period. This allowed the imbalance to continue and undermined the reforms needed in the productive structure of the economy. In addition to generating foreign exchange, Mexico's oil resources enabled the acquisition of $60 billion in foreign credit in this period. Continued reliance on oil led to oil dependence by the end of 1981. Oil increased from 15 to 73 percent of Mexico's total exports. Oil revenues came

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[126] Blanca Heredia, "Making Economic Reform Politically Viable: The Mexican Experience," in *Democracy, Markets, and Structural Reform in Latin America: Argentina, Bolivia, Brazil, Chile, and Mexico*, ed. William C. Smith, Carlos H. Acuña, and Eduardo A. Gamarra (Coral Gables, FL: North-South Center Press, 1994), 272.

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to generate nearly 50 percent of the government's fiscal income.[127]

By 1976, the Echeverría economic program collapsed under balance of payments pressures. Import controls were imposed, and state-owned enterprise expenditures were cut back. However, spending in the other branches of government was not scaled down, and monetary expansion continued. The current account deficit was high at $3.7 billion in 1976, there were high levels of capital flight outside of the country, and foreign exchange reserves were depleted.[128] When the *peso* experienced a 100 percent devaluation, manufacturing sector employment declined by 4.2 percent, inflation rose to 60 percent, and there were threats of bank runs, the Echeverría administration began negotiations on the terms for a standby agreement with the IMF.[129]

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[127] Villarreal, "Latin American Strategy," 311.

[128] Although figures are difficult to establish, the following have been estimated for cumulative capital flight from Mexico: $47 billion (1976-88); $30-40 billion (1977-87); $64 billion (1973-84); $25 billion (1976-82); $35 billion (1983-87). Cited in Ben Ross Schneider, "Big Business and the Politics of Economic Reform: Confidence and Concertation in Brazil and Mexico," in *Business and the State in Developing Countries*, ed. Sylvia Maxfield and Ben Ross Schneider (Ithaca, NY: Cornell University Press, 1997), 196.

[129] Buffie, "Mexico 1958-86," 147.

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The administration of José López Portillo (1976-82) completed the negotiations for a three-year stabilization program. The program entailed trade liberalization measures and monetary and fiscal austerity. In 1977, the fiscal deficit was reduced from 9.9 percent to 6.7 percent of GDP, inflation declined from 27.2 percent to 20.7 percent, and the current account deficit fell by over $2 billion. However, when additional oil was discovered in Mexico, a more expansionary policy package that entailed large, sustained increased in real government expenditures was adopted. This strategy was similar to that of the Echeverría administration, although it was believed that with oil wealth behind it, a strong role for the public sector could be maintained.

Between 1978 and 1981, the public sector contracted a large amount of new debt. While private-sector debt in the period was $21.9 billion in 1981, public sector debt in the same year was $53 billion in the form of medium and long-term commercial bank loans to state-owned enterprises, including PEMEX (the state-owned oil company) with almost 20 percent of the total. Short-term debt also grew. It accounted for 20.3 percent of the total public sector debt by the end of 1981. This heavy debt burden placed the country in a precarious financial position. In 1981, debt service, including short-term amortization, was equivalent to roughly 80 percent of

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total current account income. This period was also characterized by large amounts of capital flight.[130]

3. Macroeconomic Imbalance

In 1982 the worst economic crisis in Mexico since the early part of the century began. The economy had the following characteristics: (a) there was negative GNP growth of 0.5 percent; (b) inflation was 98.9 percent; (c) the value of the *peso* depreciated by 133 percent; (d) the increase in public foreign debt was $6 billion; (e) total foreign debt was $86 billion, which constituted 52.5 percent of GNP; (f) interest payments on the debt were $11 billion; and (g) the public budget deficit increased from 6.5 percent of GNP in 1980 to 15.6 percent in 1982. In the later part of the year, the government announced an involuntary moratorium on debt payments and nationalized the banking system.

The nationalization of the banking system in September 1982 generated a rift between the government and the business sector in Mexico. Until that time there had existed an

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[130] It is estimated that 38-53 percent of the debt accumulated during the López Portillo administration financed capital flight, rather than financing efficient investment projects. In addition, a large proportion of it financed higher public sector consumption and investment. Ibid., 155.

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informal agreement between the Mexican business community and the ruling party wherein the business leaders did not interfere in politics in exchange for the ruling party's guarantee of a profitable investment climate. Business community mistrust of the government translated into reluctance to invest. In 1987, it was reported that 80-90 percent of Mexican entrepreneurs had no confidence in the government's capacity to manage the economy.[131]

Throughout the period 1983-88, there was low average growth in GDP of roughly 0.1 percent per year. Inflation was high, public consumption grew at a slow pace, and private consumption did not grow. Investment fell at an average of 4 percent per year. There was rapid growth of the informal economy. There were high levels of unemployment and underemployment, and real disposable income per capita fell 5 percent each year between 1983 and 1988. There were large flows of migration to the capital city and to the United States.

A substantial policy reorientation was undertaken during this period that reduced state involvement in economic

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[131] Sylvia Maxfield, "National Business, Debt-Led Growth and Political Transition in Latin America," in *Debt and Democracy*, 86-87.

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production and regulation and aimed to integrate Mexico into the world economy.[132] This period entailed a shift in development ideology. The onset of the crisis in 1982 resulted in a loss of credibility of statist and developmentalist policy orientations. It was this shift, coupled with a scarcity of financial resources and the need to re-establish relations with international creditors, that led to a redefinition of the balance of power within the government. It enabled the *Banco de México* and the Finance Ministry to have a larger role in policy making. As a result, it became possible for the government to institute sharp cuts in government spending. Total government expenditures fell from 44.5 percent of GNP in 1982 to 41 percent in 1983. Throughout the presidential administration of Miguel de la Madrid, the government maintained an orthodox fiscal stance.

Another element that was critical in enabling the market-oriented reform strategy was the re-establishment of relations between the government and the major business groups in Mexico, after President López Portillo nationalized the

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[132] Ramón Martínez Escamilla, Irma Manrique Campos, and Jaime Bautista Romero, *Crisis económica: ¿Fin del intervencionismo estatal?* (México: Ediciones el Caballito S.A., 1996), 103-154.

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banking system in September 1982.[133] This was achieved through federally-subsidized foreign exchange that eased the burden of repayment of private foreign debt. In addition, the government showed a favorable tendency toward business in the loose application of controls over the financial management and employment policy in PEMEX, which was the country's largest foreign-exchange earning institution.

As a consequence of several factors adverse to the Mexican economy, including the international financial restrictions that resulted from the debt crisis, Mexico was no longer able to access the international financial market. Thus, capital inflows that were necessary for financing the Mexican economy were halted. This was especially difficult when the Mexican government was engaged in negotiations with foreign creditors in 1985 and 1986. This was a time of high inflation and exchange rate instability, which resulted in financial instability for the domestic private sector. In addition, the government needed financial resources to pay the foreign debt.

As a result of this situation, the public sector deficit came to dominate the financial system. The Mexican banking

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[133] Rogelio Hernández Rodríguez, *Empresarios, banca y estado: el conflicto durante el gobierno de José López Portillo, 1976-1982* (México: Grupo Editorial Miguel Ángel Porrúa, 1988), 187.

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system obtained resources from the *Banco de México* at interest rates that were set below market rates and were negative in real terms. At the same time, the government acquired resources to finance the public budget through the use of the required reserve of the nationalized banks. Through these mechanisms, the state used money that the banking sector attracted from the market in order to finance public activities. However, this financing was not sufficient to cover the public deficit. For this reason, the government increased the issuance of short-term bonds at interest rates that were higher than the market rate.

The international financial environment in 1981 and 1982 was characterized by high interest rates, the inability of developing countries to pay their foreign debt obligations, and unease on the part of international bankers. This last point was because the debtor countries were willing to acquire increasing amounts of loans to pay their debt even though their export income declined due to a fall in international commodity prices.

In this context, Mexico was incorporated into the international environment as a country with no capacity to pay its foreign debt. In what was termed the "Mexican weekend" of

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August 13-15, 1982 the de la Madrid administration informed the U.S. authorities that Mexico's international reserves were exhausted and the country could not pay service on its debt. This situation provoked a massive outflow of capital and sent Mexico into a deep recession.

The decision adopted by Mexico was not an isolated event. In a September 1982 IMF and World Bank meeting, the developing countries' inability to pay off their foreign debt and their efforts to establish a debtor club were clear to the international financial community. A situation similar to that of Mexico also occurred in other developing countries. For example, Brazil established a debt moratorium because it could not reach an agreement with its creditors. In the following weeks, the rest of the Latin American countries, with the exception of Colombia, expressed an intention to reschedule their payment conditions.

The flow of capital that constituted the service on the foreign debt that the Latin American countries provided to their creditors was considered crucial for the functioning of the international financial system. For example, in the United States, the banks had been putting their loans in accounts with low profitability, such as housing and agricultural loans, and any eventual moratorium from the Latin American countries would have been disastrous for those banks. For that

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reason, they pushed the Latin American countries to continue paying at least the interest on the foreign debt.

The creditor countries found that they could influence stabilization policies and structural adjustment measures in the debtor countries. This mission was given to the IMF, who defined the priorities for the debtor countries in order to be able to acquire credit. The economic programs promoted by these institutions concentrated on controlling inflation and fixing exchange-rate distortions. They recommended currency devaluation, import control reductions, government subsidies reductions, public services price liberalization, wage contraction, public sector reduction, fiscal deficit reduction, and state-owned enterprise privatization.

The debt crisis resulted in the creditor countries' approval of several initiatives. For example, the Baker Plan was approved at the 1985 annual meeting of the IMF and World Bank in Seoul. According to the plan, the international financial community was able to put fresh money into the debtor countries in order to help them to continue to pay the foreign debt. However, the Baker Plan did not address the deep problems of the economies.

Another example of creditor country initiatives to address the debt crisis was the proposal presented in March

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1989 by the U.S. Treasury Secretary Nicholas Brady.[134] It consisted of the following elements:

1. The creditor banks would suspend the clause of equal treatment to all debtors for three years, in order to negotiate with each according with their own needs.
2. The plan requested innovative measures from the debtor countries to encourage the international creditors to participate in programs to reduce the countries' foreign debt.
3. The plan proposed a complex process of debt reduction with the support of the World Bank in order to give new loans to the countries so that they could recover from the temporary condition.
4. The plan authorized the IMF to finance adjustment programs under special conditions, even if the country did not achieve an agreement with the international creditors.

In this context, in July 1989, Mexico, using the Brady Plan as an umbrella, initiated the re-negotiation of its foreign debt. Mexico became the first country to reach an agreement that entailed $48 billion in foreign debt based on three criteria: (1) the reduction of the principal of the

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[134] Nora Lustig, *Mexico: The Remaking on an Economy*, second ed. (Washington, DC: Brookings Institution Press, 1998), 56-58.

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foreign debt; (2) the reduction of the interest rate; and (3) access to new sources of financing. The Brady Plan was one of the conditions that Mexico had to meet in order to gain the qualification of "eligible country" from the international financial community that was necessary according to the country's creditors.

In the period 1982-87, Mexico faced the most severe aspects of the foreign debt crisis. This crisis was accompanied by a substantial reduction in the price of oil, which was Mexico's main export product. Both elements, the debt crisis and the reduction in the price of oil, pushed structural adjustment to the top of the government agenda in order to generate the necessary revenue to pay the foreign debt and absorb the oil shock of 1986. An additional constraint was the effect of the U.S. stock market crash of 1987 on the securities market.

Currency devaluation was the principal instrument used to address the external imbalance. This resulted in rates of inflation that were higher than had occurred in contemporary Mexican history. In 1986, during this stage, Mexico gained membership in GATT, which signified a break with the old model of economic development based on import substitution. However, in this period it was difficult to establish sustainable economic growth.

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B. Political Design

1. Institutional Arrangement

President Lázaro Cárdenas institutionalized the post-revolution political system through a corporatist arrangement that extended throughout the decade of the 1990s.[135] The central point of Mexican corporatism, which incorporated the labor unions, the business representative organizations, and peasant organizations, was the institution of the presidency. The presidency was the principal source of the political initiatives that affected the key interests of the corporatist organizations. The policies directed toward the corporatist institutions determined national policy, even though the majority of the Mexican people did not belong to the corporatist organizations or political parties. In response to presidential decisions, the corporatist institutions reacted either with acceptance or by negotiating modifications to them. Sometimes the business organizations, to a small degree,

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[135] John F. Purcell and Susan Kaufman Purcell, "Mexican Business and Public Policies," in *Authoritarianism and Corporatism in Latin America*, ed. James M. Malloy (Pittsburgh: University of Pittsburgh Press, 1977).

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and labor unions and peasant organizations, to a lesser degree, tried to exercise their veto right. However, they were rarely successful in practice. Since the time of the Mexican revolution, the behavior of the corporatist institutions was characterized by the subordination of their interests to the interests of the nation. The interests of the nation were viewed and defined by the federal government in general terms, and in specific terms by the president.[136]

Beginning with the administration of Lázaro Cárdenas, corporatism in Mexico was the key element supporting the political preeminence of the state over Mexican society.[137] Corporatism was not only a mechanism through which the state was linked to the unions, but it also served as a mechanism linking different sectors of society that were politically subordinate to the state. The corporatist system constituted by the *Partido Revolucionario Institucional*-PRI (Revolutionary Institutional Party) integrated broad sectors of the population under the domain of the state. Their organization was compulsory and affiliated by mandate to the PRI. Through

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[136] José Antonio Crespo, *Jaque al rey: hacia un nuevo presidencialismo en México* (México: Grupo Editorial Planeta, 1995), 55-82.

[137] Agustín Yáñez, *La formación política* (México: Grupo Editorial Miguel Ángel Porrúa, 1997), 21-46.

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this mechanism, they recruited their leaders who became representatives of the state within the sectors of the population and the organization that they represented, including the unions. Even though they were leaders of the societal institutions, they actually became representatives of the state.

Through this mechanism the state co-opted the leaders of the societal institutions. The administrative units that emerged from the social organizations came to represent the state and its politics, even though their relationship with their constituents gave them room to maneuver and partially influence the policies of the state. The PRI became the arena in which political bargaining took place between the bureaucracies of the corporatist institutions. This allowed the PRI to maintain its central position in Mexican politics and society.

Within the Mexican political system there were "informal rules" that explained how power was distributed within the Mexican political system. Among them were those that emerged gradually in the establishment of the corporatist mechanism in the country. Examples are: the inclusion of the organized sectors, such as labor, peasants, popular sectors, and military sectors in the political process in the 1930s; and in the 1940s and 1950s, the inclusion of the business

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organizations that were not only incorporated into the leadership of the PRI but strengthened the vertical patron-client relationship in which there was an exchange of protection for political support.[138]

The informal rules of corporatism strengthened the linkage of loyalty upward at all levels of society, building a network of relations that surrounded the presidentialist system.[139] The informal rules of corporatism that emerged from the political pact of 1929 were the following.

1. Personal loyalty through a "patron" was an essential condition of the political life of any individual. The individual existence outside of the group was not considered acceptable. The corporatist system required that all individuals were permanently integrated into the hierarchical network of the group. At the same time the group represented part of the support base for the political system.
2. Personal loyalty was demonstrated through protection and support. This constituted a principal element of a

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[138] Rafael Loret de Mola, *Galería del poder* (México: Editorial Océano de México, 1996), 55-65.

[139] Alonso Aguilar Monteverde, *Nuevas realidades, nuevos desafíos, nuevos caminos* (México: Editorial Nuestro Tiempo, 1996), 143-224.

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permanent political relationship. The reluctance to ask for or give personal favors of any type was perceived by the members of the corporatist institutions as an attempt to gain political independence. Consequently, individuals who exercised this reluctance were perceived as not trustworthy.

3. Political linkages were personally non-transferable. These linkages were based on personal trust, were a result of mutual knowledge and understanding, and signified the expectation of maintaining a continued relationship. These linkages were established through implicit or explicit private agreements that were difficult to formalize or generalize. In this way, the rules were informal and implicit, flexible in their application, and particular in their character.

By the end of the 1990s, the relationship between the Mexican state and the corporatist institutions was changing, in particular with regard to the labor unions. This was especially true after the death of Fidel Velásquez in 1998, who had presided as Secretary General of the *Confederación de Trabajadores Mexicanos*-CTM (Confederation of Mexican Workers) since 1941. Among the explanations for this situation is that the relationship between the state and labor unions had been changing since the early 1990s in order to respond to the new

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economic environment that Mexico had been shaping.[140] The corporatist relationship between the state and society in Mexico served as a functional substitute for political democracy and represented the source of legitimacy of the political regime. Rather than political democracy, the Mexican regime offered the citizens a form of "societal democracy," which signified receptivity to demands from the organizations representing different sectors of society. From this perspective, the dismantling of the corporatist structure as a system of social representation cane to represent a strong challenge to the government.[141] This signified a challenge to the way the Mexican political system functioned since the 1930s.

Mexican corporatism faced several challenges throughout its history, including the Tlatelolco riots of 1968.[142] Despite

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[140] Jorge Robles and Luis Angel Gómez, *De la autonomía al corporativismo: memoria cronológica del movimiento obrero mexicano, 1900-1980* (México: El Atajo Ediciones, 1995).

[141] Samuel Schmidt, *Amenaza y oportunidad* (México: Aguilar, 1997), 103-134.

[142] Just prior to the scheduled Olympic games in Mexico City, on October 2, 1968 roughly 5,000 student demonstrators gathered in the Tlatelolco district of Mexico City to protest against the government. Their demands included freedom for political prisoners, the dismissal of the police chief, the disbanding of the anti-riot police, and university autonomy. When the military could not force them to disband, a panic

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these challenges, the stability of the regime was maintained because of a combination of repression and co-optation on the part of the government. However, the challenge that confronted the government in the 1960s and worsened after the crisis of 1982, continued throughout the decade of the 1990s.

The fact that Mexico became a net exporter of capital after 1982 impacted the overall economy and impeded its growth.[143] This was reflected in a decline in the Mexican quality of life involving high inflation and low wages. The corporatist arrangement and control of the unions by the state enabled a situation of wage repression. Another impact of the economic crisis was that the economic resources to which the state directly and indirectly had access declined.

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ensued and many of the protesters were killed. Estimates range from several dozen to 400 deaths related to the incident.

[143] In 1982 after the collapse of international oil prices, Mexican corporatism was unable to address the structural problems of the Mexican economy, which had started to display signs of impending crisis since 1976. The chronic deficit in the foreign trade balance and the inefficient industrial structure required a large infusion of foreign currency, larger than the country could acquire through foreign exports, in order to grow. This situation pushed the country to contract public and private foreign debt, resulting in a situation in which Mexico, a country that in the 1960s had a foreign debt of roughly $5 billion, had by 1988 accumulated a foreign debt of $101 billion. At the time this was among the largest foreign debt burdens in the developing world. As a consequence of the foreign debt during the 1980s, foreign debt service payments represented roughly $14 billion annually.

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The economic depression that began in 1982 provided an opening for a political challenge to the state, particularly with regard to the corporatist model upon which Mexican stability had been based. For this reason, Presidents de la Madrid and Salinas de Gortari began to look for solutions to the problems associated with the economic model. They saw a partial solution in dismantling the old model of growth that was based on producer protection and protection of organized labor. Instead, they instituted a model based on the development of the country's export capacity.

In January 1989, President Salinas ordered the military to imprison the board of the oil union, one of the strongest unions in Mexico, on charges of corruption. This action sent a signal to the unions about President Salinas's commitment to the adoption of neoliberal policies. According to him, the protection of inefficient enterprises and union privilege represented a constraint to the modernization of the Mexican economy. In this context, corporatism represented a constraint on the country's ability to pass from a semi-closed to an open economy because the political structure was inconsistent with the new model of the economy.

Thus, the post-revolutionary political system did not serve the President's aims for a new neoliberal economic model. However, inside the state and the corporatist

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institutions, there were strong sectors that wanted to maintain or postpone the collapse of the corporatist system. These sectors were called the "dinosaurs," which represented the traditional union leaders, regional government leaders, and the old party bureaucrats. Despite the opposition of these sectors, they did not present an alternative to replace the corporatist system with another form of organization that would support the Mexican political model.[144] The transition to the neoliberal economic project in Mexico was associated with the use of the corporatist system as a control mechanism. This mechanism became threatened because of the inability of the state bureaucracy and the PRI to confront the new challenges of the new economic organization with old-style leadership.[145]

Political domination in Mexico was constituted by the state party organized in corporatist form. It was also based on another key element, presidentialism. The presidentialist system in Mexico consisted of absolute power and virtually no societal control over the presidency. It was ideologically

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[144] Ignacio Castillo Mena, *Nueve presidentes civiles en el poder: del carisma desbordante de Alemán a la peligrosa indecisión de Zedillo* (México: EDAMEX, 1996), 105-120.

[145] Lorenzo Meyer, "El corporativismo mexicano en los tiempos del neoliberalismo," in *Estado y sindicatos: crisis de una relación*, comp. Graciela Bensusan and Carlos García (México: Fundación Friedrich Ebert, 1989), 21-29.

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based and had been perpetuated through the legends of the Mexican revolution. The legislative and judiciary system, and the police and military institutions were subordinated parts of the overall structure. All of these elements combined with the requirements of the Mexican economy and guaranteed that the state would reproduce social and political stability.

The corporatist system did not formally incorporate the high-income sectors of Mexican society. However, it worked according to their interests and requirements. The state encouraged them to organize in trade and professional institutions in order to express their economic interests. These institutions were more autonomous than the formal corporatist institutions and were less subordinated to the state. At the same time, they tended to cooperate with the state.

In sum, Mexican corporatism, as an organization that was representative of the interests of society, became an arrangement that supported the authoritarian form of the political system that emerged from the Mexican revolution and extended throughout the 1990s. There were two basic elements of the system: first, a party state that incorporated members of society; and second, presidentialism and the concentration of power around the executive branch. These elements were complemented by legislation, particularly in the areas of

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labor and the agrarian sector, which gave juridical expression to the mechanism of social and political control over the subordinated sectors of society. Also, they were supported by the implementation of social policies that reflected the compromise between the government and the PRI with the sectors of the population that formed the party bases.[146]

The linkage between the Mexican state and society organized in corporatist fashion closed the space for political democracy. The principal source of legitimacy of the post-revolutionary regime in Mexico was based on its capacity to satisfy, even partially, the necessities of the organized sectors in the official party. With regard to labor, corporatist domination was expressed in a specific union type and in a particular legal and collective bargaining mechanism that formalized the relationship between workers and business owners in post-revolutionary Mexico. In this context, the design of the economy was led by the corporatist state without significant participation of societal interests. The policies of the state and their implementation were also a reflection of the corporatist state in which the lack of accountability and transparency were key aspects of the process of economic

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[146] Francisco Suárez Farías, *Elite, tecnocracia y movilidad política en México* (México: Universidad Autónoma Metropolitana-Xochimilco, 1991), 81.

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policy making. This element ultimately led the country to the debt crisis of the 1980s and to the financial crisis of 1994/95, without the participation of the majority of the population. It was these sectors who, in the end, paid the price for the crises.

2. Leadership

The characteristics of the Mexican presidentialist system derived from the Mexican Political Constitution of 1917. The Constitution established that the president is the sole depository of the federal executive power. The citizens directly elect the president for a period of six years without the possibility for re-election. The Constitution also established that the president is the head of the state, the federal public administration, and the armed forces.

According to the Mexican Constitution, Mexico is a republic in which the powers of the state are located in different institutions that are separate from each other.[147] In reality, the institutional and political regime that emerged

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[147] Lorenzo Córdova Vianello, "El sistema presidencial en México: orígenes y razones," in *Ensayos sobre presidencialismo Mexicano*, comp. Miguel Carbonell y Sánchez (México: Editorial Aldus, 1994), 26.

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beginning in 1929 is characterized by a concentration of power in the presidency.[148] Beginning with the political pact of 1929, the functioning of the political system in Mexico required the political actors to adhere to a basic set of rules. Some of these political rules were written in law, but in other cases they existed in informal form. Among the most important characteristics of the Mexican political system were:

First, no presidential re-election. This was the first basic rule of the political pact of 1929, which endured through the decade of the 1990s. Based on this rule, the political system assured that the president remained above any particular interests. In this capacity, the president could be considered the "supreme arbiter" and impartial in any dispute. This rule also meant that during the six years of the presidential term, the president had almost unlimited power in leading the country.

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[148] The 1929 political "pact" was an agreement between caudillos and revolutionary leaders who formulated "rules of the political game" and created its operative mechanisms, including the official party, in order to put the agreement into practice. The fundamental agreements of the system were never put in writing. Nevertheless, they can be deduced from the behavior of the official party and political leaders during this period.

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This rule secured the stability of the political system.[149] For this reason, it was written into the Constitution. Society and political actors largely supported the principle of no presidential re-election. In the Mexican political system, the expectation of political advancement of the members of the different groups was considered to be a right that should be respected by the president and other leaders in power. The no presidential re-election principle opened possibilities for advancement to different political groups of the country. In addition, the president was encouraged to sustain the no re-election rule. By manipulating the expectations of the political groups, the president could secure the loyalty of a large proportion of the political system throughout his tenure as president. This explains why Presidents López Portillo, de la Madrid, and Salinas were able to lead the country and redirect the economy through different policy programs without any significant opposition or difficulty.

Second, the principle of no immediate re-election in all elected positions, at the federal and state levels. As long as the power of the president was consolidated, this rule applied to the broad spectrum of the political system. The function of

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[149] Loret de Mola, *Manos sucias*, 53-70.

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this rule was to avoid the possibility that individuals emerge with political careers independent of the support of the president, and consequently, their loyalties were not compromised with the president. At the federal level, this rule allowed the president to weaken the local political groups and allowed the governors to centralize the political loyalties of different political groups.[150] The no immediate re-election rule imposed at all levels of the political system was an important instrument in concentrating the power of the president.

While the president had incentives to obey this rule, local political groups had reasons to seek to avoid obeying it. There were political groups in several regions of the country that were able to avoid total compliance with the rule. For example, the law prohibited immediate re-election to the same position. However, it did not prohibit immediate election to another position. One individual could be elected first as a local deputy, then as a federal deputy, and later return as local deputy. In between, this individual could be elected as governor, municipal president, or public administrator. This situation was exercised by labor leaders,

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[150] Crespo, *Jaque al rey*, 20-54.

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who in practice became local "caciques" monopolizing political positions.

