Are policy makers irrational?

Currency crises in Mexico, a comparative perspective
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ARE POLICY MAKERS IRRATIONAL?
CURRENCY CRISSES IN MEXICO, A COMPARATIVE PERSPECTIVE
Abstract

Managing exchange rates in developing countries is a key issue. Politicians very often defend currency pegs in a way that can lead to serious currency crises. Structural restrictions, the political cycle and the incentives provided by political institutions can be helpful in explaining short sighted policies that make currency crises possible. Policy maker’s misperception seems to be an additional explanation for economic disruptions. Using these concepts and some key lessons of recent currency crises, this paper focus on Mexico’s 1994-95 crisis and seeks to explain why it happened.

Resumen

El manejo del tipo de cambio en países en vías de desarrollo es un tema de gran importancia. Los políticos comúnmente defienden los tipos de cambio fijos de una forma que pueden traer como consecuencia graves crisis cambiarias. Las restricciones estructurales, los ciclos políticos y los incentivos propios de las instituciones políticas pueden ayudar a explicar las políticas de corta visión que hacen las crisis cambiarias posibles. La mala percepción de los políticos parece ser una explicación adicional de los trastornos económicos. Usando estos conceptos, y algunas lecciones clave de recientes crisis cambiarias, este artículo se enfoca en la crisis mexicana de 1994-95 y busca explicar porque sucedió.
I. Introduction

Few financial events are as notorious as some sort of currency peg, crawling peg or managed float abruptly destroyed by a major devaluation. Few are more costly. They are, however, once again quite common. What was seen as a particularly Latin American malaise of the old days of fiscal imbalance and state intervention has now been extended to most of the formerly successful developing countries of East Asia and more recently to Eastern Europe.

Managing exchange rates in developing countries is a key issue in the government's capacity to ensure conditions propitious for economic growth or at least to maintain macroeconomic stability. A currency crisis, usually accompanied by a financial crisis threatens the domestic financial markets with a meltdown. It imposes severe costs on the economy and on the taxpayers that have to bail out insolvent financial institutions, which in turn has adverse political implications for those in government. The overall instability can endanger their capacity to retain power.

Politicians, nevertheless, very often defend currency pegs in a way that can lead to serious currency crises. Instead of reacting swiftly to an attack against the currency, they bet they can defend the currency with minor changes, but as their time frame becomes shorter they are forced to devalue when they have very low foreign reserves and high short term dollar obligations that were used to protect their currency. They tend to forget that there is no such thing as a fixed exchange rate, as Margaret Thatcher repeatedly said, although only after the 1992 pound devaluation.

Game theory has increasingly dominated political analysis. It states that any individual decision is based on the assessment of how others will act and what costs and benefits these actions will bring about. Actors have preferences and try to maximize their utilities. Politicians want to hold on power, private investors are looking to maximize their wealth. Both act based on what they perceive as likely.

It is easy to blame financial speculators for destroying a currency. This argument is simplistic. Game theory is precisely about anticipating the reactions of others. Investors are rational and seek to maximize revenue and minimize risk, as any textbook on economics shows. Liquid investors seek short term profits.

* I would like to thank Blanca Heredia and Oscar Vera for their comments.

1 There are many kinds of pegs, which have different implications, but all of them are based on specific limits that if trespassed usually send the currency into a free fall. Some managed floats, like in Korea prior to the 1997 crises, although more flexible than pegs, can also lead to a long defense of some targeted rate that can end up being very costly.

2 It is clearly not a sufficient condition. French-speaking countries of West and Central Africa maintained a fixed exchange rate for 35 years, up to 1994 when they devalued their currencies, but are no example of rapid growth and were former colonies with strong ties with France. Jeffrey Frankel, "Recent Exchange-Rate Experience and Proposals for Reform", AEA Papers and Proceedings, Vol.86, No. 2, May 1996, pp. 153-158.
However, policy makers repeatedly fail to pursue policies that are sustainable and that provide incentives to avoid a run against the currency. Undoubtedly more open markets increase the structural power of holders of capital. Moreover, one country’s financial volatility can easily create volatility in other markets, but this is a given reality policy makers must be well aware of and should therefore act accordingly to this well known logic of financial markets. What remains puzzling is how often they bet they can beat the market.

Policy makers, not surprisingly, often blame speculators for their failures to manage the economy. There is always a Soros that allegedly stands to gain from the devaluation and can be depicted by the government as the villain. But policy makers must be aware that financiers seek profits and to cut losses panic, not only in the face of a devaluation, but even at the slightest risk of one. Prior to a currency crisis, investors’ desire for profits, if nothing else explained why money poured into their country, despite weak economic fundamentals and unpredictable political institutions when compared to, say, Switzerland. Investors expect higher rates of return to reward for the risks they are incurring. High real interest rates, open capital markets, and a quasi fixed exchange rate, that helps insulating investors from exchange risks, made this possible, at least for a while.

This paper addresses the issue of why so often governments defend some sort of pegged exchange rate and then lose control over their currency. Is managing the exchange rate a particularly difficult task subjected to exogenous shocks, restrictions from world markets and major domestic structural limits? Do policy makers favor certain private interests contrary to public interest or do they face political restrictions and electoral temptations that prevent them from acting more wisely? Are they simply fools?

This paper argues that although world markets and political incentives play an important role, policy makers misperceptions should be seriously taken into consideration in explaining recurrent currency crises. In other words, the interests of actors are not enough to explain the policies followed, as by stubbornly defending a currency they ended damaging their own interests. Policy makers translate their interests into what they think are the appropriate policies. They have a view of how policies will affect reality, including how these policies will enhance their political position.

It can be argued that the fact that a policy maker made a wrong decision that plunged his country into a financial crisis has nothing to do with irrational behavior. At most, it simply means that the decision was made based on the information available at that time and that it was, considering the costs of alternative politics, the best course of action. But ex post, the interpretation of the given information is so astonishingly wrong that it looks as if policy makers were irrational. Usually, before the economic disruption there were different points of view about what should have

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been done to prevent it, but the government followed policies based on a paradigm\textsuperscript{4} that incorrectly interpreted events. Repeated mistakes, as in the case of recurrent devaluations, are puzzling, which suggests some sort of rationality constraint.

The paper first presents the argument and then uses the unfortunate Mexican experience, in particular the 1994 devaluation, as a case study.

\textit{II. The structural dimension}

In protected markets, where financial intermediation is undeveloped, and few sophisticated financial instruments exist, managing the exchange rate is comparatively easier. Some kind of fixed exchange rate has more chances of survival. Although devaluations do take place in closely knit financial systems, governments retain a significant margin for maneuver as they control key variables that allow them more capacity to impose capital controls or harsh stabilization programs\textsuperscript{5}, and, in the event of a devaluation, to minimize its costs.

With the development of the economy, which implies increasing links with world markets, more complex financial instruments and more liquidity, markets become more difficult to manage in a centralized way. Unnecessary regulations impose extra costs on the economy. The more successful business groups demand more open financial markets.\textsuperscript{6} Some liberalization is perceived as necessary and international financial organizations are quick to endorse them.

Less successful developing countries can also have extremely open capital markets. To confront past financial crises, some have tried to recapture the domestic investors that pull out or to attract foreign investment through more open markets, even at the risk of losing more policy autonomy.\textsuperscript{7}

As financial markets are liberalized, capital control are lifted, new instruments are developed, which channel savings in a more efficient way. They, however, also become potentially more fragile. Arbitrage becomes a powerful force that can make any currency extremely volatile. Contradictory policies are

\textsuperscript{4} On ideas as paradigms that act as cognitive constrains on which policies are perceived as possible see John L. Campbell "Institutional analysis and the role of ideas in political economy", \textit{Theory and Society}, Vol. 27 No. 3, June 1998, pp. 387-392.