In this context, it is possible to identify three different types of political career in Mexico.[151] The first is the local political career, which ended with a position as state governor, and along the way the individual was elected to the federal congress and as public administrator at the federal level. The second is the corporatist career. The political career was sustained through participation at the level of labor unions or peasant organizations. This path could culminate with a governorship. The politicians who followed this career path usually attained positions in the local or federal legislature. In other cases, their careers led them to participate in the structure of the official political party of the state in leading positions. Usually individuals following this track did not hold important positions in the federal administration. The third political career track is one that became successful for individuals working in the federal administration seeking a political career after 1970. This was the path followed by most of the Mexican presidents since 1970, and it was also the path of the principal political leaders. The exception to this rule was

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[151] Schmidt, *Amenaza y oportunidad*, 83-134.

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Luis Donaldo Colosio Murrietta, candidate for the PRI who was assassinated in 1994. His political career included federal deputy, senator, national leader of the PRI, and public administrator at the federal level.

Third, the president's right to freely appoint his successor.[152] Originally, this practice was limited and the president was only allowed to appoint his successor through a complex bargaining process with the different political groups of the party in order to generate support for the presidential candidate. The full exercise of this presidential prerogative was a result of the majority approval of the "revolutionary family" through the actions of the president during his six-year term in power. This consensual aspect of the designation of the president's successor was another control mechanism that the political actors of the system exercised over the president. The president's right to freely appoint his successor was an instrument to exercise the power of the president, but it never served as a "blank check" in favor of the president. Under Mexico's political system, a successful succession was the most important objective of the presidential administration, which at the same time was a

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[152] Eliseo Rangel Gaspar, *Debate desde ultratumba* (México: Plaza y Valdes Editores, 1996), 122-174.

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powerful instrument of control that the members of the "revolutionary family" exercise over the president.[153] However, this was one element that permitted the lack of presidential accountability. When the president selected his successor, he was at the same time securing that his actions would not be scrutinized. This was the case of the successions from the administrations of López Portillo and Salinas. Their successors, de la Madrid and Zedillo, did not hold them accountable for the debt crisis and the financial crisis in which their outgoing administrations left the country.[154]

The process of presidential succession did not always proceed successfully. The most significant ruptures within the PRI occurred at the time of the designation of the president's successor. A key example is the origin of the Partido de Acción Nacional (PAN), whose principal leaders broke their affiliation with the PRI in 1939. Another example is the origin of the *Partido de la Revolución Democrática* (PRD),

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[153] Lorenzo Meyer, *Liberalismo autoritario: las contradicciones del sistema político mexicano* (México: Editorial Océano de México, 1995), 84.

[154] José Luis Beraud, "Modernización autoritaria versus modernización integral y participativa," in *México en América*, vol. 1, coord. Carlos J. Maya Ambía (México: Plaza y Valdés Editores, 1998), 291-314.

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which emerged out of the splintering of a group of PRI leaders in the late 1980s.

Fourth, periodic elections. This rule was established in order to legitimize the political power of the PRI with the popular vote and also to consolidate the political party.[155] This rule is an example of how the formal regulations were used not only to achieve democratic legitimacy but also to strengthen the system of informal arrangements in which "shared complicity" brought together all of the political groups under the political institutionality of the country.[156]

Fifth, public power is not shared with individuals or groups outside of the PRI family. This rule established a closed monopoly on political power. It was the basis for the functioning of the political process in Mexico because it secured the mechanism to sustain incentives and guarantee the loyalty of the different factions within the PRI. As long as the monopoly on the access of power was maintained in the hands of the PRI, it had the means to reward or punish any individual or group that was not willing to abide by the

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[155] Eduardo Andrade Sánchez, *La reforma política de 1996 en México* (México: Universidad Nacional Autónoma de México, Instituto de Investigaciones Jurídicas, 1997), 195-236.

[156] Everardo Espino, *La democracia política en México, ¿cómo? ¿para qué?* (México: Joaquín Porrúa Editores, 1994), 17.

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decisions taken by those in power. This fundamental rule of the Mexican political system began to weaken with the economic crisis of 1982, which gave the opposition access to different levels of power, especially at the municipal level in key cities. The weakness became more evident after the crisis of 1994/95, when in 1997 the PRI lost the mayorship in the capital city and the majority in the deputy chamber.[157]

Presidentialism in Mexico operated through the presidential cabinet, an institution that was not formally established in the set of rules of the country but existed in practice. There were four forms of the presidential cabinet.[158] The first form of the presidential cabinet was the one known as the "legal cabinet." This cabinet was comprised of all of the secretaries (ministers), the attorney general at the federal level, and the attorney general of the capital city. The personal secretary of the president and the head of presidential security, the press secretary of the presidency, the chief legal advisor, and the chief of the presidential staff were also present at the meetings of the legal cabinet.

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[157] Julio Hernández López, *Las horas contadas del PRI: la historia real de una disidencia por la democracia* (México: Editorial Grijalbo, 1997).

[158] Jaime Ramírez Garrido, *El gabinete del doctor Zedillo* (México: Grupo Editorial Planeta, 1995).

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The second form of the cabinet was the "extended cabinet," comprised of members of the public administration and key presidential advisors who were not in the legal cabinet. High-ranking officials and the heads of the key state-run entities were also part of this extended cabinet. They included the presidents or directors of the principal state institutions, which totaled approximately 15. They included the general directors of *Petroleos Mexicanos* (PEMEX), the governor of the *Banco de México*, the general director of the *Comisión Federal de la Electricidad* (CFE), the general director of the national railway (*Ferrocarriles Nacionales*), the general director of the *Instituto Mexicano de Seguridad Social*-IMSS (Mexican Social Security Institute), the general director of the *Comisión Nacional de Ciencia y Tecnología*-Conacyt (The National Science and Technology Commission), the general director of *Comisión Nacional de Desarrollo*-Conade (National Development Commission), the general director of *Consejo Nacional para la Cultura y las Artes*-CNCA (National Council for Culture and Arts), the head of the *Procurador Federal del Consumidor* (Consumer Protection Agency), the general director of *Nacional Financiera*-NAFINSA, the general director of Bancomex, the general director of Infonavi, and the general director of Conasupo.

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The third form of cabinet was the presidential cabinet. This was the addition of the legal cabinet and the extended cabinet. Neither the Mexican Constitution nor law mentioned the functioning of this administrative body.

The fourth type of cabinet was the "specialized cabinet," constituted by a small number of members of the public administration and presidential advisors. The specialized cabinet met regularly to evaluate policies and programs with regard to their expertise or areas of specialization. There were clearly defined rules in the presidential agreements that created the specialized cabinets. However, there were few official references to these cabinets.[159]

The Mexican cabinet was an extra-Constitutional institution, because it was not expressed in the Constitution or any law.[160] Even though there was no law that created the cabinets or established their functions, they constituted key elements in Mexican political life and presidential structure. The president decided if and when the cabinet would meet. The agreements or decisions that the cabinet recommended became

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[159] Armando Ruiz Massieu, *El gabinete en México: revisión histórica y propuestas de discusión* (México: Editorial Océano de México, 1996), 133.

[160] Universidad Nacional Autónoma de México, Instituto de Investigaciones Jurídicas, *Diccionario jurídico mexicano*, 6th ed., vol. 4 (México: Editorial Porrúa, 1993), 264.

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orders through presidential decision. The cabinet did not have administrative authority. There had been cases in which the personal secretary of the president or the head of the presidential office called the cabinet, but in those cases it was because the president had given authorization. In and of itself the cabinet did not have power; its only power came from the president and from the disposition that the president gave to the cabinet.

The presidentialist system in Mexico through the 1990s can be summarized as follows: (1) the president was the head of the government; (2) the president was not obligated to create a cabinet; (3) the power to appoint or remove almost all of the government officials was concentrated in the hands of the president. Thus, the political future of key members of the state apparatus was directly under the control of the president; and (4) the Congress did not have control over the president's cabinet. As a result, the president had the discretion to form a cabinet with the individuals upon whom he decided and to give them the level of authority he saw fit.

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3. The State Party

The PRI was founded in 1946 as a reconstitution of the *Partido de la Revolución Mexicana*-PRM (Party of the Mexican Revolution), which itself was a 1938 reconstitution of the *Partido Nacional Revolucionario*-PNR (National Revolutionary Party), founded in 1929 by Plutarco Elías Calles, who was the president of Mexico from 1924 to 1928.

The founding of the PNR was intended to bring together all of the political parties that had been formed during the time of the Mexican Revolution in order to achieve a single organization of national character and to peacefully group together all the members of the political parties and individuals for a peaceful transition of elected power. This was done in order to guard against the risk of a new civil war in Mexico. The PNR was of a constitutionalist, nationalist, peasant, and labor ideology. The party articulated a position against all foreign doctrine.

The PNR party served two important functions: one was ideological, and the other was legislative. The PNR was the first political party to collaborate with the country's public administration in the struggle to develop and maintain a single political ideology. In addition, the PNR disciplined the deputies, including those of the PNR party. The PNR party

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was established as the party of the state, guaranteeing that political mobility would take place through a set of institutions that were endowed with political stability.

In 1938 President Lázaro Cárdenas proposed the creation of a movement with a long-term view. His attention was directed toward a campaign against the foreign petroleum companies, whose expropriation he proposed. The 1938 expropriation won for President Cârdenas the admiration of the worker and peasant movements. This enabled him to integrate these sectors into a new political alliance, the PRM. The party members were organized in the form of sectors: agrarian, labor, military, and popular. There was not a substantial shift in the ideological principles of the PRM over those of its predecessor, the PNR. They remained an amalgamation of the liberal and social thinking of the Mexican Revolution and of Marxist socialism. The difference between the two parties was that the PRM put forth a project of state capitalism that was nationalist, anti-monopoly, and oriented toward agrarian and labor interests.

In this context, the model of import-substitution industrialization was put into practice. The country's policies were oriented toward increased state intervention in the economy with preference for domestic capital. At the same time, the party promised to organize the workers, to whom they

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offered collective work contracts and a larger degree of influence over the decisions of the state. The party also committed to institute social security and to fight for the political, civil, and cultural equality of women.

In 1946 the correlation of forces within the party changed in favor of the business community. After 1946 the military sector was no longer part of the structure of the party, and the power of the labor and agrarian sectors was weakened. The new character of the party became legalized and institutionalized as the PRI (Institutional Revolutionary Party). The name signified not only that the new political body would fight to defend the existing institutions, but it also affirmed that in Mexico the revolution was an institution in charge of the state and its party.

The majority of the ideological concepts of the PRM were eliminated in the newly-constituted PRI. However, the PRI continued with the process of agrarian reform, the struggle to achieve equality for women, and to maintain the economic preeminence of the state. There were also significant organizational changes which, as a whole, tended to concentrate power in the hands of the party leaders, its central committee, and at its head. The result was a decline in power among the assemblies and the party bases.

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The first attempt at reform of the PRI occurred in 1950 in the context of the cold war. The reforms pertained to ideological and structural changes. With regard to the form, the PRI abandoned discourse that could be associated with socialist ideas, such as the class struggle. In its place, the party emphasized references to the organized community at the municipal level, the value of the family, civil rights, and the values of western civilization.

With regard to the party structure, the PRI returned to a system of sectors. The PRI became a party of representatives in which the main leaders chose those who were beneath them and represented them in a personal and organized manner. The party was also based on a system of representative organizations. In the period 1950-77, there were no fundamental changes in the constitution of the PRI. Rather, during this period the party was at the center of the state, which, from this central position, made small left or rightward movements in order to maintain hegemony over the opposition political parties.

At the end of the 1970s the party system was reformed.[161] The legal requirements for registering national parties were modified so that the political parties could participate in

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[161] Meyer, *Liberalismo autoritario*, 111.

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domestic stability and could be politically active by participating in the legislative branch. In this context, in 1978 the PRI modified its statutes, the Declaration of Principles and the Program of Party Action. Although its achievements were limited, the modifications entailed a larger ideological dominance of labor, to define the PRI as a labor party.

Beginning in the late 1980s, the PRI reassumed the discourse of revolutionary nationalism and adopted new causes such as housing, urban reform, university reform, and strengthening the "social sector" of the economy. In this context, beginning in 1986 a movement of internal division arose from within the party that ended with key party leaders leaving the party and forming the *Frente Democrático Nacional*-FDN (National Democratic Front). This party became the *Partido Revolucionario Democrático*-PRD (Democratic Revolutionary Party) in 1989.

This situation, and the advance of the *Partido de Acción Nacional*-PAN (National Action Party) within the context of economic crisis, increasingly provoked the discrediting of the PRI, which was reflected in the elections of 1988. In those elections, for the first time in the party's history, the

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party's electoral position was severely eroded in the share of the presidential vote and in the seats in the Chamber of Deputies. In addition, in the 1988 elections the party received its most severe questioning of the legitimacy of the presidential elections.

Under these circumstances, Carlos Salinas de Gortari, who was elected president in 1988, instituted reforms in the party in order to make the party fit within the new political environment of the country. From that time and with the arrival of Luis Donaldo Colosio to the PRI, the party entered a period of political debate aimed at achieving a restructuring. The reform of the PRI brought about by President Salinas was characterized by internal division. Although the division did not bring about the rupture of the party, it did affect the party's hegemonic political position.

4. Agents

a. Parties

On September 16, 1939 Manuel Gómez Morán, with the support of the Catholic Student Union, founded the *Partido de Acción Nacional*-PAN (National Action Party). The party emerged as opposition to the PRM, the state party, and to the policies

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of President Lázaro Cárdenas, as well as to the Marxist content of the program of the PRM. The party's doctrine was based on the social doctrine of the Catholic Church and defended political and economic liberalism. The PAN considered private initiative to be most vital source of social improvement. For this reason, the PAN put forth the concept of the primacy of the individual over the state. Thus, the PAN felt that it was necessary to fight against those who had turned against the principles of free expression and property rights.

Since this initial position, the PAN evolved over the course of three stages. The first stage coincided with the administration of Manuel Camacho Ávila (1940-46), who began a process of abandoning the socialist orientation of the PRM in order to attract members of the business community. The PAN, which no longer attacked the economic policies of the state, wanted to become the democratic conscience of the country. At the center of the party's goals was to spread the social doctrine of the Catholic Church and constitute itself as an instrument of civic education for the population.

The second stage of the PAN's evolution was during the 1980s. During this stage the party placed emphasis on liberal themes oriented toward members of the business community and the middle classes. They were critical of state intervention

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in the economy, particularly when the economic crisis worsened. As a result of the disagreement of the social groups toward the regime of the PRI, the PAN came to constitute a broad front against the PRI.

The third stage in the party's evolution began at the end of the 1980s. At that time, the party faced three issues. The first of these issues was the growth of the PRD as an important political force under the leadership of Cuauhtémoc Cárdenas. The second pertains to the weakening of the PRI as a hegemonic party because of the declining proportion of votes for PRI candidates. The third issue regards the loss of legitimacy of the administration of Carlos Salinas because of the suggestion of electoral fraud at that time. By that time, the PAN was no longer the only opposition force. The PRD competed with the PRI to attract the electoral votes of the middle classes and the popular sectors. For the PAN this meant that the party had to differentiate itself from the new opposing anti-PRI force.

In 1989 the PRI conceded its first governorship to an opposition party when the PAN candidate, Ernesto Ruffo Appel, was acknowledged as triumphant in the state of Baja California. During the administration of Carlos Salinas, the presence of the PRD, to the left of the PRI on the political spectrum, placed the PAN in an intermediate position. When

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Carlos Salinas assumed the presidency in 1988, the PAN found it fruitless to continue to argue the illegitimacy of the PRI. Instead, the party took advantage of the situation to push the PRI to establish a new relationship with the opposition parties.[162]

Beginning in October 1986, internal divisions within PRI led to the establishment of a movement within the party. It was led by Porfirio Muñoz Ledo, former chairman of the PRI, and Cuauhtémoc Cárdenas, former governor of the state of Michoacán and the son of General Lázaro Cárdenas. The faction was united around their desire for a democratization of the procedure by which candidates were selected, particularly those for the presidential elections. The members of this faction claimed that the government had adopted neoliberal objectives in terms of economic policy and had abandoned the principles of the Mexican Revolution. Thus, in May 1989 the faction split from the PRI and formed the PRD.

The objective of the new party was to restore the historic ideals of the Mexican Revolution, the strength of the

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[162] Jorge Alonso, "Cultura política y partidos en México," in *El estudio de la cultura política en México: (perspectivas disciplinarias y actores políticos)*, comp. Esteban Krotz (México: Consejo Nacional para la Cultura y las Artes (CNCA) and Centro de Investigaciones y Estudios Superiores en Antropología Social (CIESAS), 1996), 187-214.

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constitution, and the legality of the government. The objective of the PRD was to restore the republic based on new institutions in a political culture of liberty, rationality, and tolerance. In the electoral platform presented in November 1994, the PRD suggested the need for change regarding the severe national problems generated by past policies. The policies were said to have resulted in the subordination of Mexico to the international financial system, the expansion of poverty, and inequality and injustice for the majority of Mexicans.

The PRD platform condemned the government for the anti-democratic elements of the electoral process, social organizations, and daily life of the Mexican people. The ideological position of the PRD was expressed in the following objectives: the democratization of the state and society, economic growth with equity, a new social pact, and a new international agenda for the end of the century. The PRD lost the presidential elections in 1994. However, the party presented Cuauhtémoc Cárdenas as candidate for the elections for the mayor of Mexico City, which he won in 1997.

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b. Labor

From the 1970s through the 1990s, roughly 85 percent of the Mexican labor force was unionized under the umbrella of the *Congreso del Trabajo*-CT (Congress of Labor). The CT was comprised of independent unions and labor federations. The *Confederación de Trabajadores Mexicanos*-CTM (Confederation of Mexican Workers) was the main labor organization in the country, which represented 53 percent of the labor in the CT. This organization had a direct relationship with the PRI and represented approximately 85 percent of the Mexican labor force. This institution represented the link between the Mexican workers and the government. It had been used as a mechanism to control the labor force and keep them under the direction of the PRI.

From 1941 through 1998, Fidel Velásquez led the CTM. He was considered to have been one of the most influential political figures in Mexico. Velásquez, 97 when he died, was part of the "dinosaurs" of the PRI, which represented the traditional post-revolutionary branch of the party. Under his leadership, the labor movement served as an instrument of co-optation for the PRI. The CTM was an influential part of the social pact that had maintained stability in Mexico throughout the post-revolutionary period.

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The next-largest union, the *Federación de Sindicatos de Trabajadores al Servicio del Estado*-FSTSE (Federation of Unions of Workers in the Service of the State), represented 19 percent of the labor of the CT. It was followed by the *Confederación Revolucionaria de Obreros y Campesinos*-CROC (Revolutionary Confederation of Workers and Peasants), which had 6 percent of the labor of the CT. The remaining 22 percent of labor represented by the CT were divided among hundreds of smaller unions.

Only the labor unions that were recognized by the government were protected by the labor code. The labor code stipulated that strikes were illegal if the Secretary of Labor and Social Welfare did not authorize them. This left labor with little bargaining power in labor disputes. Also, it said that workers participating in illegal strikes would be subject to government sanctions and fired by their employers.

c. Business

The business sector was constituted by several organizations that exercised their political action through their formal participation in the institutions of the government, individual connections to the PRI, and through their financial contributions to the party. The political

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behavior of the business community was accompanied by the policies of the government that favored their interests. For example, the business community had a close relationship with the Salinas administration. There were five main business organizations in Mexico.[163]

Confederación de Cámaras Nacionales de Comercio-CONCANACO (National Confederation of Chambers of Commerce). This institution was founded in 1917 to group together 46 chambers of commerce that existed in the country that had been formed between 1867 and 1911. The chief aim of the institution was to coordinate the activities of the small and medium-sized businesses. Roughly 250 chambers of commerce were represented.

Confederación de Cámaras de Industria-Concamin (Confederation of Chambers of Industry). Concamin was founded in 1918 to coordinate the activities of the business community and represent them as members of the private sector in dealing with the state. According to Mexican law, Concamin served as an advisory board to the government. The objectives of the institution pertained to the expression or modification of laws and administrative rulings aimed at strengthening

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[163] Matilde Luna, Ricardo Tirado, and Francisco Valdés, "Los empresarios y la política en México, 1982-1986," in *Las empresas y los empresarios en el México contemporáneo*, comp. Ricardo Pozas and Matilde Luna (México: Editorial Grijalbo, 1991), 76-84.

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domestic industry in Mexico. Concamin formed part of the *Consejo Coordinador Empresarial*-CCE (Business Coordinating Council). Approximately 200 chambers of industry and 20 industrial associations were among its members.

Consejo Coordinador Empresarial-CCE (Business Coordinating Council). The council was founded in 1976. It was comprised of the *Asociación Mexicana de Instituciones de Seguros* (Mexican Association of Insurance Institutions), the *Asociación Mexicana de Intermedianas Bursátiles* (Mexican Association of Securities Intermediaries), Concanaco, Concamin, the *Confederación Patronal de la República Mexicana*-COPARMEX (Employers' Confederation of the Mexican Republic), the *Consejo Mexicano de Hombres de Negocio*-CMHN (Mexican Businessmen's Council), and the *Consejo Nacional Agropecuario* (National Agriculture and Livestock Council). In addition, the *Asociación de Banqueros de México* (Mexican Bankers' Association), the *Cámara Nacional de Comercio de la Ciudad de México*-CANACO-MEX (National Chamber of Commerce for Mexico City), and the *Cámara Nacional de la Industria de la Transformación*-Canacintra (National Chamber of Manufacturing Industries) participated as permanent observers. This was the most powerful business organization in Mexico. The objectives

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of the institution were to represent the voice of the business sector, principally in its relations with the government. The CCE was also important because it provided direction for business activity in the country. This was accomplished through sub-groups of the CCE, including the *Centro de Estudios Económicos del Sector Privado* (Center for Economic Studies of the Private Sector), whose main objective was the preservation of free enterprise, and the *Centro de Estudios Sociales*-CES (Center for Social Studies), which aimed to analyze the structure and functioning of the Mexican political system and the ideological tendencies that influenced public opinion.

La Confederación Patronal de la República Mexicana-Coearnex (Employers' Confederation of the Mexican Republic). This organization was founded in 1929 to accomplish the following: to study the social problems associated with relations between owners and workers; to provide both owners and workers with the results of studies conducted by the institution regarding social welfare and progress for both groups; to harmonize relations between labor and owners; and to defend owners' interests. This institution was not subject to the laws that regulated business associations because membership in the organization was free and individual, and the activities of the organization were subject to the law.

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Asociación de Banqueros de México (Mexican Bankers Association). This association was founded as a civil association in 1928. In September 1982, when the banks were nationalized, the association changed its name to the *Asociación Mexicana de Bancos* (Mexican Association of Banks). In October 1994, the original name was restored when reprivatization of the banks was in process.

Centro de Estudios Fiscales y Legislativos-CEFYL (Center for Legislative and Budgetary Studies). This center was comprised of three commissions, studies of the public budget, legislative analysis, and productivity. The objective of the CEFYL was to improve the Mexican legal system in order to protect fundamental rights and social justice.

Consejo Empresarial Mexicano para Asuntos Internacionales-CEMAI (Mexican Business Council for International Affairs). This institution formulated and put in practice the strategic policies that supported foreign trade, coordinated research with foreign and domestic investors, and facilitated the transfer of technology. The organization functioned with 52 committees comprised of members of the Mexican business community and those of other countries.

Centro de Estudios para el Desarrollo Sostenido-Cespedes (Center for the Study of Sustained Development). This center brought together groups dedicated to the study and promotion

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of the Mexican economy and the determination of the costs and benefits of environmentally-friendly economic development.

All of these organizations grouped together the mid to large-sized enterprises of the country. However, because of the diversity of interests among the different enterprises and sectors, their goals and objectives were not clearly defined or represented. The interests of the large enterprises, which were highly concentrated in a few industrial groups and financial institutions, were represented through direct linkages with the highest levels of political decision making in the country. Among this group were the Mexicans who were on the list of the 25 wealthiest individuals of the world published by *Fortune* magazine in the 1990s.

C. Banking and Financial System

1. Institutions

Beginning in the 1950s the banking sector passed through stages of concentration, nationalization, and reprivatization. In 1950, roughly 75 percent of the total financing resources of the country were concentrated in 42 banking institutions. By 1979, only 6 banks controlled this percentage. By the end of the 1970s, a notable aspect of the concentration and

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centralization of capital in the banks was the process of reorganization of its structures that had taken place. The result of this reorganization was the multipurpose banking sector, which concentrated financial resources in a small number of banks.

The participation of Mexican multipurpose banks in the international financial market increased through their obtaining foreign credit. For example, in the period 1970-79 roughly $8 billion flowed into the Mexican industrial sector through the multipurpose banking system. This situation brought to light the relationship between industrial and financial capital in Mexico. The most powerful Mexican business groups had their own bank. For example, the business group *Grupo Alfa* owned Banpaís, *Grupo Ica* owned Banco de Atlántico, and *Grupo Monterrey* owned Banco Serfín.

Another example of the relationship between the banks and the industrial sector in this period is the *Grupo Financiero Banamex-Accival* (Banacci), which was a key shareholder of 10 of the country's 100 largest companies. This shows how the money obtained through the banking system was allocated among the business groups and provides evidence of a blending together of industrial and banking capital. High interest rates, exchange rate instability, and inflation resulted in a domestic financial system that was strongly speculative in

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nature. This situation was a factor in the economic policy decisions taken during the following decade, particularly the nationalization of the banking system and the imposition of exchange controls.

The Mexican private sector was also characterized by a process of centralization of capital in a small number of groups, supported by domestic and foreign financial resources. This process of centralization took place not only in times of crisis but also in times of economic expansion. The process of centralization led to the following pattern: (1) the industrial sector was financed with low-cost financial resources; (2) the private banking sector obtained the largest proportion of its profit from foreign speculative financing; and (3) domestic savings did not increase and was displaced by foreign savings. These elements, together with the fall in the international price of oil in 1981, were the key economic elements behind the crisis of the early 1980s.

At the beginning of the 1980s, despite having an increased presence in the economy, the Mexican state had a reduced capacity to manage the crisis and support production. This was because the decision making process followed by the state was conditioned by the large degree of foreign and domestic indebtedness. The monetary and financial policies of this period reflected a loss of state control over the Mexican

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economy. This was manifested first in the scarcity of dollars and vast exchange rate fluctuations, then in a brief period of a double and triple parallel markets, and finally in the bank nationalization and the imposition of exchange controls.