\textsuperscript{5} Bartlett persuasively argues that more capital controls and less sophisticated financial markets explain Eastern Europe’s successful stabilization as compared to Latin America. Latin America, and Mexico in particular, have clearly more sophisticated financial markets and have less controls on capital transactions than Eastern Europe, that “maintained restrictions on capital account convertibility”. China too has significant controls that have helped them avoid devaluation. David Bartlett, “Has the East Really Become the South? Ownership Structure and Economic Policy in Eastern Europe and Latin America”, \textit{Politics and Society}, Vol. 25, No. 2, June 1997, p. 210.


increasingly difficult to sustain for a long time. Even what are perceived as correct policies can be difficult to sustain, as excessive resources that flow to the economy with the “appropriate” fundamentals can create unbalances. Although external flows can help finance the economy, when these flows exit, they can destroy a currency and economic stability.

To confront volatility some sort of peg can be very helpful, leading to less inflation and uncertainty. However, pegs are vulnerable to speculative attacks, and \textit{ex ante} there is no optimal time to change the peg or the currency regime. Economic theory can neither predict why a run against a currency takes place at a specific moment. This can always be used by governments as a justification for having postponed adjustment. It was mere bad luck, called exogenous shock.

However, some sort of currency peg and macroeconomic imbalances imply an obvious risk, which are usually penalized by financial markets, especially in countries with unfortunate rich experiences of sudden devaluations, such as Mexico. When fundamentals are weak and no reform is undertaken to strengthen them, speculation will eventually take place to correct macroeconomic imbalance. No one disputes this, yet so many governments have tried—and some with the support of the IMF—t o take control of the markets, and only few of them can claim some sort of victory.\footnote{We, however, only study those bets that failed. Those that were successful are forgotten. But those that failed are so costly and in some countries so common that they shed light on the limits of currency regimes based on some sort of currency peg.}

Sudden devaluations are not restricted to developing countries, as European governments realized in the 1992-93 currency crisis. Developing countries, have clearly even resources at hand, as their institutions are weaker, their banks more fragile and many of their citizens have learnt to keep their savings abroad. Developing countries have less margin for maneuver. They should have learnt to act more prudently. However, in spite of the 1992-93 European devaluations, and even after the 1994 Mexican disaster, in many countries policy makers happily continued to defend a peg and to pursue policies that allowed a serious external imbalance arguing “we are different”.

The track record of developing countries varies enormously. From 1985 to 1997 Mexico devalued seven times, and adopted a floating currency from 1995. Thailand devalued only once. While Mexico did not seem to learn its lesson from previous devaluations, Chile did so after its 1982 devaluation.\footnote{Sebastian Edwards. “Exchange-Rate Anchors, Credibility and Inertia: A Tale of Two Crises, Chile and Mexico”, \textit{AEA Papers and Proceedings}, Vol. 86, No. 2, May 1996, pp. 176-180.} Its central parity was adjusted on a monthly basis to compensate for the difference of inflation between Chile and its main trading partners, although, the currency was revalued through movements of the band at certain key moments. Chile also imposed some controls on short-term capital inflows, which limited volatility. This contrasts with the policies followed by Mexico from 1988 to 1994, with an exchange rate based on a band and no capital controls.
In 1994-95 Argentina was caught in a similar situation as that of Mexico, but was able to defend its currency, although at a high cost in terms of recession and unemployment. Chile was virtually unaffected throughout this period.

Thailand had to devalue nearly three years after the Mexican crisis, when the Tequila effect had evaporated. After the Thai July devaluation, Malaysia, Indonesia and Philippines had to devalue. The currency instability afterwards affected Taiwan, Hong Kong and China but the three have managed so far to avert a major devaluation. Even a more protected market, like South Korea, faced devaluation and a serious crisis as its firms were highly leveraged. Brazil faced a speculative attack against its currency, the real, just after the 1998 Russian crisis. It reacted proposing tax hikes and more economic reforms, but as imbalances accumulated, much radical policies were needed to defend the peg and President Fernando Henrique Cardoso lacked the political support to implement them and finally was obliged to devalue.