The bank nationalization conducted by President José López Portillo on September 1, 1982 was not merely a response to capital flight, but also to the process of destabilization that had been underway since the early part of 1982. For the Mexican state, the bank nationalization represented the restoration of its role and force in the economy.[164] As for the private sector, it represented not only the loss of an economic stronghold but also a weakening of the influence of the business community in Mexican economic development. Domestic capital flight out of the country signaled a state of crisis for the country and its government. It also placed pressure on the government to institute rectification, the

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[164] In his last presidential address, López Portillo announced several measures to halt the flight of capital out of Mexico. These included exchange controls and bank nationalization. This decision complicated the process of negotiation in which Mexico had been engaged with the IMF and finally forced the country to sign a letter of intent to adopt a three-year adjustment program. The IMF-sponsored adjustment program was implemented by his successor, Miguel de la Madrid.

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beneficiaries of which would be principally the private sector.[165]

President Miguel de la Madrid, who assumed the presidency in 1982, determined the form of payment through indemnification of the expropriated banks. The indemnification was made by issuing federal government bonds. The bonds were directly and indirectly guaranteed by the state. The bonds were negotiable on the Mexican stock market. A trust was established by the *Banco de México* to issue the bonds and pay indemnification to the previous owners.

In the period 1982-88, the Mexican economy was characterized by economic stagnation accompanied by high inflation and currency speculation. The way that monetary and fiscal policies were employed to confront the crisis affected the goods sector more than the financial sector. The economic stagnation, inflation, and financial speculation resulted in significant transformations in the structure of Mexican markets, with regard to both the origin of national income and its destination and application. This signified the restructuring of the economic power of the different economic groups within the Mexican economy.

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[165] Hernández Rodríguez, *Empresarios, banca y estado*.

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The application of stabilization and adjustment policies recommended by the IMF was justified by the Mexican government as necessary to achieve a new level of macroeconomic stability. During the period 1982-88, policies were applied to reduce credit, liberalize trade, restructure public finances, and set the real exchange rate. As a result of these policies, the state reduced its participation in investment to 30 percent of the country's total investment. Private investment, both domestic and foreign, represented 70 percent of total investment in the country. Another signal of the new role of the state in the economy was the privatization of state-owned enterprises. In 1982 there were 1,155 public enterprises. Throughout the process of privatization, 30 percent of these enterprises were sold to the private sector, 35 percent were liquidated, 18 percent were closed, 10 percent experienced no change, and the rest were transferred to other sectors. By the end of the Salinas administration, there were 213 remaining.[166]

2. Market Behavior

A new economic actor emerged in Mexico in the decade of the 1970s. This new actor was constituted by domestic private

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[166] "Concluye la privatización," *Reforma*, 13 July 1993.

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capital and replaced the domestic bankers who had dominated the economy earlier. The formation of this new group was a result of the evolution of the commercial banking sector. It was linked to industrial groups and came to constitute a financial sector with ties to the goods sector of the Mexican domestic economy. Over the course of the 1970s, significant changes occurred within the power structure of the government. At the same time, there were parallel changes within the business community.

Also beginning in the 1970s, there were significant changes in corporate finance because businesses became increasingly dependent on the flow of foreign financing. The instability that characterized this period was also reflected in private-sector organizations, such as the *Consejo Coordinador Empresarial*-CCE (Business Coordinating Council), which constituted a more aggressive leadership organization of the business sector than its predecessor, the Mexican Bankers Association. Enclaves of economic power within the business community became increasingly relevant, as reflected in the rise in economic power of the *Consejo Mexicano de Hombres de Negocio*-CMHN (Mexican Businessmen's Council), which became one of the most powerful representative institutions of domestic

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capital in Mexico. Financial relationships between business and government that had previously provided financial stability were broken. The domestic capital goods market ceased to grow at a steady rate. The increasing participation of the state in the productive process served to increase capital and intermediate goods imports.

Because the government borrowed heavily on the international market in order to cover the fiscal deficit, sustain the exchange rate, and finance outflows of capital, Mexico's foreign debt increased throughout the 1970s. As a result, the international banks and debt service payments came to constitute key elements in the functioning of the Mexican economy. Similarly, the organization of the commercial banking sector and the other financial institutions was not related to the size of the domestic market. Rather, it depended upon the adequate management of and speculation with financial resources.

In this context, the financial linkages in the country changed, not only between the state and the private sector but also within the private sector itself. However, in contrast to what had occurred in the 1960s, financial relationships did not develop among the new sectors emerging within the private business community and the state. Instead, a linkage developed

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between the Mexican financial sector and the international financial market.

The oil boom provided the state and the businesses community the opportunity to re-establish economic ties. In this context, private economic groups had increasing access to foreign credit with the backing of the state. The private groups diversified, and their economic importance increased. The expansion of the energy sector provided inputs for the growth of state-owned enterprises and enlarged the domestic market. The inflows of foreign currency that resulted from oil revenue during this period enabled private-sector imports to grow rapidly. The government and private organizations contracted a large amount of loans on the international market.

When international oil prices fell after 1980, the country faced capital outflows. A reduced amount of foreign currency inflows placed pressure on the *peso*, which had been stable since 1976. In this context, with expectations for a currency devaluation, private companies and individuals who held liquid assets in national currency tried to exchange them for dollars and deposit them inside or outside of the country.

At this time the *Banco de México*, under free exchange conditions, had to provide foreign currency to all who demanded it. However, the international reserves held by the

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government were insufficient to satisfy the demand for more than $15 billion. For this reason, the government contracted a large amount of short-term loans (with maturity of less than one year) from the international banks. By 1982, there was strong pressure for devaluation. In February, the *peso* was devalued by 65 percent in relation to the dollar.

Decreased access to foreign credit and the pending maturity of short-term obligations that had been contracted in 1981 placed pressure on Mexico's international reserves. Combined with speculation on the currency, this provoked another devaluation. The total currency devaluation for 1982 was more than 500 percent. The sectors holding assets in dollars were able to purchase domestic companies. This provided them with access to a significant portion of Mexican economic activity.

The first effect of the devaluation was an increase in the income and wealth of those who held assets in dollars. The value in *pesos* of the capital outflow increased from 270 billion *pesos* at the beginning of 1981 to 4.7 trillion by the end of 1982. Up until 1980 capital outflows represented approximately 6.5 percent of the GDP. By the end of 1982 they represented almost 50 percent of GDP. The relationship between foreign debt and capital outflows can be seen by the fact that 1981 and 1982 are the years that have the largest degree of

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gross debt, and the most significant outflows of capital occurred also in these years, which represented approximately $20 billion.

The nationalization of the banking system in September 1982, was intended to keep the economic groups that were organized around the banking sector from provoking more financial speculation and capital outflows. Additionally, it was undertaken to protect the economy from the imminent breakdown of the banking system because of the large liabilities of the banking sector. In this context the nationalization of the banking system served as a temporary blow to the sector of the business community that had virtual control over the Mexican economy.

In May 1983 the *Banco de México* (the Central Bank) introduced a plan for a government trust that would assume the foreign exchange rate risk of Mexican companies but would assume no payment risk. This was done in response to the currency devaluation and the resulting inability of companies with dollar-denominated loans to pay their debts. Under the *Fidecomiso para la Cobertura de los Riesgos Cambiarios*-FICORCA (Trust to Cover Foreign Exchange Risk), private interests paid the equivalent of their debt to foreign creditors to the *Banco de México* in *pesos* at a guaranteed exchange rate, and FICORCA paid their foreign creditors in dollars. The creditors, 70

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percent of which were U.S. banks, had to agree to allow the debtors to reschedule their debt in a 6-8 year period (with a 3-4 year grace period).[167]

At the time, the 10 largest industrial groups in Mexico owed half of the $15-18 billion in corporate dollar-denominated debt. The first companies to avail themselves of the program were the Mexican subsidiaries of multinational companies.[168] In the end, roughly 20 large companies received 80 percent of the funding, and FICORCA paid more than $11 billion to foreign creditors. Adding the $10 billion in bank debt, the state paid a total of $21 billion to foreign creditors to cover the foreign debt of the private banking and business community.

The FICORCA program lasted for three years and, according to the government, represented the state's commitment to the business community. The establishment of FICORCA and the nationalization of the banking system halted the breakdown of the banks and large enterprises in Mexico. Instead of going into bankruptcy, a few large firms were able to gain substantial liquidity through FICORCA and were able to avoid

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[167] "A Mañana Plan Saves Companies on the Brink," *Business Week*, 7 November 1983, 61.

[168] William Chislett, "Mexico Concerned Over Private Sector Debt," *Financial Times*, 9 August 1983.

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the effects of the economic depression affecting the country and the subsequent financial problems. In contrast, this was not the case with the majority of domestic businesses, who were not able to avail themselves of the resources of FICORCA.

In the end the beneficiaries of the program were: (1) the large companies that had access to funds through FICORCA; (2) the government because it was able to allocate foreign exchange to other priorities such as imports; and (3) foreign banks, who although not entirely pleased with the arrangement because it meant an extended maturity period and an interest-rate limit, were able to salvage loans upon which they may never otherwise have been able to collect.

The reorganization of the financial sector that took place in 1984-85 was designed to link the pre-nationalization banking groups with the newly-emerging financial groups that had links to the international financial market. There were several additional changes in the mid-1980s, including new banking laws and laws regulating the public credit institutions. There were modifications in the laws pertaining to the stock market.

As a consequence of these changes, there was a change in the way that the public sector financed itself. Where it used

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to finance its operations through government-issued bonds backed up by the required reserves of the banking system, the state started to issue *certificados de la tesorería*-cetes (treasury certificates) on the market through the securities firms.[169] The securities firms, principally owned by the former bankers and some members of the industrial business community, became the new financial leaders of the economic groups of Mexico.

Public financing through *cetes* was made possible because the government increased the interest rate at the time of their issuance in order to make them attractive. The nominal interest rate on national currency went from 48 percent in the first weeks of 1985 to 75 percent at the end of the year. Issues of *cetes* increased. The quantity of *cetes* in circulation went from 700 million to more than 3 billion at the end of 1985. The securities firms and the holders of the cetes reaped the high cost of this type of financing. In both cases, it was the financial groups that survived the bank nationalization and that were the principal beneficiaries of FICORCA. The result of the financial policies in these years was an allocation of wealth similar to the result of the

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[169] Cetes were among the key money-market instruments in Mexico. They were *peso*-denominated certificates with maturities ranging from 14 days to two years.

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policies of 1982. The securities firms and the former bank owners benefited from the policies.

At the end of 1985 parallel financial markets began to emerge within the Mexican economy as alternatives for allocating financial resources.[170] In the context of a contraction of credit and high interest rates, those who had liquid funds began to lend them outside of formal institutional channels at rates lower than the interest rate on loans offered at the banks but higher than the most attractive interest rate on deposits. The amount of money mobilized in the parallel financial market turned the actors in this market into important elements of the restructuring of the financial system.

In September 1982, 90 percent of the assets of 56 banks were expropriated. The process of indemnification was begun in February 1983 with a resolution by the *Comisión Bancaria y de Seguros* (Banking and Securities Commission). The indemnification was based on estimation of the value of the assets according with financial statements as of August 31, 1982. In relation to the shares on the stock market, 50 percent were valued at book value, and 50 percent were valued

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[170] This development coincided with the growth of narcotrafficking and money laundering activity in Mexico.

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at the average of the value of the stock's market value for the previous 12 months.

The Mexican banking system was reorganized as a consequence of the bank nationalization. The 60 banks that existed at the time of the nationalization were put together to form 29 national financial institutions (*sociedades nacionales de crédito*). The banks that were nationalized owned assets in companies in the industrial and commercial sector, and the state sold the banks' assets in those roughly 339 companies because they were not directly related to the financial business.

Out of the 339 companies, the banks held more than 50 percent ownership in roughly 170 companies; between 25 and 50 percent ownership in about 45 companies; and 24 percent ownership in the remaining 124. This reflects the strong influence of the nationalized banks in the private industrial and commercial sector. Of the total number of companies, there were 142 from the industrial sector, 115 from the service sector, 69 non-bank financial intermediaries, and 13 from the construction industry. This shows how the banking system that was nationalized was linked to the industrial and commercial sector. It explains how the bankers provided credit to their

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own companies without following generally-acceptable lending practice standards. For this reason, they were unable to collect on the loans, placing the pre-nationalization banking system on the verge of collapse.

Technically, in terms of ownership, as a consequence of the sale of these assets, the linkage between the banking sector and the industrial and commercial sector was broken. However, because the former owners of the banks were given priority to purchase the assets of the companies that were sold by the state with indemnification bonds, these enterprises were returned to their previous owners.[171] This situation brought about a change in the domestic business environment because the restructuring of new economic and financial groups revitalized financial flows in Mexico and reactivated the stock exchange. The most significant aspect of this reorganization of the economic and business sector was the emergence of new economic groups. This was due to the compensation that the government paid for the bank nationalization and the priority that the previous bank owners were given to repurchase the assets of the companies that were sold by the state. New financial groups formed because the

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[171] These same previous owners became the eventual owners of the banks again during the administration of Salinas de Gortari with the reprivatization process.

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former owners of the banks established new securities firms and investment companies.[172]

For example, Agustín F. Legorreta Chauvet came to lead one of the new industrial groups. He had been one of the owners and the director of the *Banco Nacional de México* (Banamex) and bought the securities firm that had been owned by Banamex, which came to be called INVERLAT. He assumed the presidency of *Seguros America*, an insurance firm. Similarly, Manuel Espinosa Yglesias, who was director of Bancomer, oriented his investments toward the real estate business, tourism, and mining, in which Bancomer previously had companies.

D. Policies

The fall of international oil prices in 1981, the large deficit in Mexico's current account, the failure of the economic stabilization program initiated in 1982, and flight capital from Mexico led to an economic crisis that became evident with the announcement of Mexico's inability to service

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[172] Enrique Cárdenas Sánchez, "Mexico's Private Sector, Then and Now," in *Mexico's Private Sector: Recent History, Future Challenges*, ed. Riordan Roett (Boulder, CO: Lynne Rienner Publishers, 1998), 33-34.

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the foreign debt. This situation occurred within an international context of high interest rates, a reduction in external financing for developing countries, and the beginning of a recessive cycle in the industrialized countries.

The economic crisis and the process of economic destabilization created conflicts among domestic groups in Mexico, which are divided according to coalitions. Among these coalitions were those that supported the adjustment programs advocated by the International Monetary Fund (IMF). This group was comprised of the exporting sectors and of foreign and domestic financial and industrial groups. The sector that opposed the measures of the IMF was comprised principally of labor unions and of the base-level sectors of the political parties and small business community.

The advanced economies agreed to rescue Mexico through a program of financial assistance. Led by the United States, the multipurpose banks, and international financial institutions, including the IMF, the rescue plan allocated additional funds to Mexico through a bailout package that entailed credits on the basis of advance payments for oil and a restructuring of the portfolio of international loans to Mexico. IMF conditions were imposed on Mexico not only with regard to access to IMF

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financing but also with respect to new loans resulting from debt restructuring made by governments and private multipurpose banks. The World Bank imposed a new means of providing credit for structural adjustment parallel to that of the IMF.

The 1982 crisis was perceived by the international financial community as a short-term liquidity crisis.[173] As such, it was met with an emergency rescue package arranged through a group of international banks, which entailed additional financing and a program of short-term restructuring. However, at the root of the crisis was Mexico's dependence on funds that accumulated as foreign debt during the decade of the 1970s. This made Mexico particularly vulnerable to international interest rates, inflation, recessions, and protectionism in the advanced economies in the 1980s.

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[173] In this context, both illiquidity and insolvency refer to the inability of the government to meet current and maturing obligations. The distinction centers on whether the situation is one in which a government is in need of a quick infusion of cash in order to meet current obligations, similar to a firm with a positive net worth that cannot meet its current obligations, or if what is required is a permanent reduction of debt obligations, as would be the case with a firm with a negative net worth. See William R. Cline, *International Debt and the Stability of the World Economy* (Washington, DC: Institute for International Economics, 1983), 45-46.

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On the domestic level, with the presidency of Miguel de la Madrid, the sector of Mexican business that was allied with foreign companies, such as the *Grupo Monterrey*, exercised its political power to exert influence in naming the members of the Cabinet. With the support of the private sector, the technocrats of the *Banco de México* and the *Secretaría de Hacienda y Crédito Público* (Secretariat of Finance and Public Credit), which had been relegated to a minimal role during the administration of Luis Echeverría, gained power in 1981.[174] This was reflected in the fact that 13 of the 18 members of de la Madrid's Cabinet were technocrats with close connections to the private sector. Among this group was Carlos Salinas, Secretary of Budget and Planning under de la Madrid.[175]

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[174] Prior to 1982 the *Banco de México* functioned much as a commercial bank, with the difference that it issued money. It regulated the money supply, reserves, and the interest rate indirectly through open market operations. In 1982 the Mexican Congress approved reforms to the Constitution that made the *Banco de México* a public decentralized institution in order to give it legal status to conduct the monetary policy of the federal government. In March 1994 the government of President Salinas made the *Banco de México* autonomous from the federal government in order to give it more capacity to design the monetary policy of the country. Francisco Borja Martínez, *El Banco de México* (México: Fondo de Cultura Económica, 1996), 105-140.

[175] Carlos Salinas had influence on the policies of Miguel de la Madrid since 1979. He was one of the designers of the *Plan Global de Desarrollo* at the time that Miguel de la Madrid was in the Cabinet. Later when de la Madrid was appointed PRI candidate for the presidency, he named Salinas as director of

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The *Grupo de Monterrey* and other economic groups with ties to the international community and the foreign companies doing business in Mexico increased their power. The crisis interrupted the flow of foreign credit and weakened the financial power of the state to grant subsidies and contracts to business groups with a domestic orientation. In contrast, control over their liquid assets and their linkages to the international market enabled the majority of the enterprises connected to the government, those located principally in the northern part of the country, to overcome the situation of tight credit, take advantage of the *peso* devaluation, and take their money out of the country. The erosion of the traditional relationship between the state and society, the rupture of consensus among the elite, the condition of uncertainty pervasive in Mexico, the lack of confidence in the business sector, and capital flight served to alter the balance of power of the private sector in its relationship with the government.[176]

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the *Instituto de Estudios Politicos, Economicos, y Sociales* in September 1981. Miguel Ángel Granados Chapa *¡Escuche, Carlos Salinas! Una respuesta al villano favorito* (México: Editorial Océano de México, 1996), 65-86.

[176] This was the private sector that benefited from the relationship with the government throughout the period of state-led development and import-substitution industrialization of the 1950s-70s. The 1982 crisis

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As a result, the economic policies of the de la Madrid administration were conditioned by the scarcity of foreign currency and by the influence of the domestic business sector, which had to be persuaded to invest in Mexico, to not send their money out of the country, and to repatriate the money they already had abroad. Furthermore, members of the business sector, principally those of the largest companies, sought to revise the model of state capitalism that Mexico had followed and to drastically reduce the level of government intervention. In this way, one sector of the business community that was linked to international companies had the ability to limit the powers of the president and to guarantee private-sector representation in the decision-making bodies of the government.

Although the World Bank played a key role in the design of certain trade reforms, the Mexican industrial and financial elite, including large-scale export-oriented enterprises, pursued a position that supported currency devaluation, trade liberalization, high interest rates, and limited exchange controls. This position overpowered other commercial sectors that opposed these measures.

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represented the point of collapse of the model and shifted the relationship between the state and the private sector.

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Competing groups within the de la Madrid administration, such as those led by Carlos Salinas, Minister of Budget and Planning, and Jesús Silva Herzog, Minister of Finance and Public Credit, pushed for competing economic policies.[177] As a result, the imposition of reforms was gradual. The government concentrated on adjustment policies, such as postponing economic opening. President de la Madrid was caught in the middle of a fight between the interests that had developed throughout the period of import substitution and the new groups that sought the internationalization of the economy.

The debt crisis in 1982 set off a series of changes in the Mexican economy and politics:

First, an immediate effect of the shortage of foreign currency stemming from the debt crisis was that trade restrictions on imports increased substantially. However, later protectionism was reduced substantially. Import controls were reduced by the replacement of import licenses with a general system of tariffs, which reflected a rapid liberalization. The average tariff fell from 27 percent in 1982 to 11 percent in 1988. The maximum tariff declined from 100 percent in 1985 to 20 percent in 1987.

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[177] Gustavo Petriccioli, from the side of Salinas, eventually replaced Herzog as Minister of Finance. Granados Chapa *¡Escuche, Carlos Salinas!*, 65-86.

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Second, in order for Mexico to appear committed to the free market, President de la Madrid agreed to join the General Agreement on Tariffs and Trade (GATT) in 1985. The large Mexican companies, multinational companies operating in Mexico, and the advanced economies, supported Mexico's joining GATT. However, since 1987 the undervaluation of the real exchange rate of the *peso* and recession in the domestic market represented an additional barrier for Mexico that impeded imports and preserved the imbalance in the current account. The undervaluation of the *peso* made imported goods expensive, even though there was a reduction in tariffs. However, because the degree of *peso* undervaluation decreased and the rate of inflation declined, in 1988 imports grew by significant measure.

Third, President Miguel de la Madrid worked out the FICORCA plan to compensate for the nationalization of the banks in 1982. The plan offered private enterprises funds at a government-subsidized exchange rate so that they could pay off their debts in dollars. The plan enabled the establishment and growth of securities firms able to make various financial transactions in order to modernize the Mexican stock exchange.

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President de la Madrid initiated a program of downsizing the public enterprise sector. As a consequence, by the end of the de la Madrid administration the government had closed or sold many mid and small-sized public enterprises. Among them were the closing of the *Fundidora Monterrey*, a steel mill, the restructuring of the aviation enterprise *Aeroméxico*, and the sale of the *Compañía Minera Cananea*, a copper mining company.

Fourth, another reflection of the reorientation of the Mexican economy was in regard to policies directed toward increasing foreign investment in Mexico. In 1985 President de la Madrid allowed foreign investors to have 100 percent ownership of companies in Mexico and gave subsidies through debt swaps at prices lower than those of the market. Foreign investment in Mexico grew in the period 1980-87 by 200 percent, as a consequence of debt-swap agreements and of the growth of *maquiladora* factories. Incentives for *maquiladora* operations were enhanced by the authorization that the government gave to these enterprises to sell what they produced on the domestic market.

Fifth, the administration of de la Madrid followed a path of monetary and fiscal adjustment, trade liberalization, and non-confrontation with the IMF. This institution assumed a position oriented toward reducing public expenditures and fiscal imbalances. Medium-term structural adjustment

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conditions were included in the agreements established with the IMF. They included policies of rapid trade liberalization, reduction of state involvement in the economy, privatization of state enterprises, increased opening to foreign investment, reductions of public subsidies, and public-sector reform. Mexico's "good performance" as a debtor and the application of the conditions of the IMF enabled Mexico to obtain limited concessions on long-term debt restructuring and low rates of interest. However, the weak negotiating power of Mexico stemming from international and domestic pressures in favor of adjustment was reflected in a strong degree of conditionality for the country.

Sixth, from the end of 1982 to the middle of 1985 government policies were designed with the intention that the agreements with the IMF would improve Mexico's international credit situation and enable a rapid economic recovery.[178] There was a brief reactivation in the period 1984-85. However, the trade deficit increased due to a fall in petroleum prices in

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[178] In December 1982, just after de la Madrid assumed the presidency, the government announced the *Programa Inmediato de Reordenación Económica* (PIRE). It was an austerity plan with the following elements: reduction of public expenditures, credit restrictions, increased tax revenues, import restrictions, price increases of public enterprises, currency devaluation, and re-negotiation of foreign debt. Delgado de Cantú, *México*, 143-180.

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the second half of 1985. As a result, the government instituted a credit freeze and the economy again fell into severe recession.

At the end of 1985, the IMF suspended disbursements to Mexico because of an increase in the fiscal deficit.[179] This provoked a new round of negotiations. As it had in 1982, the fiscal deficit increased as a result of debt service payments and the government's inability to control inflation, stabilize foreign exchange markets, and comply with the objectives of the wage policy of the 1983 stabilization program.

Although the fundamental element of the economic adjustment was for Mexico to re-establish its capacity to service the foreign debt, the adjustment conditions imposed left the country with limited funds available to achieve this goal. The economic adjustment measures forced Mexico to reduce the level of investment. This strained the country's ability to produce and export and thereby hindered Mexico's ability to service the debt. This situation led to reduced growth, deteriorating infrastructure, and worsening social conditions.

Seventh, the consequences of economic adjustment brought about increased political costs for the government of

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[179] Among the key factors behind this increase were payments on the foreign debt.

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President de la Madrid. Between 1985 and 1986 the *Confederación de Trabajadores de México*-CTM (Confederation of Mexican Workers) openly expressed unprecedented criticism of the government's policies. This resulted in labor strikes in the steel, electricity, and telephone sectors.

The nomination of Carlos Salinas de Gortari as presidential candidate for the PRI in October 1987 aggravated tensions within the party.[180] Members of the center and left-wing factions of the party broke with the PRD, supporting Cuauhtémoc Cárdenas as presidential candidate. The consequences of this split were seen in the next elections in which the PRI candidate received 50 percent of the votes, and Cárdenas received 37 percent. This situation constituted a strong setback for the PRI, which was accustomed to obtaining 70-80 percent of the votes. Politically, the PAN continued to gain ground, particularly in the states in the northern part

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[180] Members of the PRI felt that as Minister of Budget and Planning, Carlos Salinas was the architect of the economic policies that had caused the economic turmoil of 1984-85. Salinas held a large degree of power, particularly in the management of the economy, during the de la Madrid administration. This was reflected in two sayings that Salinas was reported to have enjoyed hearing. First, he could not run for the presidency in 1988 because re-election was not allowed. Second, he was not interested in becoming president because it would signify a loss of power. Granados Chapa *¡Escuche, Carlos Salinas!*, 68.

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of the country, with the support of the strongest groups of the business community in this region.

E. Conclusion

In the early 1960s most of Mexican debt was in the form of multilateral loans provided by institutions like the World Bank and the Inter-American Development Bank (IDB). The loans were characterized by lower interest rates than the market rate and long maturities. The loans were contracted in order to improve the infrastructure of the key economic sectors of the country, including electricity, telephones, roads, and bridges. Loans from the International Monetary Fund (IMF) were mainly to achieve financial stability. In 1964 Mexican foreign debt was approximately $2.3 billion.

Beginning in 1970, the Mexican foreign debt increased dramatically. In 1970, the foreign debt was $6 billion; in 1974, $14 billion; and in 1980, $51 billion, which represented 30.5 percent of the GNP. This increase of the Mexican foreign debt coincided with a highly liquid international financial market due to the recycling of petrodollars and a prolonged economic recession in Europe. Since the 1970s, the Mexican economy supported an increase in the size of the public sector, especially the state-owned enterprises, which

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contracted loans on the international market on a large scale. These loans were not only contracted with the traditional suppliers of capital, the international financial institutions, but they were also made with private banks, particularly those from the United States, Europe, and Japan. These private banks competed among each other to allocate loans in the Mexican economy. For example, *Petróleos Mexicanos* (PEMEX), the main state-owned company in the oil sector, had contracted foreign loans in 1970 for $367 million. By the end of 1981, PEMEX had outstanding loans totaling $11 billion. Similarly, the *Comisión Federal de Electricidad* (CFE), the main institution of the state-owned electricity system, had outstanding loans in the amount of $990 million in 1970. In 1981, CFE had loans outstanding in the amount of $8.2 billion. Similarly, the state financial sector contracted a significant amount of loans from 1970-81. In 1981 *Nacional Financiera Sociedad Anónima* (NAFINSA), *Banco Nacional de Obras y Servicios Públicos* (BANOBRAS), the *Banco Nacional de Comercio Exterior*, and the *Banco de Crédito Rural*, together had $10 billion in foreign loans, of which roughly $8 billion were short-term obligations. From 1970 until 1981, 70 percent of the foreign debt was contracted by the state. The other 30 percent was contracted by the private sector; most of the loans were guaranteed by the state. For example, the

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industrial group *Grupo Alfa* contracted loans for $1 billion from 1970-81 and ended in bankruptcy.

Through the early 1980s, the government did not enact policies that displayed recognition of the potential impact that the foreign debt could play in the country's financial situation. In this context, when the U.S. Federal Reserve raised interest rates in the early 1980s, Mexico was unable to meet short-term obligations. In August 1982, President José López Portillo y Pacheco (1976-1982) declared that Mexico was enacting a temporary suspension of its foreign debt service payments. At that time, the total debt outstanding was roughly $86 billion, which represented 52.5 percent of the GNP.

This large amount of foreign debt, which ultimately led Mexico into crisis, was made possible because of the conjuncture of the three elements mentioned above. The first is the configuration of the economy. The economic system was based on a big state that participated in the most important activities of the economy and determined the outcome of the economy overall. The state-owned companies financed their inefficiency with the public budget. At the same time, the private sector overprotected the domestic market by imposing high tariffs.

The second element of the crisis was the lack of accountability on the part of the state. The citizens did not

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have channels of participation in the decision making process, and the political institutions did not function to represent the interests of their constituencies. Rather, the interests of the political and societal institutions were subordinated to the political exigencies of the president and the federal government.

The third element was the characteristics of the economic policies followed during the administrations of Presidents Luis Echeverría Álvarez (1970-1976) and López Portillo (1976-1982), which were enticed by the abundance of capital in the international market. Their administrations pursued policies that led the country into a vicious circle of contracting loans in order to pay loans.

The aftermath of the crisis involved controversial government decisions, such as the nationalization of the banking system in September 1982. The nationalization had repercussions on the overall political and economic environment and structure of the country.

The resolution to the crisis entailed the corroboration of three actors, the U.S. Treasury, the international financial institutions, and the private banks. The rescue package allowed Mexico to overcome the crisis. However, the resolution resulted in economic recession, high inflation, a

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decline of real wages, and an increase in the overall foreign debt.

From 1982 to 1988, during the administration of President Miguel de la Madrid Hurtado (1982-1988), Mexico negotiated the refinancing of its foreign debt through the Brady Plan. During this time period the state began the process of reprivatizing the banking sector. This process started in December 1982, when the government returned 30 percent of the ownership of the nationalized banks to their original owners. The other 70 percent remained in the hands of the state. At this time, the government authorized the creation of new financial institutions, such as the securities firms and financial leasing companies. In practice these institutions came to constitute a parallel banking system. Thus, even though the banks remained in large part in the hands of the state, parallel activities were taking place in the banking sector. These new institutions came to play a key role in the new correlation of power between the government and the private financial sector. Prominent members of this new financial sector were also predominant in the political sphere. For example, Eduardo Legoretta, one of the owners of the *Operadora de Bolsa* (Obsa), was at the same time a leading member of the *Comisión de Financiamiento y Consolidación Patrimonial del*

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PRI, which raised approximately 13 million *pesos* for the campaign of Carlos Salinas de Gortari in 1987.

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CHAPTER V

NEW POLICIES AND "EMERGING MARKET FAILURE"

A. Launch of the Emerging Market

In Latin America, after the Mexican debt moratorium in 1982 the supply of private foreign funds declined and the cost of servicing the existing debt increased substantially due to an increase in the international interest rate. Most countries were forced to curb domestic demand in order to achieve domestic financial and external balance. After unsuccessfully applying heterodox approaches, most Latin American countries adopted the neoliberal policies that involved a return to orthodox fiscal and monetary restraint, modest levels of domestic demand, privatization, and reopening of the economy to international trade. These policies represented a dramatic shift away from the previously-employed import-substitution industrialization strategy, which relied heavily on government

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intervention in the economy to achieve growth and industrialization.[181]

Mexico became one of the leaders in neoliberal economic reform in Latin America after the debt crisis. The market-oriented economic program implemented by President Miguel de la Madrid and his economic advisors was based on macroeconomic stabilization and structural adjustment. From December 1982 through the first half of the decade, economic policy addressed price stabilization and relied heavily on fiscal and monetary retrenchment. In the middle of the decade, the program advanced toward structural adjustment, particularly in the area of foreign trade. Advances were made along with efforts to mitigate the recessionary effects of orthodox stabilization measures. From the end of the decade through the early 1990s, the government's economic program incorporated both fiscal discipline and income policy components. It was directed at lowering inflation through a combination of wage and price controls, an exchange-rate freeze, and tight fiscal and monetary policy.[182] This was made possible through an

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[181] United Nations Conference on Trade and Development (UNCTAD), *Trade and Development Report, 1995* (Geneva: UNCTAD, 1995), 73.

[182] Jaime Ros, "On the Political Economy of Market and State Reform in Mexico," in *Democracy, Markets, and Structural Reform*, 298.

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agreement with official leaders of labor, peasant, and business sectors to restrain wages and prices called the Pact.[183] The Pact was successful in the late 1980s in achieving its targets. Annual inflation fell from 160 percent in 1987 to 20 percent in 1989. This decline in inflation took place without a deepening of the contraction of labor's real earnings.[184] In addition, there was a decisive move toward trade opening. This last phase of the program was also characterized by the deepening of privatization and deregulation. Throughout these phases, successive administrations controlled inflation, liberalized trade, deregulated, and privatized most state firms.[185]

In 1989 the Brady Plan was made with the United States to restructure the $52.7 billion debt Mexico owed to commercial creditors. The principal accomplishment of this plan was not

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[183] The *Pacto de Solidaridad Económica*-PSE (Economic Solidarity Pact) was established with leaders of the labor, peasant, and business sectors in 1987. Under the Salinas administration, the pact was renamed the *Pacto para la Estabilidad y el Crecimiento Económico*-PECE (Pact for Economic Stability and Growth). The pact was not renewed in 1995, but a new agreement was formed with the labor and business sectors, the *Alianza para la Recuperación Económica*-APRE (Alliance for Economic Recovery).

[184] Ros, "Political Economy," 306.

[185] Schneider, "Big Business," 191.

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providing relief in terms of international debt service. What it did achieve was a dramatic decline in Mexican interest rates and a rapid increase in private investment and repatriation of flight capital. By impacting uncertainty on the part of investors, the Brady plan resulted in a 16 percent reduction in the interest rate, attributable to the currency risk premium, and a 4 percent reduction due to general country risk.[186]

Under the administration of Carlos Salinas de Gortari, policies were introduced to stop holding domestic demand below output, tighten tax collection, broaden the tax base, and reduce marginal tax rates. Between 1989 and 1992 the number of taxpayers increased by 45 percent. The economy went from a public sector deficit of 9 percent of GDP in 1988 to a surplus of 2 percent of GDP in 1992.

The economic policy program followed most of the policy prescriptions outlined in the Washington Consensus. State-owned enterprises were privatized, regulations on foreign investment were loosened, the currency was stabilized, trade was liberalized, prices of goods were deregulated, import

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[186] Ibid., 199.

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barriers were reduced, the banking system was reprivatized,[187] and free-trade agreements like NAFTA were pursued.[188]

1. New Paradigm

Beginning in 1989, the Salinas administration undertook the implementation of a new policy designed to achieve macroeconomic balance under the paradigm of neoliberalism. One of the key characteristics of this new policy was a freezing of the exchange rate.[189] Under the reform plan, the state set the prices of public utility services. The Pact allowed the

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[187] From June 1991 through July 1992, the government sold its 18 banks. The government used the revenues to reduce the public debt that was left over from the 1980s. After the reprivatization, the banking system consisted of 20 commercial banks taking deposits and lending in Mexico. Market power was highly concentrated among them; the three largest accounted for roughly 60 percent of all Mexican bank assets. William Gruben and John H. Welch, "Distortions and Resolutions in Mexico's Financial System," in *Changing Structure of Mexico: Political, Social, and Economic Prospects*, ed. Laura Randall (Armonk, NY: M.E. Sharpe, 1996), 66.

[188] However, by 1994 the currency was overvalued. Trade and current account deficits were increasing. Real interest rates were maintained at high levels in order to ensure external inflows of short-term portfolio investment to cover the current account deficit. A large amount of dollar-indexed bonds (*tesobonos*) were issued. By 1995, total external debt reached $166 billion, up from a $112 billion in 1992.

[189] Salinas's exchange rate policy took the *peso* from a situation of undervaluation in relation to the dollar to one of overvaluation in relation to the dollar.

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government to institute a freeze on real wages, under the agreement that they would renegotiate wages yearly. Similarly, the private sector made an agreement with the government with regard to price increases.

The new policy also entailed financial sector reforms. The reforms involved deregulation, liberalization, and privatization. Financial sector reforms represented the Salinas administration's attempt to overcome the problems that stemmed from the debt crisis. The reform objective was to consolidate a new economic model and to enhance Mexico's international competitiveness through the promotion of savings and investment. The Salinas administration's financial reforms were based on the following: (1) a change in the form of bank operation and in interest rate determination; (2) the re-negotiation, restructuring, and reduction of the foreign and domestic public debt; (3) a change in the financial-sector regulations and laws, which entailed creating new institutions and reforming existing ones; and (4) the promotion of a gradual opening of the domestic financial sector to international competition.

In this context of financial-sector reforms, the government enacted several economic policies designed to attract domestic savings. The government liberalized the interest rate and eliminated all of the restrictions on

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financial intermediaries for establishing the interest rates on deposits. In addition, the government authorized new instruments to attract savings in national currency, including bank bonds and special accounts.

The government authorized the attraction of savings in dollars and the collection of promissory notes in dollars. Required credit quotas were eliminated for certain sectors of the economy, and banks were authorized to freely assign their resources according to their own interests. In addition, the banks were permitted to establish the interest rate on loans according to market conditions. The required reserve was substituted for a liquidity coefficient of 30 percent of deposits. Rules to qualify the portfolio of the banks were introduced, setting preventive reserves and rules to qualify the commercial banks.[190]

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[190] Francisco Gil Díaz, former Vice Governor of the *Banco de México*, said that prior to the 1994 crisis there were no reserve requirements on banks. The *Banco de México*'s position on this was that setting a reserve requirement would serve as a "tax" on the banks and put foreign banks at an advantage in relation to domestic banks. In March 1995 they established a "0" reserve requirement, meaning that banks have to average "0" at the end of a 28-day period, but they do not have to have "0" at the end of every day. According to him, this gives banks greater flexibility. Francisco Gil Díaz, speech on Designing Macroeconomic Strategies and the Bank of Mexico, October 1997, Harvard University, Kennedy School of Government.

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The re-negotiation and restructuring of the foreign and domestic debt affected financial flows between Mexico and the international financial system as well as among different sectors of the economy. The successful re-negotiation of the foreign debt generated confidence among international investors and made possible the return of international capital to Mexico. The government was able to substantially reduce domestic debt by using resources obtained from the privatization of state-owned enterprises. Additional factors, including a slowdown in domestic inflation, a decrease in interest rates, and a decline in the demand for money, also contributed to a reduction of the domestic debt.

The length of maturity of the public debt increased to an average of one year by the beginning of the 1990s. The reduction and restructuring of the domestic public debt freed up resources. It also brought about a change in the relationship between the total financing of the commercial banks and the public sector in favor of the private sector, which had more resources from the overall financial system. The new policy measures lengthened the maturity of the public debt. In addition, the reduction and restructuring of the public debt enabled a change in the market for government securities, due to the budgetary surplus position of the government. As a consequence, the government began to use the

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market for government securities to regulate the money supply through open market operations.

The government liberalized the stock market and opened it up to foreign investment. This liberalization process was one aspect of Mexican economic integration into the global financial market.[191] In the context of stock market liberalization, the government passed the *Ley de Agrupaciones Financieras* (Financial Groups Law), which authorized the formation of "financial groups" and established the conditions for their formation. In accordance with the legislation, two kinds of financial groups were established. The first was led by a *sociedad nacional de crédito* (national credit society) and was composed of financial leasing companies, factoring companies, general deposit warehouses, and investment companies. The second was headed by a securities firm and composed of financial leasing companies, factoring companies, general deposit warehouses, investment companies, insurance companies, bonding companies, managing companies of investment companies, other authorized financial service companies, and

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[191] The liberalization of the Mexican stock market occurred in May 1989. This was earlier than other countries, such as Taiwan, South Korea, the Philippines, and Argentina, which liberalized their stock markets between 1989-92. International Monetary Fund, Policy Development and Review Department, *Private Market Financing for Developing Countries* (Washington, DC: International Monetary Fund, 1995).

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holding companies. The government later modified the legislation to include financial intermediaries and give the securities firms the possibility to lead a financial group. Thus, three forms of financial groups were established: the first led by a holding company, the second headed by a bank, and the third led by a securities firm. In 1990 the Mexican Congress passed a constitutional reform to authorize the privatization of the 18 existing banks under the supervision of a board formed by the *Secretaría de Hacienda y Crédito Público* (Secretariat of Finance and Public Credit).

The negotiation of the free trade agreement with the United States and Canada ended Mexican protectionism of the domestic financial market. As a result, the means of operating and competing within the domestic financial market were changed. These changes held significant implications for the Mexican financial sector and for the rest of the economy.

The reforms implemented by the Salinas administration reshaped the Mexican financial system primarily in the following ways. First, the Mexican business sector became segmented with regard to access to the Mexican financial market and the international financial market. Company size, branch of economic activity, and linkage to domestic and international financial agents were the three elements that determined segmentation. This segmentation signified important

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differences in the costs, quantities, and conditions of financial services. Those who had access to both domestic and international markets were in a more favorable position than those with access only to domestic financial markets. Thus, a small group of Mexican companies had access to the most favorable sources of financing. As a result, they were able to restructure and gain competitive positions to internationalize their operations, principally through export activity.

The principal domestic financial economic groups were among them. They were able to tap into the resources of the international financial market and enhance their operations in the domestic market. The Mexican government was also among this group. It issued bonds internationally through public enterprises in order to finance its investments and also to finance the small and mid-sized private Mexican companies.

The large majority of Mexican businesses and domestic consumers was in the other group, with access only to the domestic financial market that was characterized by protectionist conditions and limited competition. This segment of financial market consumers was subject to high costs for financial services in comparison with those who had access to international resources. This situation impacted negatively upon the competitiveness of Mexican companies domestically and the efficiency of the Mexican economy overall.

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Despite the liberalization of the financial system, there were a limited number of private financial agents. Banamex and Bancomer maintained their positions at the top of the Mexican financial structure. These two financial institutions had held powerful positions in the Mexican financial system for over 40 years. Their economic power increased as a result of financial sector reforms because they became formally integrated into financial groups together with the largest securities firms, including *Acciones y Valores* (Accival) and *Operadora de Bolsa* (Obsa).

The financial groups that emerged at the time of the reforms did not make significant progress toward becoming universal banks. On the contrary, in most cases, the conflict of culture among the different segments of the banking system and the securities firms impacted negatively on efficiency and competitiveness within the Mexican financial system. Even though the government authorized the opening of new commercial banks and financial institutions beginning in 1993, this did not result in a notable increase in the supply of financial services.[192]

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[192] In the period 1993-94, 17 new commercial banks were approved. In the same period, the entry of 18 foreign bank subsidiaries was authorized. In addition, foreign financing companies were approved. In 1995 two foreign financial groups,

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In this period policy makers had a certain degree of room for maneuver because of a surplus in the trade balance and current account and an increase in international reserves. Economic policy was aimed at controlling inflation and promoting efficiency in the productive sector. By eliminating public expenditure in the central government and state-owned enterprises, the fiscal deficit was reduced. The restoration of economic growth served to increase the productive sector's need for imports. This increase in imports provoked new current account imbalances.[193]

The average tariff was reduced from 29 to 10 percent and import licenses, which had been required for almost all products, were only required for 5 percent of total imports. Price controls and standards on products were reduced or eliminated. The limits on ownership in petrochemicals, finance, and manufacturing sectors were diminished. Automobile, computer, and pharmaceutical sectors were liberalized.

By this point, 924 of the 1,155 state-owned enterprises had been sold, merged, or closed. Privatizations included

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Citibank (USA) and Santander (Spain) began operating in Mexico.

[193] International Monetary Fund, *International Financial Statistics Yearbook, 1997* (Washington, DC: IMF, 1997).

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Teléfonos de México, whose sale constituted a historical event among the state-owned enterprises of Latin America. Among the key privatizations were 18 multipurpose banks, 2 national airlines, and the selling of an important share of the government in industries such as food processing, fishing, automotive products, textiles, petrochemicals, paper, and construction materials. In the agrarian sector, land ownership was reformed in order to promote the capitalization of the agricultural sector, principally in areas in which subsistence agriculture was predominant. In this period the NAFTA agreement was signed with the United States and Canada.

From the political perspective, economic reform in Mexico was supported by the Pact between the labor, peasant, and business sectors. In the short term, the Pact enabled Mexico to reduce inflation and achieve macroeconomic balance. However, the currency was overvalued, making Mexican exports less competitive and encouraging large quantities of imports of goods and services from abroad. The transformation of the Mexican economy reduced the government's room for maneuver with respect to the international community, principally with regard to Mexico's main trade partner, the United States. The rapid opening of the economy and the reduction of the size of the state impacted Mexican domestic industry and generated millions of lost jobs. The openness did not create enough jobs

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to satisfy the demand for employment of the growing Mexican labor force.

From 1987 to the end of 1994, Mexico's foreign debt increased by 28 percent, from $109 billion to $140 billion, the second largest in Latin America after Brazil. In 1994, Mexico's current account deficit was $29.4 billion, the largest in Latin America. The deficit was equivalent to three times Brazil's trade deficit and ten times the trade deficit of all the countries of Central America.

In December 1994, Mexico was once again unable to pay the service on its foreign debt because international reserves were exhausted. This highlights the similarity between the 1982 crisis and the one that occurred in 1994/95. However, in 1982, even though the Mexican economy was centered on petroleum income, the country did not depend to a large degree on imported inputs in order to maintain export production as it did in 1994. In 1982 Mexico possessed 1,155 state-owned enterprises, which were bargaining chips in negotiations with foreign creditors. In 1995 it no longer had most of these enterprises. In 1982 Mexico had a lower level of debt than in 1994. In 1995 in order for Mexico to enlist the support of the United States for the bailout package, it had to guarantee all of its oil revenues.

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The government of President Salinas had been operating under several assumptions for the future that had to be dramatically modified after the devaluation of December 1994: (1) after several years of economic adjustment, there would be economic growth; (2) after the economic opening and Mexico's inclusion in NAFTA, the benefits of liberalization would trickle down to include the majority of the people; (3) after this had occurred, there would be political reform to lead the country to democratic transition.[194] However, these assumptions did not hold true. Despite the successful early years of the Salinas administration and the incorporation of Mexico into NAFTA, macroeconomic balance ended in 1994, signaling the beginning of a new economic crisis and social conflict.[195]

In sum, there were significant reforms enacted in the Mexican economy beginning in 1989, and the state retreated from ownership of banks and financial intermediaries and control over interest rates and financial resource allocation in the economy. However, despite these reforms, the general

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[194] Macario Schettino, *El TLC, Tratado de Libre Comercio: qué es y cómo nos afecta* (México: Grupo Editorial Iberoamérica, 1994).

[195] Eduardo Margáin, *Los intereses, el poder y la distribución del ingreso en relaciones internacionales altamente asimétricas: el Tratado de Libre Comercio y la crisis del neoliberalismo mexicano* (México: Universidad Nacional Autónoma de México, 1995), 175-202.

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conditions of market inefficiency, including protectionism and oligopolistic structure, persisted. As a result, a new form of market segmentation emerged that separated those with access to the international financial market from those with access only to the domestic market.

2. Reshaping the Financial System

Changes were instituted that transformed the Mexican financial and banking system. The first stage in this transformation began in 1983 under the administration of Miguel de la Madrid. The banking intermediaries were either liquidated or merged with others in order to improve the functioning of the system. Out of a total of 60 institutions, 11 were liquidated, and 20 were merged. At the end of this process, there were 29 banking institutions left. Also during this stage, new regulatory measures were approved that would operate as new financial institutions called *sociedades nacionales de crédito* (national credit societies).

The second stage, which began in 1985, also took place under the de la Madrid administration. It constituted a period of restructuring. During this phase, the number of

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institutions was reduced to 19. The third stage in this process began in 1988 under the Salinas administration. During this phase, the number of institutions was reduced to 18 due to the merging of Serfin Bank and the *Banco de Crédito Mexicano* (Bank of Mexican Credit). The multi-regional and regional national banks emerged. Also in this stage, the financial system was liberalized.

The transformation of the banking system that was initiated in the period 1983-88 had the following characteristics.

1. The traditional development financing conditions based largely on domestic savings disappeared.[196] Mexico became a net exporter of capital despite the high interest rates that were imposed by the private international creditors. Service on the foreign debt in these years signified an average annual net transfer of approximately 7 percent of GDP. This outflow of capital included short-term capital of about 40 percent of the total foreign debt.[197]

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[196] This was a key constraint on the Mexican economy. It represents one of the main elements of the link between the crises of 1982 and 1994/95.

[197] Celso Garrido and Enrique Quintana, *Las finanzas de la crisis en Mexico en la decada de los 1980s* (México: Universidad Autónoma de México, 1990).

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2. The transformation undergone since the bank nationalization brought about a process of change in the ownership structure of the non-bank financial intermediaries. Although in the beginning they were maintained as part of the nationalized banking system, they were later sold to the private sector. This was the case principally with the securities firms. These circumstances led to the development of a powerful financial securities intermediary system. This was because the owners of the securities firms joined together to form new business groups.[198] During the 1980s these institutions attracted a large volume of resources, especially after the U.S. stock market crash of 1987. However, the stock market continued to be a short-term placement market in which third-party transactions dominated. The growth of the securities intermediaries gave way to a process of financial intermediation that competed with the banking system. There was a point at which the dividing lines between the functions of the securities

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[198] According to Francisco Gil Díaz, former Vice Governor of the *Banco de México*, all of the problems that resulted in the crisis stemmed from inadequate supervision of the banking system: having sold the banks to undesirable individuals; inadequate capitalization; and not recognizing that credit growth was too quick. Francisco Gil Díaz, speech on Designing Macroeconomic Strategies and the Bank of Mexico, October 1997, Harvard University, Kennedy School of Government.

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intermediaries and the banks became blurred. This occurred when the main activities of the traditional banks were taken over by the emergence of the investment banks. The management of third-party resources with attractive rates and terms turned the investment banks into a legitimate source of competition for the banks. Since 1988 the funds they attracted increased well beyond those drawn by traditional institutions. The investment banks' regular activities were the same or more advanced than the traditional banks. They operated through the short-term money market with terms of 8, 15, and 30 days.

3. The financial system came to be comprised of a variety of institutions that enabled businesses to increase their profits through investment. At the same time, the institutions discouraged capital flight and stimulated the placement of public debt on the national stock market. The multipurpose banking system suffered a 100 percent increase in the reserve requirement. Thus, the banks came to represent a way to transfer resources toward fiscal ends. The absorption of funds attracted through the multipurpose banks to finance the public debt came to represent a larger amount than the public foreign debt.
4. As a result of transformations in the structure and functions of the financial sector, the Mexican public

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sector adopted a strongly debt-oriented position. Members of the private sector, in particular those with the highest degree of economic power, positioned themselves as creditors in the financial market. The most significant effect was that the diversification of the investments in various spheres of Mexican economic activity, principally in financial activity, dispersed the opportunity for profit across the financial and banking system. The process of integration between productive and financial activities generated new economic groups that were more powerful and structured than those that had existed prior to the 1982 crisis.

In May 1990 President Salinas sent to the Congress an initiative to reform Articles 28 and 123 of the Constitution, which pertain to banking legislation. The votes of the deputies from the PRI and PAN gave the two-thirds necessary to approve the initiative. Although some deputies expressed fear that the reprivatization would result in an oligopolistic banking structure or one where economic power is concentrated in small groups, the two-thirds vote ensured that the President did not have to make any concessions.

The *Ley del Servicio Público de Banca y Crédito* (Public Service Law of Bank and Credit), established during the administration of López Portillo, which determined state

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ownership of most of the financial institutions of the country, initially prevented the reprivatization of the banks. This law was reformed in July 1990 by the Congress with the support of PRI and PAN deputies. This made the reprivatization of the banking system possible and opened the doors for a flexible multipurpose banking system. According to this law, the banking system no longer constituted a public service and became an activity in which any private individual or entity could operate with the authorization of the government.

The *Ley del Servicio Público de Banca y Crédito* permitted the participation of foreign capital up to 30 percent of Series C shares with voting rights. Similarly, the law established for the first time in Mexico that financial groups could simultaneously operate a bank, a securities firm, an insurance company, a factoring company, a foreign exchange firm, a bonding company, and an investment company. According to the new law, all financial services could be concentrated in the hands of one group or constitute the property of a single economic group.

The law gave preference to the owners of securities firms over other investment groups to act in the banking system. This was because of regulatory measures that made it easier to own a bank if one already owned a financial group. For this reason, the main securities firms presented the best proposals

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in the process of privatization of the banks. As a result, of all of the banks privatized, only Bancrecer, *Banco de Cédulas Hipotecárias*, and *Banco Mercantíl del Norte* were acquired by industrial groups that were not directly linked to any securities firms. Those banks were bought by the Alcántara Group, the Cabal Group, and the Mazeca Group, respectively.