External restrictions and crisis contagion are increasingly important and countries need to devise ways of diminishing risks associated with more open financial markets. After the Russian crisis this is more urgent. Yet, as countries have shown different success in managing exchange rates, global structural restrictions are only one explanation of the difficulties of managing exchange rates. Other variables explaining why certain policies are defended have to be taken into consideration.

III. The political cycle and the political institutions

The political cycle and the incentives provided by existing political institutions can be helpful in explaining short sighted policies that make currency crises so recurrent and so virulent. Political incentives can make it attractive for politicians to postpone difficult decisions, such as devaluing, raising interest rates, deepening economic reform or imposing some sort of capital controls.

A fixed exchange rate with the proper institutional restrictions that obliges the government to back the monetary base with currency reserves can be a satisfactory policy to avoid volatility in open financial markets, as volatility imposes a high cost both to producers and consumers. However, most fixed or quasi-fixed exchange rates do not include credible government commitments. That is, they


Although the strategy can stimulate growth and stability, it is not costless nor riskless, as the Hong Kong or Argentina recent problems show. Another option is a monetary union, such as the one Europe decided to follow after the 1992-93 currency crisis. This, however, moves the issue into a supranational dimension. It has yet to be seen if the Euro can avoid future devaluations. Even if successful, it is not an option that can easily be followed by other countries. It implies a sophisticated institutional framework not easy to achieve by developing countries and developed countries are unlikely to risk the stability of their currencies in monetary unions with developing countries. A last option is complete dollarization, like in Panama. No large country has yet followed this path.
do not include currency boards that have a legal binding to limit monetary expansion.\textsuperscript{12}

Governments tend to use some sort of peg instead of a currency board because they seek to retain some monetary autonomy. They want a predictable exchange rate to attract investment and as an anchor for domestic prices, that is to promote growth and price stability, but at the same time they want to have margins for maneuver in the case of an “exogenous” shock or, perhaps more important, to manipulate the political cycle. Undoubtedly pegs have been very popular, at least prior to the recent cycle of currency crises, as they seek to combine stability with flexibility\textsuperscript{13}, favoring a large group of potential winners and avoiding the tough constrains a currency board implies.

\textit{Ex ante,} if credible, a fixed exchange rate can lead to higher private investment, as certainly increases, returns are more predictable. Many high growth economies were based on some kind of peg, as in the case of Mexico from 1954 to 1976 or Thailand from 1985 to 1997. Nevertheless, success can also sow the seeds of destruction, especially if capital accounts are completely opened, which most developing countries did in the 1990’s, as investors can move their assets when if the government inflates or threatens to inflate the economy.

A high flow of resources tends to cause currency appreciation, to distort money supply and domestic credit, and can put a strain on weak banking systems in the case of capital outflows. Capital outflows is a possibility that policy makers and international organizations such as the International Monetary Fund (IMF) should always consider as low returns in developed markets explain in a significant proportion why external flows move to developing countries.\textsuperscript{14} Under poor regulation and perverse incentives, foreign resources can lead to bad investments induced by arbitrage between domestic and international interest rates, backed by predictable exchange rates.

The perversity of fixed exchange regimes is that, even when things go sour—when there is some sort of exogenous shock or when imbalances become obvious—they can be defended for some time with high real short-term interests. This can lead to more capital inflows, and if these resources are not sterilized, to further appreciation, a higher current account deficit and weaker public finances.

Using the exchange rate as an anti-inflationary anchor and as investors’ insurance has short-term benefits. Countries with a history of inflationary policies

\textsuperscript{12} Not even currency boards are a guarantee of success, but under proper institutional restrictions they tend to show more strength than currency pegs. In case of devaluation, however, the price paid by the failure to defend the currency would be much higher.