A September 1990 presidential decree authorized constitutional reforms that gave way to a process of reprivatization of the multipurpose banks through the Committee of Bank Disincorporation, which established the bases and criteria on which recommendations and proposals could be made to the authorities. Among the criteria followed by the Committee were the following: (1) to build a more efficient and competitive financial system; (2) to guarantee diversified and pluralistic participation in ownership, with the objective of advancing investment in the banking sector and impeding concentration; (3) to link ethical behavior in the administration of the banks with an adequate level of capitalization; (4) to guarantee that the Mexican banks would be controlled by Mexican nationals; (5) to seek decentralization and regional distribution of the institutions; (6) to obtain a fair price for the institutions in accordance with valuation based on objective criteria; (7)

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to build a balanced financial system; and (8) to engage in sound banking practices.[199]

In September 1990, the Secretariat of Finance and Public Credit announced the procedure for registration and authorization of those interested in acquiring shares of stock in the multipurpose banking system, at the time owned by the government. Thus, the Salinas administration provided the initiative for the reversal of the previous decade's process of nationalization and began a process of reprivatization of the banking system.

However, this process was criticized because even in the *Plan Nacional de Desarrollo* (National Development Plan) of 1989-94 it says that according to Article 28 of the Constitution, banks are strategic areas and should be maintained as the property and under the control of the state. The multipurpose banks were not running deficits. On the contrary, during the period 1982-89 the banking sector showed a high degree of profitability. For example, in the period 1983-89, gross profits increased by 105.5 percent. Net profits increased by 188 percent over the same period.[200]

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[199] *Diario Oficial de la Federación* (México), 6 September 1990.

[200] "El sistema bancario mexicano," *Comercio Exterior* (México), supplement, February 1991.

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Similarly, the capitalization of the banking sector in the period 1982-89 increased by 139 percent in real terms. The ratio of capital to total assets increased from 2.75 in 1982 to 6.48 in 1989. Profits as a percentage of total assets in real terms increased from 0.45 percent in 1982 to 1.33 percent in 1989. Over this period, the bank profitability index increased by the same proportion as the rate of inflation and at a higher rate than the *cetes* index. Growth of GDP in the banking sector was larger than the GDP of the economy as a whole. This suggests that the changes to the Constitution and other laws related to the banking system in 1990 did not necessarily respond to the needs of the banking system. Rather, they emerged as a result of the intention of President Salinas to open the economy and the join the North American Free Trade Area (NAFTA) with the United States and Canada.

The changes in the laws governing the Mexican banks resulted in the deregulation of the system, which meant the reduction of the reserve requirement from 70 to 30 percent. Another consequence of the reform was that the federal government stopped financing itself through the banking system and began to gain financing directly through market instruments, such as *cetes*, *tesobonos*, and *ajustabonos*.[201]

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[201] *Ajustabonos* are inflation-indexed government bonds.

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Similarly, the government passed a new law to regulate all of the activities of the financial intermediaries. It created the *Comisión Nacional de Seguros* (National Insurance Commission), the insurance industry regulatory agency, and increased the powers of the *Comisión Nacional de Valores* (National Exchange Commission), the securities industry regulatory agency. The government established a maximum level of participation for any person or institution in Series B *Certificados de Aportación Patrimonial* (CAPS) and authorized the issue of Series C CAPS. With these measures, the government opened the participation of foreign investment to up to 34 percent of the new bank capital.

The role of the development bank was redefined so that its functions would be combined with those of the investment banks, as a complement to the functions of the multipurpose banks. The finance and insurance companies reoriented their structure in order to be more active in the area of financial investment.

The constitutional reforms represented a transition from strong state regulatory control over the banking system to a more open system in which the market played the key role. As a consequence, the government was able to reprivatize the multipurpose banking system. In this way, the law passed in July 1990 that regulates the function of the financial

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institutions established a new organization of the banking system through financial groups headed by one institution, a holding company. This institution constituted the ownership of at least 51 percent of the stock of each of the members of the group. Similarly, this institution appointed the majority of the members of the board of directors of each member institution. The holding company purchased and managed the shares issued by the member institutions of the financial group.[202] Thus, one financial group was comprised of one holding company and institutions such as depository institutions, leasing houses, securities firms, foreign exchange firms, factoring companies, multipurpose banks, financial institutions, and insurance companies.

This legislation also modified the structure of the stockholders of the financial groups because the holding company issued stocks of different categories. An example is Series A stocks, which should represent 51 percent of the holdings of the company's stock. These stocks could only be purchased by Mexicans, through the *Fondo Bancario de Protección y Ahorro* (FOBAPROA), or the *Fondo de Protección y Garantía*, as established by the Law of the Stock Market. Series B stocks could represent up to 49 percent of the

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[202] *Diario Oficial de la Federación* (México), 18 July 1990.

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holdings of the company. Mexican nationals, investment companies, and institutional investors could purchase these shares. The holders of Series B stocks had corporate rights. Series C stocks could represent up to 30 percent of the shares of the company's stock and could be purchased by foreigners, as well as those able to purchase Series A and Series B stocks.

No Mexican national or foreigner could directly or indirectly purchase more than 5 percent of a company's shares. However, with the authorization of the Secretariat of Finance and Public Credit, individuals could buy up to 10 percent of a company's shares and institutional investors could buy up to 15 percent.

By the implementation of this structure, the government intended to separate the financial groups, industrial groups, and commercial groups. With this new structure, a financial group could not control an industrial group or commercial group. Similarly, an industrial group could not control a commercial group or financial group. With the new legislation, the government wanted to ensure that the private sector would provide investment that would contribute to innovation in the banking system and strengthen international competitiveness.

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Similarly, the state secured its control over the banking system, impeded monopoly, and assured that Mexican nationals owned the system.

However, in practice the stock exchange and investment companies represented powerful business groups whose operations were concentrated in different economic areas, from minerals to food, auto parts, chemicals, insurance, and storage. The economic capacity of these groups allowed them to purchase the multipurpose banks.

Three groups can be distinguished among the new bankers. The first was comprised of bankers who were bank owners before the bank nationalization. With the indemnification from President de la Madrid's administration and the facilities to develop financial activities in the securities firms, they maintained control over financial resources and later came to control a bank as head of a financial group.

The second group was formed by those who came from the stock market activity, which was not highly developed prior to the bank nationalization in 1982, or who initiated activity in this area with the development of the "parallel banking system" and speculation on the stock market. The third group was formed by regional members of the business community, based in an urban or agricultural industry who had the ability

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to bring together a wide group of local investors to enter banking activity.

Agustín Legoretta, nephew of the founder of Banamex and its director until 1982, was in the first group. After the nationalization, he formed the Inverlat securities firm and came to be president of the administrative council of the Comermex Bank. Gastón Lukin, who was a stockholder of the Unibanco Bank, was one of the heads of *Operadora de Bolsa*. Adrián Sada, who was president of Banpaís until 1982 became the head of Serfín. Eugenio Garza Lagüera, who was president of Serfín as the head of the Visa consortium, became the president of Bancomer.

Among the second group were those who came from stock market activity, former stockbrokers, who acquired a large degree of economic power when the market grew in the 1980s. The most prominent is Roberto Hernández, former president of the *Bolsa Mexicana de Valores* (Mexican Stock Market), who acquired control of Banamex with his associate Alfredo Harp Helú. Among this group of prominent members of the business community are José Maradiaga Lomelín, who acquired the *Banco Mercantíl de México*, and Manuel Somoza, who bought the Somex Bank.

In the third group were the banks that were acquired by the members of the business community from different regions

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in Mexico, such as the *Banco Cremi*, Bancrecer, and the *Banco Mercantíl del Norte*, which were acquired in the states of Nuevo León, Jalisco, México, Tamauripas, Sinaloa, Sonora, Puebla, and the Mexican Southeast. These banks were bought by financial groups that had been recently created through the massive participation of the business sector of the regions.

In theory, the law was established in order to democratize capital ownership and promote the development of financial intermediaries in the country. In practice, the ownership of the financial intermediaries ended up in the hands of small economic groups where a large degree of the country's capital was concentrated. Roughly six economic groups controlled the Mexican financial system by the early 1990s.

Even though the new banking law was intended to impede concentration, 18 groups were created in the period 1990-94. The grouping together of the banks and financial intermediaries in Mexico brought about the vertical and horizontal integration of the most powerful economic groups of the country, which represent the largest degree of economic power in Mexico. Among the most important groups are the *Grupo Aluminio*, the *Corporación Industrial San Luis*, the *Grupo Industrial Minera México*, *Grupo Alfa*, *Grupo Cydsa*, and *Grupo Condumex*. The same names repeat themselves across the boards

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of directors of each group, -- e.g., the Probursa Group and the Serfin Group, and the Imbursa Group and Banamex-Accival, in which the names of the most powerful members of the Mexican business community are repeated. These powerful members of the business community include Raymundo Gómez Flores, Roberto Hernández, Alonso de Garay, Alberto Bailleres, Antonio del Valle Ruiz, José Madariaga Lomelín, Adrián Sada Gonzáles, who were all in attendance at the infamous "banquet" held at the home of former finance minister Antonio Ortiz Mena in February 1993. They where asked on the behalf of the PRI and in the presence of President Salinas to raise $500 million, $25 million each, for the upcoming electoral campaign.[203]

Among the largest industrial groups that at that time had a high degree of financial power or gained more power after the privatization of the banks are: the Visa Group, which had the fifth-highest sales in Mexico and controlled Bancomer Bank; the Vitro Group, with the second-highest sales in Mexico, which controlled the Serfin Bank; the Sidek Group, headed by Martínez Guitrón, which controlled the *Banco Mercantil de México*; and the Macera Industrial Group, headed

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[203] Andrés Oppenheimer, *Bordering on Chaos: Guerrillas, Stockbrokers, Politicians, and Mexico's Road to Prosperity* (New York: Little, Brown and Company, 1996), 83-110.

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by Roberto González Barrera, which controlled the *Banco Mercantil del Norte*.

Among the members of the business community who bought Banamex were important leaders such as: Lorenzo Sambrano, who controlled Cemex, the main cement group of Mexico; Rómulo O'Farril, owner of the Novedades Group and stockholder of the Industrial Group *Minera México*; Carlos Hank Rohn, who led the Hirmis Group; Mack Mitchell Suberbill, associate of the Sofilmex Company; Valentín Diaz Mordoro, associated with the Oxy Industrial Group; and Jorge Martinez Güitron, head of the Sidex Group.

The new banks authorized to operate after 1993 joined this group of banks. The most important were: Imbursa Bank, headed by Carlos Slim; and the Interacciones Bank, headed by Carlos Hank Rohn. Additionally, there was authorization at the regional level to create new banks, such as the Mifel Bank and the *Banco Promotor del Norte*.

The financial reform served to lessen the rigidity of the banking system and excessive state control. However, it led to new problems, such as a marked difference between the interest rate on loans and the interest rate on deposits. At the same time, the financial system did not overcome past inefficiencies, which became even more salient in an environment of enhanced international competition, the

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adoption of new technologies, and new organizational structures in the financial market.

According to President Salinas, a key objective of the privatization program was to guarantee plural participation in bank ownership to encourage investment in the sector and impede concentration. However, these objectives were not met. In practice, the reprivatized banks evidenced a large degree of concentration among a few economic groups who possessed the majority of the stocks. In total, these groups were comprised of roughly 274 investors. This meant that the decisions made by the banks were in the hands of a small number of stockholders who managed the shares of thousands of people.

The success of the privatization of the banking system, 18 banks in total, is explained by the favorable financial situation of the banks that were privatized and by the economic power of the sector that bought the banks. The process of privatization of the Mexican banking system achieved the government's goal in terms of the revenues that the state expected to gain from the banks, which represented roughly 40 billion Mexican *pesos*. Those revenues gave the Mexican state new resources to balance the public budget. Additionally, the state maintained 15.98 percent of the stock of Serfin Bank, 22.53 percent of Bancomer's stock, and 21.04 percent of the stock of International Bank. At the time of the

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privatization, this would have represented close to 5 billion Mexican *pesos*.

The reprivatization of the Mexican banking system led to the reshaping of the Mexican business sector around domestic financial capital, which showed a high level of concentration in a few powerful economic groups. This process of bank concentration was led by the executive branch of the Mexican government, which was a key factor in allocating the banks to different economic groups. After the reprivatization, these economic and financial groups came to possess privileged positions and a set of rules that enabled them to increase their power and participation in the economic life of Mexico.

The most notable outcome of the financial reform was that the Mexican banking system distanced its operations from state control. Monetary policy came to reflect the interests of the economic groups, who were faced with international competition and sought a larger degree of profitability.

B. Prelude to the Failure

1. The State

Carlos Salinas de Gortari took office December 1988. The circumstances under which he took power were unfavorable. Even

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though inflation was in decline, the economy was in recession, and foreign debt was $101 billion. An attempt to maintain the hegemony of the PRI through partial political reforms had unexpected results. The reforms introduced new actors into the political arena who constituted potential threats to the system, such as the PRD. As a consequence, the PRI was challenged from different sides of the political spectrum, which generated pressure for political change.

In this context, in which the demands of the business community, the middle class, and the popular sector coincided, a combination of political reform, economic neoliberalism, and social assistance programs emerged. The first of these sought to destroy the corporatist base of the political system and change the official party into an organization capable of responding to the demands of the population. The second supported free inter-regional trade. The third resuscitated the concept of the "popular alliance" through a new program of social welfare.

In the first year of the Salinas administration he was devoted to attacking his most important political enemies, the coalition from the political left, the conservative opposition, and the corporatist leaders that did not support

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his policies.[204] In economic terms he strengthened and institutionalized the *Pacto para la Estabilidad y el Crecimiento Económico*-PECE (Pact for Economic Stability and Growth) and renegotiated the foreign debt. On social issues, he developed the *Programa Nacional de Solidaridad*-PRONASOL (National Solidarity Program), which in practice put a new name an old program, *Coordinación General del Plan Nacional de Zonas Deprimidas y Grupos Marginales*-COPLAMAR (General Coordination of National Plan for Depressed Zones and Marginal Groups).[205]

In the second year of the Salinas administration and through 1993, President Salinas's principal efforts were made to direct the Mexican economy through the international market. He also put special emphasis on generating revenues for the state through the privatization of state-owned enterprises. The new financial resources contributed to the PRONASOL program and political success for the PRI, evident after the triumph of the PRI in the 1991 legislative

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[204] Eduardo Valle, *El segundo disparo: la narcodemocracia mexicana* (México: Editorial Océano de México, 1995), 225.

[205] COPLAMAR was introduced by the López Portillo administration in 1977 as an anti-poverty initiative. It constituted an umbrella organization that developed linkages with government agencies to achieve improvements in health care, education, and basic infrastructure.

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elections. From these elections to the end of 1993, the principal efforts of the Salinas administration were focused on restructuring the support base of his government and overcoming the remaining obstacles to implementing the neoliberal economic model.

The attack on the Salinas administration's political opposition was developed in several stages. First, the government passed several electoral laws that favored the PRI and eliminated the possibility for the opposition to build electoral coalitions, as was the case in the elections of 1988. The second stage was to reduce the power of the traditional labor leaders, who were inefficient or opposed to Salinas's policies. For example, the leader of the labor union of the oil sector proclaimed his independence from the PRI and gave his financial support to the opposing party, the PRD. A similar situation occurred with Joaquín Barrios, leader of the teachers' union, who was unable to control the members of the teachers' union's demands for higher salaries and reform of the educational system. The third stage, which suited the immediate objectives of economic stability, was the institutionalization of PECE. This entailed incorporating the most powerful sector of the business community into the governmental decision-making process. As a result, the business community became divided between those who challenged

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the PRI, following the PAN proposal of 1988, and other sectors that preferred to negotiate from within the state apparatus. However, one outcome of this stage was that the PAN's tone of discourse started to become less aggressive and more conciliatory.

When President Salinas consolidated his power and began to see results from the PECE in the stabilization of the economy, he started to fully develop the key elements of his program. They were the liberalization of tariffs and the implementation of PRONASOL, which was designed to serve as a mechanism to alleviate the social impact of the economic opening.[206]

More than 40 percent of PRONASOL funds were spent on infrastructure projects. Roughly 15 percent went to projects that could generate employment among the poor sectors of the population. Despite this program, during the Salinas administration, the proportion of poor in relation to the overall population increased from 64 percent in 1989 to 66 percent in 1992. Formal employment remained at the same level, and employment in the informal sector increased. Between 1989 and 1993 the formal sector of the economy incorporated half a

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[206] Pedro Aspe Armella, *El camino mexicano de la transformación económica* (Mexico: Fondo de Cultura Económica, 1993).

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million people, while the informal sector incorporated 3.93 million during the same period.[207]

PRONASOL served a political purpose in allowing the regime to rebuild its support base through social reforms that were different from those that had been implemented by the previous administration. In this sense, PRONASOL represented the state response to the electoral challenge of 1988. Those elections revealed the weakness of popular support for the PRI due to the economic crisis prior to the elections.

Inaugurating a new style of populism, Salinas incorporated the head of PRONASOL into the cabinet. The labor sector of the corporatist relationship was maintained, even though the old leaders, the "party dinosaurs" were pushed back. Those sectors lost their privileged representation in the Congress and were shut out from labor policy making because their traditional role as intermediaries was eliminated. This was because the President negotiated directly with each of the unions. Wage increases were linked to productivity, which favored workers in the most dynamic sectors of the economy. The rural sector maintained its previous status because any negative response to the reforms

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[207] Data from the Mexican *Instituto Nacional de Estadística, Geografía e Informática*-INEGI.

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implemented in the agricultural sector was not powerful enough to challenge the government.

The triumph of the PRI over the PRD and PAN in the legislative elections of 1991 showed the political leverage gained through the reforms of President Salinas. However, a crucial element of the Mexican economic transformation was missing: transformation of the agrarian sector.

According to Article 27 of the 1917 Constitution, peasants were protected by the state. However, in November 1991, shortly after the peasants voted for the PRI, the government reformed Article 27 in order to allow the rental and sale of the *ejidal* lands.[208] Although the *ejido* as an institution was maintained, it was preserved as a type of modern cooperative rather than what it had originally been.

In January 1992, under pressure from the sectors close to the Catholic Church, the Salinas administration modified Article 130 of the Constitution, which prohibited priests and other members of the clergy from participating in politics. Article 3 of the Constitution, pertaining to public education,

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[208] The term *ejido* means communal land holding. The *ejidal* system in Mexico was codified in the Constitution of 1917. Mexican legislation says that the *ejido* is a legal entity of the "social interest sector," and its jurisdiction is in the hands of Mexican-born peasants. Salinas lifted the constitutional prohibition on the sale of these lands in order to allow it to be converted to larger, more efficient farms.

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was also modified. This was done in response to pressure from the Catholic middle class. With these actions, the Salinas administration moved the PRI to the center-right of the political spectrum, near to its principal rival, the PAN. President Salinas had a policy to systemically undermine the PRI's other rival, the PRD, in order to secure electoral success in the presidential elections of 1994 for the PRI and avoid a situation similar to that which occurred in 1988.

To prevent a response from the peasant sector against the PRI, in January 1993 the government announced the Procampo program. This program was designed to provide direct subsidies to the corn-producing peasants when Mexico became incorporated into NAFTA.

From the end of 1993 though the end 1994 the early signs of pending stagnation of the Mexican economy were evident. The challenge was for domestic producers to satisfy the domestic market and expand the export sector in the context of an import boom that resulted from the economic opening policies.

Beginning in 1982, it was necessary for the Mexican industrial sector to modernize their stocks of capital in order to increase productivity to meet international levels of competitiveness. However, the high interest rate that was

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established to attract foreign capital and provide monetary stability precluded many small and mid-sized companies from achieving their modernization objectives. Some of these companies were able to modernize their operations despite the high cost of credit. However, most became importers of the same products that they had previously been producing. These products were in high demand, because of the attraction of imported products and the overvaluation of the Mexican currency.

In practice, the economic opening did not stimulate exports but encouraged imports. This served to weaken the industrial base of the Mexican economy. Many small and mid-sized companies closed, and this contributed to increased unemployment. Despite a modest rate of real economic growth, there was a significant deficit in the trade balance from 1989 until 1993, which was covered with private international capital. These sources of capital were attracted on the basis of the expectations created by NAFTA.[209]

Another element that worsened the domestic economic situation was the fact that most of the poor sectors of

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[209] José Romero and Leslie Young, "Los efectos del TLC en la economía mexicana," in *Integración financiera y TLC: retos y perspectivas*, comps. Alicia Girón, Edgar Ortiz, Eugenia Correa (México: Siglo Veintiuno Editores, 1995), 117-132.

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Mexican society were not beneficiaries of PRONASOL. This was because most of the funds from this program were allocated to building infrastructure more than to alleviating poverty. The poorest sectors of Mexican society did not have an opportunity to benefit from the economic model. On the contrary, they constituted a potential challenge to the stability of the country because of potential social conflict. This danger became evident in January 1994 when the *Ejército Zapatista de Liberación Nacional*-EZLN (Zapatista Army of National Liberation), an insurgent movement that had been developing since 1984, emerged violently on January 1, 1994 claiming jurisdiction over the state of Chiapas. The insurgents requested land, jobs, housing, health, education, food, independence, freedom, democracy, justice, and peace from the government. They declared that they would not stop fighting until those goals were achieved.[210]

The first reaction of the government was a military response, with bombing attacks. However, this response was not successful and because of international pressure, President

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[210] The sentiment of the EZLN fight against the government was summed up by Alberto N. He told me, "We the poor people have been forgotten by all the governments. We are tired of promises. It's time to emerge as Zapata did and fight for our rights. Our problems have been developing for years. We know that the solution will take a long time." Mexico City, July 1998.

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Salinas declared a unilateral cease-fire and appointed a special peace commission. The principal function of the peace commission was to establish dialogue with the insurgents. Even though the dialogue was not successful, it moved the Chiapas conflict out of the central debate in Mexican political discussion and created a stalemate in the conflict between the government and the insurgents.

On March 23, 1994 Luis Donaldo Colosio, official PRI candidate for the presidency, was assassinated. One week after the assassination, Ernesto Zedillo was appointed PRI candidate. Zedillo was successful in the elections of August 1994. A new Congress was also elected in the elections. Despite the strong victory of the PRI, stability did not return to the country. Foreign and some domestic investors maintained a lack of confidence in the political and economic future of the country. The gap between inflows and outflows of capital continued to widen through 1995 but recovered in 1996.

Only three weeks after President Zedillo took office, the announcement of an increase in the band of floatation of the *peso* set off a financial panic. In addition, the recently-named Secretary of Finance and Public Credit, Jaime Serra-Puche, was dismissed, which heightened insecurity. In January

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1995, the trade deficit rose to 8 percent of GDP, and gross international reserves in dollars were $3.5 billion, down from $20 billion in reserves at the end of 1993. The country's short-term debt was $3.5 billion, which, in net terms left Mexico without international reserves.

This emergency situation brought the Mexican government to ask the international financial institutions for help and to announce an emergency program called *Acuerdo de Unidad* (Unity Accord) to overcome the economic situation. Several international financial institutions and entities, including the IMF, the Bank of International Settlements (BIS), the European Union, and the United States government proposed a rescue package for Mexico. A rescue was eventually worked out with the United States and guaranteed with Mexico's petroleum export revenues. The package was promised in order to rescue Mexico and minimize the "*tequila* effect," which threatened the global financial system.[211] The formidable size of the rescue

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[211] The potential impact of the *peso* crisis on the U.S. economy was considerable. As of March 1994, U.S. securities firms were receiving an annual average of $133 million in underwriting fees for Mexican securities, and $305 million in underwriting fees for Latin American securities. Roughly $17.1 billion in Latin American assets was held by U.S. mutual funds, yielding $250 million in annual revenue. U.S. banks held $15.9 billion in loans to Mexico, and $41 billion in loans to Latin America. Randall Smith, Robert McGough, and Thomas T. Vogel, Jr., "U.S. Securities Firms and Mutual Funds Have Big Bucks Riding on Mexico Rescue," *Wall Street Journal*, 1 February 1995, sec. C.

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package was small in relation to the total short-term debt contracted. The package was designed to enable Mexico to pay its public debt, but private Mexican debtors were not included in the rescue package.

Despite the cease fire agreement between the government and the EZLN, President Zedillo launched a military operation against the *Zapatistas* on February 9, 1995. The government revealed the presumed identity of *Subcomandante Marcos*, the movement's leader, hoping to weaken the mystique that surrounded him. Dozens of suspected *Zapatista* collaborators were arrested throughout the country. However, the movement was not destroyed, and President Zedillo's credibility suffered.

Secretary Serra-Puche's successor, Guillermo Ortiz Martinez publicly declared that the previous economic program had failed because it was not possible to maintain a trade deficit of only 4 percent of GDP. A new emergency plan was put into practice, *Programa de Acción para Reforzar el Acuerdo y la Unidad para Superar la Emergencia Económica*-PARAUSEE (Action Program to Reinforce the Unity Agreement to Overcome the Economic Emergency) in March 1996. This plan placed a high priority on financial market stability through a restrictive

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monetary policy. The program gave priority to the financial problems of households, companies, and banks. With this plan, the government renewed its commitment to social development.

Two months later only the restrictive monetary policy and a partial rescue of the banking system had been implemented. Roughly $1 billion (6.5 billion new *pesos*) were channeled to six banks[212] through the *Programa de Capitalización Temporal*-PROCAPTE (Temporary Capitalization Program) to help them cover their obligations.[213] Through the program, FOBAPROA provided banks with funds in exchange for five-year mandatory convertible subordinated bonds. To entice banks to repay the bonds before maturity, conversion could be made at book value. As a result of this program, there were several bankruptcies of companies that did not have the capacity to pay because of prohibitively high interest rates. This situation also increased the level of unemployment in Mexico.[214]

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[212] Banco Serfin, Banco Inverlat, Banco Bital, Banco Confia, Banco del Centro, and Banco del Oriente. The first three were among the country's five largest banks. The plan was initiated after capital and reserves at the banks fell below required minimum levels.

[213] *La Jornada* (México), 7 April 1995.

[214] This program was defended by Javier Arrigunaga, Director General of FOBAPROA, who said that in order to take care of the Mexican Banking system, the government must intervene and save it despite the costs. Saving the banking system will avoid the collapse of the overall economy because the banking

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In sum, the system of personal loyalties that developed since the 1930s in order to include society in the Mexican political system underwent a process of reshaping in the 1990s. Restructuring within the economy, characterized by openness and the incorporation of the Mexican economy into the global market, required formalization of social and productive activities. This process provoked tension between the traditional political system based on personal and informal relationships and the actors of the emerging economy.[215]

The erosion of this political system became evident beginning in 1989, when the opposition political party, the PAN, won elections in several states and in numerous municipalities.[216] With these opposition triumphs, the

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system is the core of the economy. Javier Arrigunaga, 2 November 1998, Harvard University, Kennedy School of Government.

[215] One reflection of this is the *Barzón* movement, an expanding social movement fighting for favorable restructuring of more than $3 billion in debt. The movement began in 1993 but expanded dramatically after the 1994 devaluation inflated the amount of citizens' personal and small-business debt dramatically. According to Alfonso Torres, a middle-class member of the movement, "we are fighting for ourselves and we are fighting for our country. Decades of political corruption, corrupt bankers, and a lack of democracy have brought us to the point where we are today. We have no choice but to protest because we are drowning in debt." Mexico City, July 1998.

[216] Eduardo R. Huchim, *El sistema se cae: últimos escenarios de la crisis política* (México: Editorial Grijalbo, 1996), 241-260.

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traditional mechanisms to access public power through the PRI were called into question. Also, the events of 1989 provoked the elimination of the informal rules established in 1929 that impeded the sharing of power with groups outside of the "revolutionary family" and its party, the PRI. Similarly, they signified the destruction of one of the main elements of the incentive system of the PRI, provoking discord among local political interests and the national and regional leaders, and also with the president.

This situation contributed to a gradual erosion of the PRI's monopoly on political power, and consequently diminished the value of upward political loyalty. Similarly, electoral reforms translated into processes of electoral control that made it more difficult for members of the PRI to engage in illegal acts in elections or to provoke division and confrontation among the different groups within the PRI.[217]

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[217] According to Mexican historian Lorenzo Meyer, there were shifts within the corporatist groups due to economic changes. Whereas the peasants had been a principal source of the PRI's power, they were disappearing. The middle class suffered from economic transformation and no longer supported the PRI. In the new economic situation, labor unions were not paid according to political performance but according to economic performance. These changes were leading to a strong challenge for the PRI. The previous five PRI presidents lost political capital. Lorenzo Meyer, 29 October 1997, Harvard University, Kennedy School of Government.

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The right of the president to appoint his successor became called into question beginning in 1987, when a key group of PRI leaders abandoned the party to support the candidacy of Cuauhtémoc Cárdenas, which demonstrated a public questioning of this basic rule of the Mexican political system. Subsequent events suggest that members of the "revolutionary family" were no longer willing to accept the right of the president to freely appoint his successor or to give him their loyalty.[218]

Beginning in 1994, the Mexican political system experienced a loss of credibility.[219] The armed rebellion of the Zapatista group in Chiapas, and the assassinations of Luis Donaldo Colosio, presidential candidate of the PRI, and Luis Guillermo Jorge Ruiz Massieu, Secretary General of the PRI, represented a new phase of violence in the country and suggested the deterioration of the political pact of 1929, the principal objective of which was to avoid violence against the

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[218] Centro de Estudios para la Reforma del Estado, *En busca de un consenso para la reforma electoral* (México: Centro de Estudios para la Reforma del Estado, 1995), 75-119.

[219] Guillermina Baena Paz and Sergio Montero Olivares, "La identidad: factor de construcción de imagen y credibilidad en la política," in *Credibilidad política: globalización, sociedad y medios masivos*, comp. Silvia Molina y Vedia (México: Fundación Manuel Buendía, 1996), 155.

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different political groups and solve the problem of presidential succession.

2. The Business Community

Even though during the 1990s, Mexico was one of the big emerging markets in the world of international finance, the behavior of the business community overall and its linkage to the state did not evidence fundamental changes since the 1980s. For example, although the top business organizations made weak demands for a more transparent electoral system, the most important leaders of the business community gave their immediate support to Carlos Salinas de Gortari. They declared him the winner of the elections even before the official confirmation in the context of the numerous questions surrounding the elections.[220] The business community and the government of President Salinas formed a tacit alliance in order to implement the changes in the economic and social arena under the acceptance of the traditional political regime in Mexico, a presidentialist system.

Throughout the Salinas administration, several members of the business community continued to express their support for

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[220] *El Financiero* (México), 15 August 1988.

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political reforms that would assure the permanence of the economic measures adopted. However, the confrontational attitude of the business community with the government changed to one of cooperation with the government. Instead of criticizing the government for not taking the business community into account, this sector came to understand that the political climate had changed.

Historically in Mexico, the most radical and independent sectors of the business community had abandoned their criticisms of the government during the first years of the six-year presidential term and when the economic situation was favorable to them. This situation was clear in the case of the early years of the Salinas administration. In the first years there was economic stability, and the process of economic reform beneficial to the private sector was initiated.
The government of President Salinas promoted the configuration of a group of business community leaders who were close to him and cooperated with his government. Notable among this group were: Rolando Vega, former president of the *Consejo Coordinador Empresarial*; and Luis German Carcová, former president of CONCAMIN and later president of the *Consejo Coordinador Empresarial*.

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President Salinas attracted owners and leaders of the financial and industrial consortiums as advisors and promoters of his policies. For example, Claudio Gonzalez, president of Kimberly Clark, Mexico, was advisor to the President on foreign direct investment; Gilberto Borja, director of the consulting company Ica, was a promoter among the business community in favor of the PRI candidates in the 1994 elections; Marcelo Sada Zambrano, president of Cydsa, became advisor to the government and negotiator for Mexico in the NAFTA agreements.

This new relationship between the private sector and the government appeared to have been based in a new project whose goal was to promote the role of the private sector as predominant in the economy and at the same time enable the members of the business community to play political and advisory roles that were traditionally reserved for members of the state bureaucracy. The idea of a "mixed economy," based in both public and private sector initiatives, was accepted in Mexico, but with a strong predominance of the private sector. The PRI was able to get close to the business community to the point that the PRI presented several business people as candidates for elected positions. The PRI involved other business leaders in internal issues of the party, such as in the Finance Committee. The PRI pushed for the formation of

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business task forces in order to promote the party among the business community. The business community, beyond their political preferences, became incorporated into the government through several advisory committees and negotiating commissions. Additionally, the business community created special teams in order to involve themselves in the projects of the government. In the first three years of the administration of President Salinas not only did the presidential discourse reflect the language of the business community, but most of the actions of the government served the interests of some branches of the private sector to a large degree. The sale of key state enterprises such as *Teléfonos de México*, the reprivatization of the banks, the deregulation of the financial system, the trade opening and the NAFTA initiative, the modernization programs, and the large reduction in public expenditures were all initiatives that were well received by the business community.

At the time, there was not a truly cohesive private sector in Mexico. The private sector was not able to present a unified economic program for the country. Even though there were some accomplishments for certain groups within the private sector, there was diversity among the objectives of the sector. There was disagreement on important themes such as the maintenance of the economic pact or the rapid and

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unilateral trade opening. Disputes within the private sector representative institutions were also frequent, as well as a questioning of their ability to represent them.

In order to carry out President Salinas's "strategic alliance" project between the government and the private sector, in the first years of his administration a large number of modernizing programs were instituted with the private sector. Examples are: the *Programa Nacional de Modernización Industrial y de Comercio Exterior* (National Program of Industrial Modernization and Foreign Trade) of January 1990; the *Programa de Modernización de Abasto y de Comercio Interior* (National Program of Supply and Domestic Trade Modernization), also in 1990; the *Programa Nacional para la Modernización de la Empresa Pública* (National Program for the Modernization of the State Enterprise); the *Programa Nacional de Ciencia y Modernización Tecnológica* (National Program of Science and Technological Modernization) of 1991; the *Programa para la Modernización y Desarrollo de la Industria Micro, Pequeña, y Mediana* (Program for the Modernization and Development of Micro, Small, and Medium-Sized Enterprise); the *Programa Nacional de Modernización del Campo* (National Program of Rural Modernization); and the *Programa de Modernización Energética* (Program of Energy Modernization).

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Among the objectives of all of these programs was for the government to demonstrate to the private sector that its plan was to modernize the country with the cooperation of the private sector.[221] However, beyond the promises of the government and the programs established, the crisis of 1994/95 negatively affected the majority of the Mexican small and mid-sized businesses. This compelled them to lay off some of their employees and in some cases forced them to close down their operations because they could not meet their financial obligations in the context of a depressed domestic market.

In 1986-87 the Mexican stock market entered a new and more pronounced speculative wave. The securities firms tried to entice all domestic savers, even the small savers, to invest in the speculative activity of the stock market, promoting an increase in the prices of the stocks. The stock market crash of October 1987 turned out to be profitable for a small group of individuals who had privileged information and were able to realize large gains based on the investments of the small or medium-sized savers. Monday, October 19, 1987, after a week of difficulties, the Mexican stock market

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[221] Roberto Blum Valenzuela, *De la política mexicana y sus medios. ¿Deterioro institucional o nuevo pacto político?* (México: Centro de Investigación para el Desarrollo (CIDAC), 1997), 53.

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experienced a dramatic decline of more than 52 points. Over the month of October the stock market fell by 41.8 percent, severely affecting the principal players in the market, and permitting the large stockholders to profit from the circumstances, acquiring companies for up to more than 20 percent under book value. These investors went from stock market activity to directing companies, and later, to the formation of financial groups with a strong capacity to acquire capital. The reprivatization of the banks worked to the advantage of the investors who participated in the development of the Mexican stock market. At the head of almost every financial group there was a bank with the capacity to obtain resources from the public through its various branches.

From 1982, when the banking system was nationalized, until 1990 when the administration of President Salinas adopted privatization and economic liberalization measures, several processes developed that resulted in the reshaping of the Mexican financial sector. There was a concentration and centralization of finance and production activity in which a small sector of the industrial and commercial business community formed financial groups. These financial groups came to monopolistically dominate branches of the Mexican economy. These groups emerged as a result of the profitable business

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that these sectors did during the crisis of the stock market and because of governmental concessions.

The economic groups that were consolidated in the 1990s emerged amidst the economic crisis of the 1980s, and other groups took on new forms. All of these groups were able to engage in changes within their organizations. During the first part of the 1990s, with the consolidation of the economic groups, not only did a process of centralization develop but there was also a large degree of concentration of capital among a few groups. The smaller companies were unable to compete with them. For example, out of the 91 main economic groups in the country in 1993, roughly 55 percent of the total sales of the country was concentrated in the ten largest economic groups. Fifty-six percent of the resources and 48 percent of the employment corresponded to these ten economic groups. These ten groups were: Vitro, Carso, Cemex, Alfa, Visa, Ica, Televisa, *Aerovias de México*, Desc, and *Empresa la Moderna*.[222] The concentration of capital was also evident among private individuals. A small number of individuals controlled the main economic groups and held large family fortunes. The

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[222] Celso Garrido, "Liderazgo de las grandes empresas industriales mexicanas," in *Grandes empresas y grupos industriales latinoamericanos*, coord. Wilson Peres (México: Siglo Veintiuno Editores, 1998), 397-471.

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stockholders who controlled the 18 multipurpose banks privatized them and they passed to the hands of 274 individuals. Twenty-four of them were among the 358 richest people in the world in 1994.[223] Carlos Slim was in the fourth place in individual wealth and twelfth place in family wealth, with $6.6 billion; Emilio Azcárraga of Televisa was at number 24, with $5.4 billion; the Zambrano family of Cemex also appeared on the list with $3.1 billion.

Until the end of the 1980s, the domestic economic groups were principally owned by Mexicans who had credit from abroad. Later, this phenomenon changed and a period began in which there was association between Mexican enterprises with international investors. Of the 104 economic groups considered to be the most important, foreign direct investment between 1989 and 1990 increased from 4 to 11 percent. In 45 of these groups, foreign capital was present, and of them, four were exclusively foreign capital; in seven cases, foreign capital comprised more than 50 percent; in 34 cases foreign capital represented less than 50 percent.

Since 1991 foreign capital in the economic groups of Mexico increased rapidly, principally because of non-bank private investment. For example, in July 1992 the Carso Group

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[223] *Forbes*, 18 July 1994.

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issued $499 million through ADRs and mutual funds. The Alfa Group placed $78 million, and the Sidek Group placed more than $57 million.[224] Similarly, strategic alliances were formed between Mexican and foreign enterprises. These alliances were formed in nearly all the economic sectors in order to transfer technology, gain new markets, or develop products for the international market.

When NAFTA was put in place in the beginning of 1994, 1,500 joint venture and strategic alliance projects were established. Notable among the groups and enterprises involved were: Vitro, which was associated with Corning Glass; Femsa, with Philip Morris and the Canadian John Labbat; Protex with PepsiCo, Burlington Northern Railroad, Northern Telecomm, and Circle K; CIS with AT&T and Cisco Systems; Imsa with Durex; Condumex with Sealed Power, Packard Electric, and Marymount; Cifra with Wal-Mart store Sam's; *Comercial Mexicana* with Price Club; and Liverpool with K-Mart, JCPenny and Dealers Giant. These groups assumed a leadership role in the Mexican economy, forming a sector of the business community with a disproportionate degree of financial power whose principal

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[224] Bolsa Mexicana de Valores, *Indicadores Bursátiles*, June 1992.

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function was to centralize the direction of economic activity in the country.

3. The Failure

After the debt crisis of 1982 Mexico was forced to devote a significant amount of resources to service the foreign debt. This placed pressure on the stability of the current account. However, during the period 1982-88 the Mexican government instituted policies with regard to the trade balance in order to compensate for the negative impact of the service on the foreign debt. In this regard, from 1982-88 there was erratic behavior in the current account. The current account balance was negative in 1982 and 1986 and positive in 1983-85 and 1987.

The policies instituted by the Salinas administration, which aggressively pursued policies to open the economy to foreign trade, placed imports at the highest level in contemporary Mexican history. From 1990-95 there was a deficit in the trade balance. This deficit, added to the service on the foreign debt, generated a growing deficit in the country's

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current account. At its highest in 1994, the current account deficit was $29.4 billion.[225]

Table 5.1: Balance of Payments, 1989-95 ($ billions)

	1989	1990	1991	1992	1993	1994	1995
I. Current Account	-5.8	-7.4	-14.9	-24.4	-23.4	-29.4	-0.7
II. Financial Account	1.1	8.4	25.1	27.0	33.7	15.7	-11.8
Direct Investment	2.7	2.4	4.7	4.4	4.3	10.9	6.9
Non-Bank Private Capital	0.3	-3.9	12.1	19.2	28.4	7.6	-10.8
Equity	0.5	2.0	6.3	4.8	10.8	4.1	0.5
Debt Securities	-0.2	-5.9	5.8	14.4	17.6	3.5	-11.3
Other Investment	-1.9	9.9	8.3	3.4	1.0	-2.8	-7.9
Monetary Authority	0.0	0.0	0.0	0.0	0.0	0.0	-0.8
Central Government	-0.1	1.6	-1.4	-5.9	-1.1	-1.0	-0.8
Banks	0.0	8.3	6.7	1.6	1.9	1.6	-7.3
Other Sectors	-0.8	0.0	3.0	7.7	0.2	-3.4	1.0
III. Net Errors and Omissions	4.5	1.2	-2.3	-0.9	-3.1	-4.0	-2.8
IV. Overall Balance	-0.2	2.2	7.9	1.7	7.2	-17.7	-15.3

Source: International Monetary Fund, *International Financial Statistics Yearbook, 1997* (Washington, DC: IMF).

The current account deficit is compensated by the inflow of capital into the economy to avoid an imbalance in the overall balance of payments and its impact on the level of international reserves. In the case of Mexico, during the 1970s and 1980s the inflow of capital was in the form of direct investment and commercial bank loans. However,

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[225] The data in this section come from the International Monetary Fund, *International Financial Statistics Yearbook, 1997.*

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beginning with the Salinas administration the most significant source of foreign capital was based on non-bank private flows of capital in the forms of portfolio equity and bond issues.

During the period 1982-88, net direct investment in Mexico averaged $1.8 billion per year. The figure increased to $4.4 billion by 1993. After Mexico joined NAFTA, net direct investment in Mexico increased to $10.9 billion in 1994. It declined slightly in the following years. However, the inflows of direct investment did not constitute the main resource for financing the current account deficit.

Another source of current account financing during the Salinas administration were commercial bank loans to the private sector. From 1990-94 net inflows of commercial bank loans into Mexico averaged $4 billion yearly. This was attributable to the need to finance domestic projects and to capitalize on the interest rate differential between the international and domestic market. The latter was made possible because of the stable exchange market that resulted from the stabilization program implemented during the Salinas administration. However, when the crisis erupted in 1995 there was a reversal of $7.3 billion in commercial bank loan flows.

During the Salinas administration the main source of financing of the current account deficit was non-bank private capital inflows, including equity investment and bond

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financing. Net flows went from $300 million in 1989 to an average of $19.9 billion in 1991-93. In 1993, net non-bank private capital inflows totaled $28.4 billion. In 1994 it declined to $7.6 billion, and after the crisis in 1995 there was a reversal of $10.8 billion.

Among non-bank private capital inflows, one of the main sources of capital during the Salinas administration came from the capital market in the form of equity investment.[226] As a result of the opening of the financial market, private enterprises were able to finance a large proportion of their operations through equity investment. One of the instruments through which this occurred was through the use of American Depository Receipts (ADRs). The use of ADRs grew rapidly after 1991, when Mexico was a leader in ADRs among Latin American countries. Other forms of equity investment in Mexico were through subscription shares, the Nafinsa National Trust Fund, and the Mexican Fund. The valuation of the Mexican equity market increased by 6,643 percent over the period 1989-93. The main instrument was ADRs, which represented around 70 percent of the stocks. The participation of the private sector in the issue of equity shares on the international market was

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[226] John A. Adams, Jr. *Mexican Banking and Investment in Transition* (Westport, CT: Quorum Books, 1997), 67-86.

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significant for a small sector of large Mexican companies who could finance their restructuring and positioning in the international market as mid-sized global enterprises. Shares of Telemex represented 62 percent of the total ADRs of Mexican companies. On the domestic market, Telemex is one of the key stocks that comprise the index of the Mexican stock market. In 1993, 87 percent of foreign investment in Mexican stocks were in shares of Telemex.

The other main source of financing during the Salinas administration came from the money market through private and publicly-issued debt securities. Mexican bond issues doubled between 1992 and 1993. The amounts of Mexican bonds issued were substantially larger than those of other emerging markets, such as Hong Kong, Argentina, and South Korea, which were also issuing large amounts of bonds on the international market. In 1993 the total amount of Mexican bonds issued was more than 80 percent larger than the average of the other emerging markets.

After 1989 private Mexican companies, such as Pemex, and CFE, began issuing a substantial amount of bonds on the international market. The growth in bond issues was rapid until 1994, when $4.3 billion in new international bonds were issued. In that year Bancomext issued the largest amount of

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bonds, $1.8 billion. Following 1994, the amount of bond issues has been decreasing as a result of the crisis.

Table 5.2: Private Bond Issues in the International Market, 1988-96 ($ millions)

	1988	1989	1990	1991	1992	1993	1994	1995	1996
Pemex	0	0	354	436	242	1,291	1,054	133	793
CFE	0	0	0	0	100	0	0	0	0
Nafin	0	69	190	375	400	488	1,374	896	359
Bancomex	0	81	63	228	108	1,577	1,860	770	204
Banobras	0	0	0	100	0	100	0	0	200
Other Entit	0	0	150	0	0	0	0	0	0
Total	0	150	757	1,139	850	3,457	4,288	1,798	1,556

Source: Secretaría de Hacienda y Crédito Público (México).

Among the instruments used by the government were *cetes*, *bondes*, *tesobonos*, and *ajustabonos*. This way of financing was attractive for investors because of the high return of these bonds compared with similar instruments on advanced-economy markets. These high rates of interest were maintained when U.S. interest rates began to rise after 1992. Additionally, these bonds allowed investors to shift their investments from low to high profitability within a short time frame. The government used the interest rate and short maturity on these bonds to keep stock market investors from sending their money out of Mexico when the stock market went down.

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Table 5.3: Cumulative Balances of Governmental Securities, at December ($ billions)

	1988	1989	1990	1991	1992	1993	1994	1995	1996
Cetes	18.1	20.1	23.6	22.6	18.5	24.2	7.2	5.8	7.1
Pagafes	0.9	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Bondes	0.0	20.8	21.7	18.7	11.9	5.4	1.6	5.9	8.6
Tesobonos	0.0	0.2	0.0	0.3	0.3	1.2	17.2	0.3	0.0
Ajustabon	0.0	1.1	3.5	9.5	11.4	10.5	5.5	5.4	3.3
Udibonos	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.7
Others	0.0	0.3	1.0	0.0	0.0	0.0	0.0	0.0	0.0
Total	19.0	42.6	49.9	51.1	42.0	41.4	31.5	17.3	19.7

Source: Secretaría de Hacienda y Crédito Público (México).

Until 1988, the bonds issued by the government were primarily *certificados de la tesorería de la federación* (cetes). *Cetes* were treasury certificates that had been issued by the Mexican government since 1978. These instruments were used to regulate the money supply, finance public investment, and encourage the development of the money market. Through *cetes* the government guaranteed a fixed rate of return to the investor. *Cetes* were intermediated through securities firms with the backing of the *Banco de México*. In December 1988 the outstanding stock of *cetes* was $18 billion. It increased to $24 billion by 1993. It declined to $5.7 billion in 1995.

In 1989 the Salinas administration began to aggressively issue bonds, especially *bondes, ajustabonos,* and to a lesser degree *tesobonos*. *Bonos de desarrollo del gobierno federal* (bondes) were negotiable certificates issued by the federal

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government and intermediated by the *Banco de México*. The maximum length of maturity of these instruments was one year. In the first year of the Salinas administration $20.8 billion were issued in *bondes*. The stock of these bonds declined progressively through 1994 when it was $1.5 billion. *Bonos ajustables del gobierno federal* (*ajustabonos*) were long-term certificates of 3-5 year maturity schedules issued by the federal government. They were adjusted for inflation and paid quarterly interest. In 1989 the stock of outstanding *ajustabonos* was $1 billion. In 1992 it was $11.3 billion. They declined to $5.4 billion in 1994.

Bonos de la tesorería (*tesobonos*) were certificates issued by the government and indexed to the U.S. dollar. They were issued at maturities of six months or less and were redeemed in *pesos* at the prevailing exchange rate. The stock outstanding of *tesobonos* was low at the beginning of the Salinas administration, at $100 million in 1989. By 1993, the outstanding stock was $1.1 billion. In 1994 the stock of *tesobonos* increased to $17.2 billion. There was an equally dramatic decline between 1994 and 1995, when the stock outstanding fell to $258 million. This was a key factor in provoking the crisis that occurred in 1994/95.

The stock of government debt issued from 1988-89 increased by 121 percent. This stock grew systematically to a

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stock of $51 billion by December 1991. It declined to $17.3 billion by 1995, reflecting a loss of investor confidence. Most of the bonds issued by the government in the 1989-94 period were of short maturity. For example, *cetes* were issued for 14, 28, 91, and 181 days and 1 and 2 years. *Tesobonos* held maturity schedules of 91 and 182 days and 1 year. This short-term nature of these instruments was one of the key factors behind the crisis.

During the Salinas administration Mexico lost more than $100 billion in the current account. Just in 1994, the current account deficit represented a loss of $29.4 billion, equivalent to roughly 8 percent of the country's GDP. The average annual loss in the current account during the administration of President Salinas was 6.1 percent of the GDP, substantially larger than had occurred during previous administrations. These current account losses were the reflection of an increase in domestic consumption of imports due to the overvaluation of the *peso* that resulted from neoliberal policies.

A negative trade and current account balance were due to a change in the structure of the industrial sector of the country. In the period 1961-82, for every 1 percent of economic growth there was the equivalent of 1.5 percent of GDP in imports. In contrast, during the Salinas administration,

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for every 1 percent of economic growth, it was necessary to import the equivalent of 5.1 percent of the Mexican GDP. This marked increase in the reliance of the industrial sector on imports brought about by the economic opening policies gave way to the collapse of the Mexican enterprises in the capital goods sectors and the sectors that produced inputs for domestic industry.

Domestic savings, which is the basis of investment, was 20.7 percent of GDP during the de la Madrid administration. This figure fell to an average of 15.7 percent of GDP during the Salinas administration. Low levels of domestic savings were covered with foreign capital during the Salinas administration, which reached 6.1 percent of GDP. This constituted a constraint for the development of the industrial sector and increased Mexico's foreign liabilities. Consequently, Mexico's negotiating power was reduced, and the Mexican economy became increasingly vulnerable to changes in the international financial market.

Low levels of domestic savings in Mexico were accompanied by the increasing participation of foreign capital in the process of financing investment in the Mexican economy. The presence of foreign capital increased progressively since the 1960s. By the time of the Salinas administration, the participation of foreign capital in investment in Mexico was

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on average 3.5 times more than it had been in the 1960s. This increased presence of foreign capital was concentrated in short-term instruments, which jeopardized balance of payments stability in the medium term.

The Salinas administration's policies served to maintain an overvalued real exchange rate. Although these policies reduced inflationary pressure, they caused a deterioration of the current account balance. This served to increase the flow of foreign investment and the repatriation of capital. The increase of foreign investment provoked an excess demand for *pesos* and generated an increased trade deficit that was met with additional foreign investment. This constituted a type of vicious circle that kept Mexico from achieving balance of payments equilibrium.

Mexico, which had a negative trade balance, maintained a disproportionately high level of expenditures financed by foreign investment. This investment brought about large foreign exchange losses in future commercial transactions. This situation meant that Mexico spent more than it had, much like what had occurred during the decade of the 1970s and the crisis of 1982. However, the difference was that this time the most significant expenditures were covered with short-term debt.

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Mexico's accession into NAFTA signified the reduction of import tariffs and resulted in an increased deficit in the trade balance. This deficit was covered with foreign investment. Mexico financed its current account deficit principally with short-term foreign investment in the form of stocks and bonds. This investment remained in Mexico as long as the government maintained an overvalued exchange rate. Mexico used this foreign capital principally to finance consumer goods imports and not capital goods, which might have had a more favorable impact on strengthening the industrial sector.

A dramatic devaluation of the *peso* and the fall of the Mexican stock market enabled investors to purchase Mexican stocks at very low prices. Domestic investors in the Mexican stock market were at an advantage in December 1994 when the Mexican government held closed-door meetings with select representatives of large enterprises in order to solicit their support for a probable devaluation. This error on the part of President Zedillo constituted privileged information that was used by businessmen and investors, which precipitated the crisis.[227]

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[227] Oppenheimer, *Bordering on Chaos*, 195-214. There was a parallel to this situation in the Asia crisis. A researcher for an investment bank in Asia referred to this as "the enemy

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International investors withdrew their funds out of Mexico. This left the *Banco de México* with only $6 billion in reserves, while the country's January and February 1995 obligations exceeded $10 billion. As a result, the government dramatically devalued the *peso*, which triggered the economic and political crisis that ensued in 1995. What occurred in Mexico at the end of 1994 and the beginning of 1995 was a manifestation of increasing losses in the current account balance caused by an inability of domestic savings to support investment and growth.

The crisis of 1994/95 resulted in a significant blow to small, medium, and some large Mexican enterprises.[228] The devaluation affected their dollar-denominated and dollar-indexed liabilities and drastically increased the interest rate, which raised their debt burden in *pesos*. It also brought about decline of their sales and revenues. This situation gave way to a process of industrial concentration in Mexico. The participation of small and medium-sized companies and labor in

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within." He described the rush by domestic corporations to buy foreign exchange as the most important factor in the depreciation of exchange rates in Asia. Jonathan Fuerbringer, "Many Players, Many Losers: How and Why Asian Currencies Tumbled so Quickly," *New York Times*, 10 December 1997, section C.

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the formation of Mexican value-added declined, while the participation of the large companies increased. In addition, these large-scale enterprises were more capital intensive and employed fewer workers per unit of capital than small businesses. This situation exacerbated unemployment levels and income polarization.

The *Confederación de Cámaras Industriales de los Estados Unidos Mexicanos*-CONCAMIN (Confederation of Chambers of Industry of the United Mexican States), an umbrella organization for industrial associations, and the *Cámara Nacional de la Industria de la Transformación*-CANACINTRA (National Chamber of the Transformation Industry), which historically represented small and medium-sized businesses, indicated that in the mid-1990s, 3 percent of industrial companies in Mexico represented 95 percent of the country's industrial production. In this context, the 160 families that controlled 25 percent of Mexican GDP in the 1980s were pushed to form strategic alliances with foreign enterprises to survive the process of economic opening and the effects of Mexico's entry into NAFTA.

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[228] Roberto Gonzãlez Villarreal et al., *Ingobernabilidad: la gestión de la crisis en el gobierno de Ernesto Zedillo* (México: Plaza y Valdés Editores, 1996), 19-132.

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Another effect of the concentration of companies and the growing presence of foreign investment in Mexico's industrial sector was the increasing need for imported inputs. In 1995, Mexican industry required on average 80 percent of imported inputs to operate. Many of these inputs were produced by domestic companies prior to the 1994-95 crisis. After the crisis, only 20 percent of the industrial inputs were produced in Mexico. Beyond their not being able to import inputs, this situation affected national industry because the domestic market could not find domestically-produced inputs to substitute for imported inputs. As a consequence, many domestic industrial producers had to cease their operations. An additional effect of the crisis was that in 1995-97, roughly 60 percent of Mexican capital goods companies were forced to close. The remainder were severely undercapitalized and operated at 30 percent or less of capacity as a result of falling demand and import competition.

There were not fundamental changes to the Mexican economy since the crisis of 1982. In constant *pesos*, per capita GDP prior to the 1994 crisis had declined 3.14 percent from 1981. Economic growth over this period occurred in some sectors and not in others. The sectors linked to exports, tourism, and financial services, experienced growth. For example, in the manufacturing sector, economic activity was highly

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concentrated. From 1991 to 1994, two metal products, machine equipment, processed food, and chemical manufacturing represented 67.5 percent of the total manufacturing product. In contrast, the remaining manufacturing activities, roughly six categories, contributed 32.5 percent of the manufacturing product.[229]

Although it appeared that Mexico was making progress in the area of manufacturing and trade during the Salinas administration, primary exports continue to represent almost half of the country's total exports. The *maquiladora* industry represented 19.4 percent of exports, and non-*maquiladora* exports represented only 34.9 percent of the country's total exports. This situation reflected the weakness of the export structure of the Mexican economy. The growth of GDP during the Salinas administration was based in large part upon exports. However, at the same time, the exports had an increasingly smaller multiplier effect on the rest of the economy because of their high import component. As a result, the growth during this period was not employment generating in nature.[230]

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[229] Instituto Nacional de Estadística, Geografía e Informática (INEGI), *XI Censo Comercial* (Aguascalientes, México: INEGI, 1995).

[230] Isabel Rueda Peiro, *México: crisis, reestructuración económica, social y política* (México: Siglo Veintiuno Editores, 1998), 83-158.

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Manufactured exports were concentrated in two branches, machinery (66.8 percent), constituted principally by computers and automobiles, and chemicals (9.6 percent). In addition, there was a tendency toward concentration in the number of companies involved in exports. There were 300 companies, the majority of which were multinationals, which conducted 70 percent of the Mexico's total exports.

Another characteristic of the export sector was that almost all the branches of the manufacturing industry, including those that were principally export oriented, showed a trade deficit. In 1989-96, the manufacturing sector overall experienced a net outflow of foreign exchange of roughly $107.5 billion. The export-oriented manufacturing activities, such as chemicals and petrochemicals, and machine equipment, represented 70 percent of the imports of the inputs of the manufacturing sector in this period. Thus, the Mexican export manufacturing sector was really a net exporter of foreign exchange. Consequently, the net foreign exchange inflows to Mexico came principally from petroleum exports. In sum, Mexico had a small export manufacturing sector that had minimal effects on the rest of the economy and on the generation of employment. In this situation, the problem for Mexico was not

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only the outflow of foreign exchange implied by the increasing trade deficit and rapid process of economic opening. The larger issue was that the export sector was not the engine of Mexican economic growth. On the contrary, the export sector was replacing domestic suppliers with imports. This weakened the domestic industrial sector of the Mexican economy.

The adjustment policies followed by the Salinas administration served to further polarize the income disparity in Mexico. According to the *Instituto Nacional de Estadística, Geografía e Informática*-INEGI (Institute of Statistics, Geography, and Data Processing), from 1984 to 1993 the participation in national income of 10 percent of the most affluent Mexicans grew from 33 to 38 percent. In contrast, the participation in national income of the rest of Mexican society fell from 67 to 62 percent. The impact of this decline was strongest on the middle class. The increase in income of 10 percent of the most affluent Mexican families coincided with the crisis, financial speculation, inflation, and stabilization policies. According to United Nations estimates, in the mid-1990s, 22 percent of the Mexican population were living in conditions of extreme poverty. During the early 1990s, government expenditures on education declined 42 percent in real terms.

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C. Resolution

The December 20, 1994 devaluation of the *peso* provoked a financial panic with severe repercussions on the Mexican economy. The country came to the brink of default on its obligations and was pushed into recession. In hindsight, there was ample evidence that a devaluation was necessary and that the longer it was delayed, the more damaging it would be for the economy. However, few foresaw the extent of the damage that would ensue, even if they did anticipate the devaluation at some point.[231] The implications were severe, not only for the Mexican economy but also for the international financial community and other emerging market economies. Mexico had been seen as a success story for free trade and open financial markets among emerging market economies. The collapse of the *peso* threatened systemic crisis in the global economy.

Although Mexico had experienced vast inflows of private foreign capital since the beginning of the 1990s and enjoyed

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[231] The *Wall Street Journal* reports of an investment manager who issued a report advising clients to pull out of Mexico in early December 1994. He was reprimanded by the bank's vice chairman, who had been planning to meet with Mexico's finance minister later that month. The meeting never took place due to the devaluation. "Peso Surprise: How Mexico's Crisis Ambushed Top Minds in Officialdom," *Wall Street Journal*, July 6, 1995, sec. A.

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an inflated degree of investor confidence as a result of NAFTA, much of the investment was in the form of short-term speculative capital that could be quickly withdrawn. In order to finance its current account deficit, the Mexican government had been issuing, among other instruments, large quantities of short-term dollar-indexed debt instruments, *tesobonos*. They were attractive to investors because they eliminated foreign exchange risk but yielded a high return. For a variety of reasons, including NAFTA and confidence in the U.S.-trained reform-minded government, the investment community downplayed the fact that Mexico's foreign currency reserves were reaching dangerously low levels. A warning signal came in March 1994 with the assassination of the presidential candidate for the ruling party, Luis Donaldo Colosio. Due to a drop in domestic and foreign investor confidence, Mexico lost more than $10 billion of its $28 billion in dollar reserves. In a coordinated response, the U.S. and Canadian governments stepped in and assisted Mexico in stabilizing the *peso* through an expansion of temporary short-term credit lines to Mexico.

Between March and December of 1994, outstanding *tesobono* obligations increased from $3.1 billion to $29.2 billion. At the same time, the interest rate on U.S. government securities

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increased, making U.S. government securities more attractive. In mid-November 1994, Mexican authorities had to draw down foreign currency reserves to meet the demand for dollars. Around the same time, political factors, such as renewed fighting in Chiapas and ongoing investigation of events surrounding the September 1994 assassination of the ruling political party's Secretary General, Francisco Ruiz Massieu, served to create unease on the part of investors about the political stability of the country. In December, the incoming Mexican administration revealed that it expected a higher current account deficit in 1995 but did not plan to change its exchange rate policy. These events together generated a further loss of investor confidence. In early December, foreign exchange reserves were at $10 billion and *tesobono* obligations coming due in 1995 were at $30 billion. Throughout December, there was a downward spiraling of investor confidence and foreign exchange reserves. By early January 1995, it became apparent that *tesobono* redemptions could soon exhaust Mexico's reserves and that without external assistance Mexico could default on its debt obligations.

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1. The Bailout Package

In response to crisis, the Clinton administration proposed a $40 billion loan guarantee package for Mexico for U.S. Congressional approval on January 12, 1995. Through this package, the U.S. government would have guaranteed payment of up to $40 billion in new private-sector loans to the Mexican government. Mexico was to use the loans to reduce its short-term obligations. In exchange for the guarantees, Mexico would have paid a guarantee fee to the United States. Under this package Mexico would have paid a supplemental interest rate on any guaranteed borrowing above market rates. The higher rate was designed to encourage the Mexican government to limit the use of guarantees and return to private capital markets as soon as possible. The assistance would have been contingent on the Mexican government instituting changes in its economic policies.[232]

Although U.S. Federal Reserve Chairman Greenspan was generally opposed to bailouts, on January 12, 1995 he joined Treasury Secretary Rubin in the White House Press Room to

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[232] United States General Accounting Office, Report to the Chairman, Committee on Banking and Financial Services, House of Representatives, *Mexico's Financial Crisis: Origins, Awareness, Assistance, and Initial Efforts to Recover*, February 1996, GAO/GGD-96-56, 109.

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announce the Clinton administration's intention to seek U.S. Congressional approval for the bailout package.[233] Greenspan had presided over the Federal Reserve since August of 1987, two months before the stock market crash of that year. He had experienced the effects of a crisis of that magnitude and the impact they have on investor confidence and behavior. He said, "Once you have a system with a safety net underneath it, creating a lot of moral hazard, you don't have a choice at that time to say, 'Well let's support laissez-faire,'…Once you construct a financial market with all sorts of fail-safe mechanisms supporting it, preventing the system from working by itself, you're forced to regulate, because you effectively have shut down part of the self-correcting mechanisms of the market. That was very clearly the case in the Mexican situation."[234]

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[233] His opposition to bailouts was demonstrated in February 1990 when the Federal Reserve allowed the investment bank Drexel, Burnham Lambert to fail rather than bail it out. Although there was concern at the time that the collapse of the bank would result in disruptive systemic consequences in the U.S. banking sector, the Federal Reserve under the direction of Alan Greenspan did not engage in any attempt to bailout the firm.

[234] Steven K. Beckner, *Back from the Brink: The Greenspan Years* (New York: John Wiley & Sons, Inc., 1996), 167-181.

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Greenspan believed that the Mexico crisis represented a significant threat to the global financial system. It was for this reason that he gave his support to the Clinton administration's plan and actively engaged in seeking Congressional approval for it. Other defenders of the bailout emphasized the close ties between the United States and Mexico, in terms of trade, employment, and immigration, and the ramifications for the global economy should the Mexico crisis trigger a global crisis as occurred in 1982.

Detractors felt that no amount of money could resolve the situation facing Mexico.[235] Others believed that providing funding for Mexico would mean that the United States would be obligated to give additional money the next time it was needed. It was suggested that if the United States were looked upon as the "country banker" demanding reforms or threatening foreclosure, it would lead to poor relations between the two countries. There was also the fear of "moral hazard," that the expectation of a future bailout package would encourage poor investment and management decisions.[236] Although it received

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[235] María Cristina Rosas, "Del Tratado McLane-Ocampo al rescate de Clinton," in *Salinas: la globalización del pánico*, comp. Gregorio Ortega (México: Grupo Editorial Planeta, 1995).

[236] The package was opposed in the U.S. Congress. For example, testifying before the Senate Committee on Banking, Housing, and Urban Affairs, Chairman of the Board of the Commercial

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bipartisan support among the party leadership, this proposal did not receive the necessary support among the rank-and-file of the Congress.

Although there were many arguments put forth against approval of the $40 billion U.S.-backed loan guarantee package for Mexico, there are two principal reasons, both stemming from U.S. domestic political circumstances, why the package was not approved. First, the situation cannot be understood without looking at the political battle over NAFTA. In legislative debate, the approval of the loan guarantee package became almost a second forum for discussing NAFTA, with similar coalitions and the resuscitation of earlier arguments. Second, after 40 years as the minority party, mid-term elections in 1994 had ushered in a new period of Republican majority control of the Senate. Democrats were taken aback by their electoral defeat, and were afraid to alienate the

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Mortgage Asset Corporation and Former Chairman of the FDIC L. William Seidman said that bailing Mexico out would be a "very bad idea" because it would be bad for Mexicans, bad for the U.S. taxpayer, and bad for the operation of free private sector markets. According to Seidman, "the big beneficiaries of this intervention in the market will be the Wall Street investment managers and their clients, a group that should be allowed to suffer the losses of their mistake." U.S. Senate Committee on Banking, Housing, and Urban Affairs, *The Mexico Peso Crisis and the Administration's Proposed Loan Guarantee Package to Mexico: Hearings before the Committee on Banking, Housing, and Urban Affairs*, 104th Cong., 1st sess., 1995, 77-78.

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voters, who were largely against a bailout package. New Republican freshmen in the Congress were also seeking to address voter concerns.

The political battle over NAFTA was highly contentious. Yet with considerable effort, President Clinton was able to build a bipartisan majority for its passage in 1993. He achieved this by promising that open trade between the United States, Canada, and Mexico would ensure new markets for U.S. companies in Mexico and generate thousands of new jobs. The argument made for the approval of the loan guarantee package was roughly the same as that made for NAFTA. The political coalitions were also the same, with right-wing extremists and labor unions both opposing.[237] Many Democrats raised the same questions about wages and other social issues that had divided the party over NAFTA in 1993. Similarly, Republicans wanted to use the package to force monetary and other reforms as they had demanded in 1993. Critics of the loan package argued that if Congress had been accurately informed of the precarious situation of the Mexican economy before the free-trade debate, they would not have voted to pass NAFTA.

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[237] "Loan Deal for Mexico in Jeopardy," *Boston Globe*, January 30, 1995.

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The electoral defeat of the Democratic party in the November 1994 elections served to weaken President Clinton's influence in the Congress. Resistance to the loan package was broad, even within the Democratic Party. President Clinton's ability to promise political assistance or threaten political reprisal was much lower than had been the case in 1993. Within Congress the argument was made that the loan package would essentially amount to a bailout of international financiers who invested in Mexico when interest rates were high.

Although the plan initially had the support of Newt Gingrich, Speaker of the House, and Bob Dole, Senate Majority Leader, their support began to wane in the face of President Clinton's inability to convince even members of his own party that the loan package would be in the best interest of the United States. Members of the Republican party who expressed support for the package said that President Clinton needed to do a better job convincing the Congress of the merits of the program and that Democrats in Congress would have to demonstrate more support for it before they would take the political gamble in support of it. However, Democrats in Congress argued that the Republicans were in the majority and had to exercise leadership in order to get the package approved.

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These factors served to delay the formal consideration of the loan package by the Congress. The delay signaled to the Clinton administration that it would not gain the requisite approval. In response, the Clinton administration took the lead in putting together a multilateral response to the Mexican crisis that involved primarily United States and IMF participation. The $48.8 billion multilateral assistance package was not among the options formally presented for discussion by the U.S. Congress and international institutions.

The U.S. government had an interest in providing a rescue package. The government sought to protect the U.S. economic position as well as avoid social destabilization that could come from a dramatic economic crisis, and the concomitant social and political implications, just south of the U.S. border, which would affect the national interests of the United States. The economic linkages between the United States and Mexico were evident in that in 1994 U.S. exports to Mexico were roughly $40-50 billion, U.S. investment in Mexican securities was $34 billion, direct investment in Mexico was $53 billion, there were additional billions of dollars worth of U.S. investments in Mexican stocks, and the Mexican government owed $8.1 billion to U.S. government agencies. It

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was estimated that U.S. GDP growth would fall by 1 percent if the Mexican economy did not receive a bailout.

Among the specific reasons why the U.S. government provided a recovery package for Mexico are the following.

First, the immediate goal was to prevent financial collapse in the country and avoid the spread of its effects to other emerging markets. In the early 1990s Mexico was one of the most attractive emerging markets for U.S. institutional investors. If the economy did not recover or the government or private sector went into default on its obligations, U.S. institutional investors would have been adversely affected.

Second, the U.S. government sought to minimize the impact of Mexico's crisis on trade, employment, and immigration. These are issues through which the economy of the United States has been closely tied to that of Mexico. These ties became more important after the initiation of NAFTA.

With regard to trade, in 1995 Mexico was the third-largest market for U.S. exports and the third-largest source of U.S. imports. It was estimated that if the United States had not provided a bailout package, U.S. exports to Mexico ($40-50 billion a year) would have been severely impacted. With regard to employment, it was also estimated that many of the roughly 700,000 jobs supported by exports to Mexico would have been jeopardized. With respect to immigration, the U.S.

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government also feared that financial collapse in Mexico would lead to as much as a 30 percent increase in Mexican illegal immigration to the United States.

Third, Mexican economic success held significance for the open-market, free trade model promoted by U.S. agencies and international financial institutions. Economic collapse in Mexico, a large economy that engaged in a rapid and broad shift toward trade and financial liberalization and privatization, might have sent a signal to other developing countries regarding the model.

Although legislative debate and public opinion polls indicated a broad degree of opposition to any kind of bailout package for Mexico, the Clinton administration argued that the loan package would serve the country's interests.[238] Although public opinion polls showed public disapproval of a package at

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[238] For this reason, the early repayment of the U.S. portion of the loan with interest in January 1997 met with a considerable degree of triumphalism on the part of the bailout package's supporters. A less sanguine perspective came from Jorge Castañeda who said, "…all that Mexico did was to borrow the money on the European bond market and send it to the U.S. Treasury. Granted, the refinancing saves Mexico some interest, and Clinton some political heat, but it should not be viewed as a reflection of Mexico's economic recovery." He went on to point out that the U.S. loan represented only a very small part of Mexico's total foreign debt, which represented a higher percentage of the Mexican economy than it was in 1982. Jorge G. Castañeda, "After the Bailout, a Flood," *Washington Post*, March 2, 1997, sec. C.

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80-95 percent, the Clinton administration opted to pursue a course of action that would provide long-term stability for the peso. Although critics believed that a bailout for Mexico would be a bailout for Wall Street, the Clinton administration argued that many middle-income Americans were also invested in Mexico through "mom and pop" pension plans and mutual funds.[239] For these reasons, and because time was a crucial factor, the Clinton administration ceased discussion of the original loan package proposal and engaged in arrangements for a new package.

A key element in the Clinton administration's decision to seek another option to put together a Mexican bailout was most likely the fact that the administration's credibility was riding on the success of NAFTA. While the prospect of NAFTA success had been eliminated in the near term, a crisis of the sort that was affecting Mexico in 1995 would have meant a political disaster for the Administration. Less than two months prior to the onset of the crisis, President Clinton had been at the Miami Summit of the Americas with the presidents of the region. NAFTA was held up as an example and a promise for regional free trade in the near future. President Clinton

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[239] "Wall Street Strategists Applaud Mexico Plan," *Wall Street Journal*, January 26, 1995, sec. C.

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also had a 1996 re-election bid about which to be concerned. As NAFTA was a cornerstone of the administration's economic policy, a resounding and ongoing failure would have had negative repercussions into November 1996.

The Clinton administration's program was announced on January 31, 1995. The stated aim of this assistance was to help Mexico avoid financial collapse and to limit the spread of the crisis to other emerging market economies.[240] The U.S. portion of the package entailed the use of up to $20 billion in currency swaps and securities guarantees from the Treasury's Exchange Stabilization Fund (ESF) funds and Federal Reserve funds backed by ESF.[241] The Treasury Secretary, with

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[240] United States General Accounting Office, *Mexico's Financial Crisis*, 109.

[241] The Federal Reserve has conducted foreign currency operations since the 1950s. These operations are directed by the Federal Open Market Committee (FOMC) in close cooperation with the U.S. Treasury. The main aim of foreign currency operations in the post-Bretton Woods era has been to counter disorderly conditions in exchange markets through the purchase or sale of foreign currencies. A key feature of the Federal Reserve's foreign currency operations has been the reciprocal currency (swap) network. It consists of reciprocal short-term arrangements among the Federal Reserve, other central banks, and the Bank of International Settlements (BIS). These arrangements give the Federal Reserve temporary access to the foreign currencies it needs for intervention operations to support the dollar and give other central banks temporary access to the dollars they need to support their own currencies. In a swap transaction, the Federal Reserve transfers dollars to another central bank in exchange foreign currency (a spot transaction, immediate delivery) and agrees

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the approval of the President, has complete discretion to decide when the use of the ESF is consistent with the IMF obligations of the United States. They can be employed without a Congressional appropriation.[242]

In the past, the ESF had been employed to buy and sell foreign currencies, extend short-term swaps to foreign countries, and to guarantee the obligations of foreign governments. The United States had lent money to Mexico through short-term swaps five times since 1982 and through a

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with another central bank to reverse the transaction at a specified time period in the future (a forward transaction, future delivery). When a foreign central bank initiates the swap drawing, it uses the dollars obtained in the spot transaction to finance the sale of dollars to support its own currency; it meets its obligation to deliver dollars to the Federal Reserve by acquiring dollars in the market. The foreign central bank pays interest on the dollar drawings at the U.S. Treasury bill rate. The Federal Reserve System, *The Federal Reserve System: Purposes and Functions.*

[242] The ESF was established pursuant to Section 10 of the Gold Reserve Act of 1934. It was codified as 31 U.S.C. § 5302 as part of the permanent codification of Title 31 in 1982. The statute that established the fund has since been amended in order to broaden its scope from the stabilization of the dollar to include the promotion of orderly exchange arrangements and a stable system of exchange rates. Under the amended statute, the Secretary or an agency designated by the Secretary, with the approval of the President, may deal in gold, foreign exchange, and other instruments of credit and securities the Secretary considers necessary. A loan or credit to a foreign entity or foreign government may be made for more than six months in any 12-month period provided that the President furnishes the Congress with a written statement that unique or emergency circumstances require the loan or credit for more than six months.

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medium-term swap once in 1982.[243] In the 15 years prior to the Mexican package, the ESF had extended guarantees three times: to assist Brazil in 1982 and Yugoslavia in 1983 and to assist Macedonia in paying off arrears to the World Bank in 1994.[244]

The use of ESF funds in the package that was put together to assist Mexico in 1995 was unprecedented for two reasons: the medium-term swaps had maturities of up to five years; and the guarantees could remain outstanding for up to a ten-year period. According to the provisions outlined in the ESF statute, Treasury Secretary Rubin and President Clinton determined that there were unique and emergency circumstances that required their lengthening the maturities on the swaps and guarantees. On March 9, 1995 President Clinton provided the Congress with a written statement attesting that emergency circumstances were such that the guarantee period should be extended to ten years.

The IMF portion of the plan involved an 18-month, $17.8-billion standby credit arrangement for Mexico. The multilateral assistance package also included $10 billion from

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[243] Short term here refers to swaps that have a maturity of not more than six months. Medium term refers to those with a maturity not exceeding one year.

[244] United States General Accounting Office, *Mexico's Financial Crisis*, 116.

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other industrial countries through the Bank for International Settlements (BIS) and $1 billion from Canada. The original agreement also included a commitment for funds from Argentina and Brazil. This pledge did not materialize after the *tequila effect* spread to those countries and capital fled their economies.

Mexico agreed to abide by the terms and conditions specified in the assistance package. They included paying interest and fees, providing additional repayment assurance to the United States through a mechanism involving revenues from Mexican oil exports, implementing a comprehensive and stringent economic plan, and providing economic information on a timely basis. Much of Mexican public opinion was opposed to a U.S.-led bailout package. This sentiment can be traced back to a long nationalist tradition in Mexico and a resentment of the "colossus to the North." Particularly unpopular was the idea of linking Mexican oil revenues, a nationalist symbol, to the package. In this sense, Mexico was essentially a "decision recipient" and had little voice in the actual decision being made in Washington. While it is to be expected that the Mexican people or government would not have decision-making capacity in the U.S. political system, the situation reflects

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the degree of asymmetrical power relations that existed between the two countries.[245]

2. The Impact of the Resolution on Subsequent Bailout Decisions

Following the Mexican bailout, the U.S. Government reassigned its leadership role from that of bailout organizer to one of improving the mechanisms by which the IMF could organize rescue packages or contribute to the strengthening of financial systems.[246] The U.S. government was involved in

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[245] A financial journalist describes the day that the Mexican aid package was announced as a "humiliating scene" for then Mexican Finance Minister Guillermo Ortiz. Although Mexico had already begun drawing on swap lines to redeem billions of dollars worth of *tesobonos* held by foreign investors, the aid package was not finalized until February 21, when it was announced in an elaborate Treasury ceremony. He says, "When Treasury, Fed, and Mexican officials finally finished negotiating the exacting terms and conditions under which Mexico could receive assistance, Rubin made a big show of it." When Ortiz and his entourage were "herded into the historic and ornate Treasury Cash Room, jammed with reporters and TV cameras…a reporter drew on what one of the bandits told Humphrey Bogart in *The Treasure of the Sierra Madre* in imagining what one of the Mexicans might say if asked to show his security badge. 'Badges? We don't need any stinking badges!'" Beckner, *Back from the Brink*, 386.

[246] From the investor side, Arthur Levitt, Chairman of the U.S. Securities and Exchange Commission, emphasized the responsibility of the investor in being educated on their investment. He said that there was an ever-widening gap between financial knowledge and financial responsibilities.

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efforts to strengthen the international institutional architecture to respond to global crisis rapidly and with sufficient resources. Representatives of the Treasury Department were engaged in efforts in collaboration with the IMF and other international bodies to enable this to occur. Among the key considerations of the U.S. government were the following:

1. Improving the IMF's surveillance techniques to place more emphasis on capital flows and the health of key financial institutions;
2. Improving banking system regulation around the world and strengthening the international community's ability to engage in dialogue with countries that appear to be headed for trouble;
3. Instituting burden-sharing mechanisms by which international investors would be made to participate in rescue packages in the form of a "bail-in," as was employed in the resolution of the Korean crisis by involving the foreign creditor banks in the restoration of stability;[247]

Within a new paradigm of systemic risk, we won't succeed by trying to manage risk. According to him, "the answer comes from disclosure and transparency." Arthur Levitt, 19 October 1998, Harvard University, Kennedy School of Government.

[247] Lawrence H. Summers, "The Role of Multilateral Institutions in Preserving International Financial Stability," Speech given

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4. Strengthening the role of the international financial institutions in financial crises to ensure that the international community could respond quickly and appropriately to problems and act to prevent their recurrence by advocating for the creation of the new Emergency Financing Mechanism;
5. Encouraging the IMF to take the lead in international efforts to promote greater disclosure of economic and financial data and improved banking supervision in emerging markets;
6. Creating a new Supplementary Reserve Financing facility to let the IMF lend at premium rates in short-term liquidity crises and improve borrower incentives; and
7. Codifying the role of the IMF in this area through the Amendment of the Fund's Articles of Agreement to include capital account liberalization.[248]

After the Mexican bailout, the IMF provided substantial loans to Indonesia, Korea, Thailand, and Brazil that were supplemented by contributions from other multilateral

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before the Bretton Woods Committee Annual Meeting in Washington DC on February 13, 1998, U.S. Treasury, Office of Public Affairs, RR-2226.

[248] Lawrence Summers, Remarks before the International Monetary Fund on March 9, 1998, U.S. Treasury, Office of Public Affairs, RR-2286.

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agencies.[249] These packages entailed U.S. support but in contrast to the Mexican case, the U.S. government did not take a leadership role or engage in activity that would have involved seeking Congressional appropriation. In those cases, although trade and the threat of systemic crisis were important considerations for the Clinton administration that might have justified the U.S. government's engaging in some form of rescue package, after the Mexico crisis, the United States directed its efforts toward strengthening the role of the IMF to address such crisis.

D. Two Manifestations of One Phenomenon

The 1982 and 1994/95 crises were the manifestation of a single phenomenon that pertains to the characteristics of the domestic economy and political system, the policies exercised during the period from the 1960s through the 1990s, and the way in which Mexico is linked to the international market. There are several similarities and differences among the two cases. Among the similarities are:

1. the overvaluation of the *peso* prior to the crisis

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[249] International Monetary Fund, *World Economic Outlook* (Washington, DC: International Monetary Fund, 1998), 6.

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2. the large degree of capital flight that preceded the crisis
3. Mexico's inability to pay the foreign debt
4. the short-term nature of a large proportion of the debt
5. the resolution of the crisis came from the U.S. government and the international institutions.

Among the differences between the crises are:

1. During the 1982 crisis there was an accelerated process of economic growth in the time leading up to the crisis. However, in the time preceding the 1994 crisis, the country was achieving only modest levels of economic growth.
2. Inflation prior to the 1982 crisis was relatively high, but prior to the 1994 crisis it was relatively low.
3. Before the crisis of 1982 exports had been based principally on petroleum. Before the crisis of 1994 exports were based predominantly in manufactures.
4. The domestic interest rate prior to the 1982 crisis was negative in real terms. In 1994 it was positive.

Behind these similarities and differences, both crises are manifestations of the same phenomenon that is explained by three elements:

First, the fundamentals of the economy. One of the key elements of the Mexican economy is the lack of domestic

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savings and consequent inability to finance domestic investment. This is reflected in the steady decline of real per capita investment. From 1980 to 1995, this indicator declined by 40 percent in real terms.

The contribution of foreign capital to investment in Mexico has been erratic throughout the period 1980-85. In the years prior to the 1982 crisis, the contribution of foreign capital to investment in Mexico was relatively high and above the average for the region. For example, in 1980 and 1981 the contribution of foreign investment to gross domestic investment was 23 and 28 percent, respectively. After the crisis of 1982, it fell to 1.3 percent. Similarly, from 1990-94 the contribution of foreign capital to gross domestic investment was relatively high. In 1992 and 1994 it was 32 and 34 percent, respectively. After the crisis, in 1995 and 1996 it fell to 2.7 and 2.4 percent.

Mexico has low domestic savings, and the country's investment relies on cyclical inflows of capital. This contrasts with the fact that, with the exception of the four years that coincided with the emerging markets phenomenon, Mexico has been a net exporter of capital for the past two decades. For example, in 1996 the net transfer of resources was $9.8 billion out of Mexico.

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In the period 1982-94, the government increasingly relied upon foreign savings to finance growth and productive investment. After the 1982 crisis, the level of foreign capital in the Mexican economy represented 4 percent of the GDP. This need for foreign capital grew during the period 1983-94 and constituted a yearly average of 5 percent of GDP. In 1994, this percentage increased to around 8 percent. The relationship between foreign savings and crisis can be explained by three factors.

1. The trade deficit increased notably following the opening of the economy and required an increased amount of foreign capital to finance it.
2. Foreign capital was primarily constituted by capital invested in the foreign exchange and securities markets. Only a small proportion was invested in the industrial sector. For example, in 1993 foreign investment was $33.7 billion, of which 53 percent was in the bond market and 32 percent in the stock market. Only 13 percent represented investment in the industrial sector.
3. The need for domestic savings was heightened. This was a result of the fact that there was a large degree of capital flight out of Mexico. Capital flight from Mexico in 1982 represented roughly 4.1 percent of the GDP. This amount was larger than the amount of foreign investment for this year,

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which was 3.6 percent of the GDP. During the first half of 1994, capital flight from Mexico represented 3.6 percent of GDP. This was roughly half of the foreign investment, which was 7.5 percent of the GDP.

Despite significant advances of the industrial export model associated with the Mexican trade opening, it did not achieve a reduction in the trade deficit, and the economy was subject to recurring devaluations and low wages. During the early 1980s, the country was reliant upon oil exports. As a result, Mexico's economic performance was determined by the international price of oil. In 1982, only 14 percent of Mexican exports were manufactured goods. This situation changed at the beginning of the 1990s. In the beginning of the 1990s, the export of manufactured goods grew to reach roughly 76 percent. However, the activity of the principal Mexican exports was based on *maquiladora* production, which has a low multiplier effect on the domestic economy.

Second, the political system. The Mexican political system was based on a corporatist structure in which the state aligned with the principal institutions and organizations of the country. The state party, the PRI, ruled the country throughout most of the twentieth century. The legislative and judiciary branches were subordinated to the executive branch, and the labor organizations and key social institutions were

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linked to the ruling party. The business community, especially that proportion of it that represented the largest corporations in the country, maintained a close relationship with political power. During the period 1980-95, the critical decisions taken by the government in the economic sphere, including the nationalization of the banking system and its later reprivatization, the privatization of the state-owned companies, and the liberalization of the economy, were made by the government. The decisions were made with virtually no participation in the decision making process of the majority of the sectors of the population.

During the early 1990s, the Mexican political system faced challenges from different sectors of society. These challenges came from within the party, from a growing opposition, and from outside, from insurgent movements. However, the main mechanisms by which the PRI maintained control over the political system throughout the century remained intact throughout the 1990s.

For example, the administration of President Zedillo engaged in a political discourse that acknowledged the main problems faced by the country. However, a few weeks into his term, the country returned to situation characterized by currency devaluation, capital outflows, cuts in public budget, wage reductions, and growing unemployment. This was a common

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occurrence at the time of change of presidential administration, which resulted in a generalized disenchantment among the population.

Third, economic policies. The economic adjustment policies that were initiated in 1982 were based on a rejection of the protectionist economic model that emphasized the domestic market, and of import substitution, principally in the period 1950-70. Policy makers justified the economic opening on the basis that because the protectionist model did not favor exports, it generated strong foreign trade and current account deficits, and, thus, it financed growth with foreign debt. Further, they claimed that protectionism contributed to productivity declines, lower quality products, an increase in domestic prices, and a market controlled by monopolies and oligopolies. Based on this justification, the new policy of opening to the international market was designed to promote manufactured exports in order to resolve the problem of the country's deficit in its transactions with the international market and the high level of foreign debt. This new policy was intended to strengthen competitiveness and increase productivity.

However, in practice the rapid opening to foreign trade worsened the trade deficit. In the period 1976-82 the trade balance had a deficit of 1.2 percent of GDP on yearly average.

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In the period 1988-94, the deficit increased to 3.5 percent of GDP. Prior to the 1994/95 crisis, the deficit reached about 7 percent of GDP. A similar situation occurred with the current account. In the period 1976-82 the current account deficit was 4 percent of GDP. In 1994 it approached 8 percent of GDP. This current account deficit was mainly a result of the trade deficit and service on the foreign debt. In the period 1988-94 the value of exports increased on yearly average by 8.2 percent. However, imports increased by 26.2 percent on yearly average. This disproportionate growth of imports had significant negative effects on the productive sector, particularly on the small and mid-sized businesses, which were not able transform their operations in order to compete with imported goods. This situation exacerbated unemployment and slowed economic growth. Although the trade opening alleviated inflation in the short run, it exacerbated it over the medium term.

Since 1991 the *peso* began to show signs of overvaluation. However, the policies instituted by Mexican economic policy makers were designed to reduce inflation, thus privileging policies of overvaluation. The *peso*/dollar exchange rate was managed as a price anchor in order to control inflationary pressures. In this period, a key objective of the government was to keep inflation below 10 percent so that Mexico could

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join NAFTA and enter the OECD. However, the overvalued *peso* and the accelerated process of commercial opening provoked a dramatic increase in imports, which brought about a rise in unemployment and a decline in the rate of economic activity. The December 1994 devaluation notably increased the competitiveness of Mexico's manufactured exports and reduced Mexican labor costs. However, the abrupt devaluation and the reduction of real wages did not improve the country's trade situation because they did not constitute the kind of long-term competitiveness-enhancing measures that would increase productivity and exports.

E. Conclusion

The implementation of the Brady Plan coincided with the beginning of the administration of President Carlos Salinas de Gortari (1988-94). Under this plan, Mexico exchanged the old foreign debt bonds for new Brady Bonds. This meant that Mexico's long-term debt instruments became guaranteed by the U.S. Treasury. Mexico refinanced its foreign debt and agreed to make several economic reforms oriented toward market opening. These reforms included the liberalization of the financial sector, foreign trade, and privatization. Also, during this period there were low international interest rates

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and a highly liquid international capital market. The series of reforms implemented by President Salinas entailed the privatization of a large part of the state-owned companies, such as *Teléfonos de México* (Telemex), sugar refineries, steel mills, and agroindustries. Among the most controversial steps was the reprivatization of 18 commercial banks, 75 percent of which were purchased by the owners of the securities firms. The other 25 percent were purchased by the owners of the industrial groups. A total of approximately 220 individuals purchased the banks. In practice, this signified the concentration and centralization of the domestic sources of capital. The result of the implementation of this series of economic reforms and policies was the launching of Mexico as an "emerging market" in the 1990s.

As had happened during the 1970s, in the 1990s the three elements discussed above came to result in a new crisis. By the 1990s, the configuration of the Mexican economy was now composed of the large, formerly state-owned companies now in private hands. These included Telemex, *Cementos Mexicanos* (Cemex), *Banco Nacional de México* (Banamex), Serfin, and *Banco de Comercio* (Bancomer). They acquired capital by issuing bonds on the international financial market. Similarly, the state development banks and the state itself also turned toward the international capital market for credit. The government went

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to the capital market in order to attain credit to finance the public budget.

The second element, which pertains to the state, also played a role in the crisis of the 1990s. Control over the key institutions of the country and the political decisions of the central bank and the judicial branch of government were subordinated to the political power of the state. The state evidenced a lack of accountability.

The third element, related to economic policies, also contributed to the crisis of the 1990s. The Salinas administration pursued economic policies that resulted in the overvaluation of the national currency and the accumulation of large deficits in the current account and trade balance. As a result of the policies instituted by the Salinas administration, in the period 1990-93, Mexico received approximately $91 billion from abroad. Out of this, 18 percent was foreign direct investment. The rest was portfolio investment and debt. These policies, combined with the poor fundamentals of the Mexican economy, e.g., low investment-to-GDP ratios, high inflation, high real exchange rate variability, constituted a key element in triggering the crisis.

The resolution of the 1994/95 crisis also required the participation of the U.S. treasury and the international

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financial institutions, which put in place a financial rescue package and allowed Mexico to achieve a temporary recovery from the crisis. In doing so, the Mexican economy contracted additional levels of debt. The collapse of the Mexican currency that occurred in 1995 signified an increase in Mexico's foreign debt to roughly $166 billion, 60.8 percent of the GNP. This was the largest amount of foreign debt in Mexico in the country's history.

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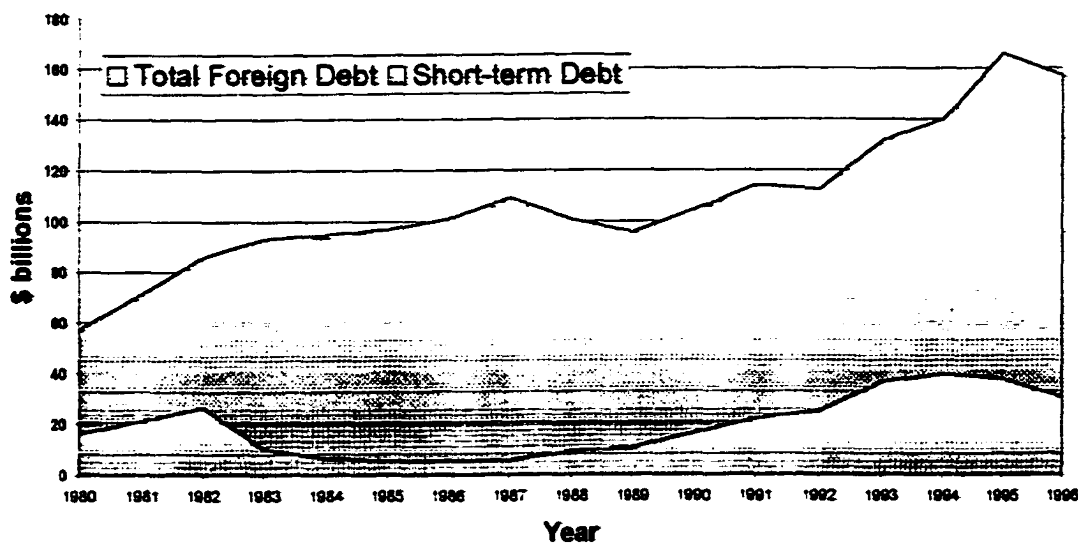
Figure 5.1: Total Foreign Debt and Short-Term Debt, 1980-96 ($ billions)



Source: World Bank, *Global Development Finance, 1998* (Washington, DC: World Bank) and *World Debt Tables, 1990* (Washington, DC: World Bank).

In 1995 and 1996 Mexico paid $27 billion and $41 billion in debt service payments, respectively.

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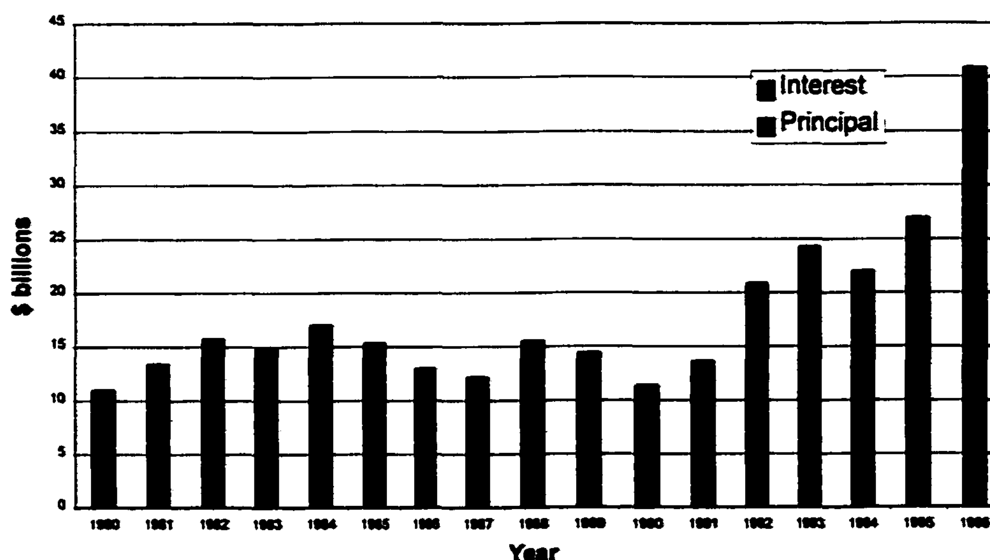
Figure 5.2: Total Debt Service, 1980-96 ($ billions)



Source: World Bank, *Global Development Finance, 1998* (Washington, DC: World Bank) and *World Debt Tables, 1990* (Washington, DC: World Bank).

Thus, the Mexican economy is caught in the trap where the country must pay out large amounts in service on the foreign debt. At the same time, the economy is in need of resources for investment to stimulate the economy. For this reason, economic actors have contracted large flows of loans from abroad for investment. In 1996 Mexican corporations took loans or issued bonds on the international market in the amount $10 billion. This placed companies like Cemex in a precarious

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situation. Cemex had $5 billion in debt outstanding in 1996. After the crisis, the Mexican government continued to acquire resources from the international capital market. For example, in 1996 J.P. Morgan issued $6 billion in notes on behalf of the Mexican government.

Throughout the 1990s, the main characteristics of the political system remained intact. The policies of the administration of President Ernesto Zedillo Ponce de León (1994-2000) served much the same purpose as had the policies applied during the 1980s. For example, the conversion of private bank debt into public debt through the *Fondo Bancario de Protección y Ahorro* (FOBAPROA) shows that the Mexican economy continues in a "debt trap."

This dissertation reveals that the patterns of the Mexican economic and political system have changed little throughout the 1980s and 1990s. While the debt crisis of the 1980s and the financial crisis of the 1990s appeared to have different causes, in reality the seeds were sowed in similar soil: (1) a domestic economy that did not generate domestic savings and with a financial system that was highly concentrated; (2) a corporatist state in which the interests of the societal organizations and representative bodies were subordinated to the interests and political exigencies of the president and the government at the federal level; and (3) an

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economic policy program that resulted in an overvalued currency, and chronic fiscal imbalance and current account deficits. In this context, the debt crisis of the 1980s was triggered by the accumulation of commercial bank loans; the financial crisis of 1990s was set off by the amassing of short-term debt instruments indexed to U.S. dollars. The globalization of finance and the introduction of new instruments and new investment strategies may have slightly transformed the external façade of what led up to and culminated in the 1994/95 crisis. However, what it actually represented was a new manifestation of the same phenomenon that occurred in the 1980s.

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CHAPTER VI

CONCLUSION

The voluminous literature about the 1994/95 crisis in Mexico from the disciplines of international relations, economics, and political science addresses the question of "what happened" in Mexico. My main contribution is in explaining why it happened and through what mechanism. My dissertation represents a contribution because it provides an explanation of how the Mexican economy, a manufacturing and development success story in the eyes of some international investors and in the inner circles of Mexican policy making, embarked on a path of successive crises throughout the 1980s and 1990s. The quick fix measures implemented produced a veneer of recovery. Yet underneath the glossy finish, the economy was gradually weakened and the quality of life for the majority of citizens was successively downgraded.

It is as if there were two realities in Mexico: one was the vibrant economy, a safe haven for global investors, a strong trading partner for North American economies, and a source of political capital for Mexican politicians; the other

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was an economy with an increasingly less important small to mid-sized domestic manufacturing sector, an economically and politically weakened middle class, and increasingly concentrated domestic banking, financial, and industrial sectors among which the main players are interconnected.

Through the analysis provided in this dissertation, I have sought to dispel myths about "globalization" that have led some to say that there are uncontrollable forces in the global economy, such as financial speculation, that prey on and destroy economies that have followed sound policies. As one of the first of the "emerging markets" to suffer a systematic reversal of private capital inflows in the 1990s, Mexico was often cited as an example of this kind of unstoppable force. Yet this dissertation has looked inside of the Mexican economy, at the political maneuvers that went on behind the scenes, at the large-scale capital flight outside of the country, at the increasing concentration of wealth in the hands of a small group of Mexicans with economic activities of "global" proportion, to describe the mechanism through which the 1994/95 crisis occurred and was yet another manifestation of the same inputs that led to the Mexican crisis that drew global attention in 1982.

During the early 1960s, due to an increase in international oil prices, the Mexican economy began its

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reliance on foreign capital and became oriented toward the production of oil. By 1980, 61 percent of Mexican exports consisted of oil. The high price of oil facilitated the appearance that the Mexican economy was doing well. At the same time, the economy became dependent on foreign savings attracted through foreign loans. These loans were easy to attract because of the expansion in international liquidity made possible by petrodollar recycling in the international economy. The foreign debt increased exponentially from $2.3 billion in 1960, to $6 billion in 1974, to $51 billion in 1980. A large proportion of this was commercial-bank-to-government loans that enabled the Mexican state to dramatically expand the state-owned enterprise sector. While the sector provided goods and services needed in the economy, it generated yearly operating deficits that were paid for with public funds, primarily originating in foreign loans to the government.

This situation was accompanied by the existence of a banking sector that was owned by a small group of Mexicans linked to the manufacturing sector through ownership. These manufacturing companies were able to survive in the protected domestic market even though they were not efficient producers. This situation coincided with a political structure in which the dominant political party, the PRI, controlled the

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resources of the state and ruled the country to the benefit of a small group of Mexicans with linkages to the state, and of the party bureaucracy.

When conditions in the international financial market changed in the 1980s and the availability of international capital contracted, the country fell into crisis because it was unable to acquire more foreign savings to finance the activities of the domestic market and to pay its debt obligations. A sector of Mexicans sent their money out of Mexico in massive flows of capital flight. International investors were protected by the U.S. government, which provided Mexico with a bailout package. The Mexican government evidenced a lack of accountability in pushing the weight of the crisis onto the majority of the population through banking sector restructuring, which increased poverty for large sectors of the population and strengthened some already wealthy Mexicans' role in the country's economy.

This phenomenon that emerged in the 1980s following the "success" years of Mexican industrialization in the 1960s and 1970s, was repeated in the 1990s. It was not an isolated event, but rather part of the phenomenon described above. After the 1982 bailout package arranged by the U.S. government, flows of foreign savings resumed into Mexico. However, the flows went to the same beneficiaries of the

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original loans and did not improve productivity or contribute to a change in the fundamentals of the Mexican economy. At the same time, the financial system was restructured to enable the owners of the banks at the time of the nationalization to transfer their power to the financial sector through regulatory changes that favored the strengthening and creation of new financial institutions, such as securities firms. With the nationalization of the banking system, the state applied public funds to address the inefficiencies and losses of the pre-nationalization banking system and the private companies that were insolvent. This occurred within an environment in which the Mexican state was not committed to maintaining an independent central bank or exercising a fair and efficient tax policy. Thus, the government worked in alliance with a small group of high-income Mexicans to reinforce the economic power of the latter group. What the government got in return was the latter group's support through campaign financing and reinforcement of the *idea* that the Mexican economy was successful.

During the late 1980s, the predominance of the neoliberal economic model coincided with changes in the international financial market, and an expansion of international liquidity due to regulatory and demographic changes in the advanced economies. Investments in the form of portfolio capital and

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international bond flows were welcomed into Mexico in order finance the activities of the domestic market. The lack of savings in the Mexican economy, exacerbated by the growing foreign debt, led, as it did in the 1970s, to Mexico's reliance on attracting foreign capital to meet needs in the domestic economy. However, the nature of foreign capital in the form of portfolio equity and bond flows did not contribute to Mexican domestic investment. What it did was generate a short-term illusion of economic prosperity that was followed by a new crisis in 1994/95.

This new situation, which I argue was part of the same old problem, occurred because throughout the period of illusory development from the 1960s through the 1990s, there were no real changes in the fundamentals of the Mexican political system and economy. The political system was not held accountable for the actions of the president, his ministers, and the state bureaucracy. Nor was the private sector made to pay for the actions of the bankers or the business people who were responsible for the crises. This environment provided the context in which international investors saw Mexico and its policies as a nearly risk-free way to allocate financial resources and receive high return for their investments.

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The lack of accountability of the administration of President Salinas and his desire to leave what appeared to be a successful economy as his legacy led him to avoid measures, such as devaluing the *peso*, that might have cushioned against the effects of the crisis. As happened in the 1980s, the country fell into crisis, and the high-income Mexicans sent their money out of the country. The investors were bailed out in an aid package to Mexico, and the Mexican state continued to be run according to the interests of the PRI.

Mexico in the 1990s illustrates a case of "emerging market failure" in which domestic economic, political, and economic policy factors come together in a context of an expansive phase in the international liquidity cycle to result in a crisis situation. In the Mexican case, a small number of people increased their wealth and economic power because they configured a system to their benefit, while for the majority of Mexicans, standards of living declined. As a consequence, Mexican foreign debt increased by 7,000 percent from 1964 to 1995.

Emerging market failure is characterized by the existence of the following elements.

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In the economic area:

1. an economic system unable to generate domestic savings and finance investment, with a consequent need for foreign savings
2. low overall productivity and inefficiencies in the manufacturing sector
3. a highly concentrated and exclusionary financial sector.

In the political area:

1. political leaders whose actions evidence short-term vision regarding the interests of the country in favor of short-term political gains
2. a political system consisting of a dominant political party that has a strong hold on the functioning of the state
3. a set of political institutions that function to maintain citizens' distance from the decision making process.

In the area of economic policy:

1. orientation to attract foreign capital at any price
2. policies that target short-term macroeconomic balance to satisfy political gains
3. policies designed to instill confidence in foreign investors by projecting an image of stability and

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prosperity without being based in the fundamentals of the economy.

The emerging market failure that occurred in Mexico is a singular case. However, the model has global implications because of Mexico's special relationship to the U.S. economy and because of the lessons that can be drawn for the emerging market phenomenon as a whole.

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