\textsuperscript{14} In the case of Latin America as high as half the flows are explained by recession and/or low interest rates in developed markets. See Guillermo A. Calvo, Leonardo Leiderman, and Carmen M. Reinhart “The Capital Inflows Problem: Concepts and Issues”, \textit{Contemporary Economic Policy}, Vol. XII, July 1994, pp. 54-66.
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use a peg as an instrument to achieve price stability without paying the price of a larger recession. However, the peg usually outlives a successful stabilization and it can easily become a trap with no easy exit if monetary policy is contradictory with the restrictions imposed by the peg and open capital markets and if economic policy does not promote that resources that flow into the country are invested in a way that makes the economy more competitive in the future, therefore justifying short term imbalances. How to exit a peg, the so called “exit strategy”, largely depends on an estimate of the sustainability of macroeconomic imbalances.15

When a country, based on some sort of peg, has flourished at high growth rates for more than a decade -as in the case of East Asian countries from the mid eighties or Mexico up to 1976- moving the currency is particularly difficult. Groups that have been profiting from a long-term stable exchange rate can pressure governments not to change currency policy as they can be highly leveraged. Political coalitions based on growth are particularly difficult to change, as legitimacy is based on government’s capacity to distribute goods and to enhance the welfare of political supporters. For the vociferous middle classes devaluation poses a threat to their way of living so dependent on imported goods and services and, usually when there is financial stability, highly leveraged.

Even when slow economic growth has accompanied the quasi-fixed exchange rate, but at least some price stability has occurred -like in Mexico, from 1988 to 1994, or Brazil, from 1994 to 1998- moving a currency is not easy. Politicians tend to oppose to any change that could threaten stability, which is seen as the basis of their economic success and of their political support among financial investors, international organizations, and consumers in general.

Mexico in 1994, with elections in August was a difficult scenario for adjusting the currency. Although real interest rates went up, and the currency moved to the ceiling of the band, a major adjustment was not undertaken, and the economy finally exploded in the hands of the new elected government. South Korea in 1997 also facing elections was reluctant to take costly measures, but its first crisis exploded before the election, although relatively small when compared to what happened after the elections, as difficult decisions were postponed. In Thailand, the government elected in November 17, 1996 was thought to be competent, as important technocrats regained the control of economic policy. However, the risk involved was not perceived. Brazil faced a similar political cycle, postponing tough decisions until the 1998 October 4th elections, but afterwards lacked the political strength to impose the needed reforms, being forced to devalue in January.

This is a relatively standard argument. The political cycle and political coalitions distort economic policy. But in Mexico, Thailand, Malaysia, Indonesia, the Philippines, Russia and Brazil the devaluation triggered a financial crisis that imposed a high cost on the "same actors" that delayed adjustment and on the groups that profited from the "fixed" exchange rate. A cost that was higher than anything

they would have had to pay if they had swallowed the pill before. Why then, are
they trapped in these inconsistent policies that hurt deeply their own interests and
those of their followers? Why did not the Mexican government use the months after
the election to tighten the economy or seek a less disordered devaluation,
accompanied with an agenda of economic reform?
Those groups that took advantage of a predictable exchange rate could have
hoped to anticipate the devaluation and reap an extra profit. Some no doubt did,
although in the case of most of the countries that underwent devaluations in the last
three years (except perhaps Brazil) many investors were caught short of dollars, as
many of them thought economic policy was the adequate one. For public officials,
however, an abrupt devaluation can only imply a high political cost even if, in
corrupted political systems, they are able to gain some economic benefits in the
period of high volatility.

IV. The misperceptions of policy makers
There is one plausible residual explanation. Policy makers and investors start
gambling with their future and their country because their perception of the risks
involved is incorrect, resulting in obvious errors of calculus.
Economic ideas are powerful. New economic models justify both bold
reforms and the imbalances they create during what is believed to be a mere
transitional period. After the fall of the Soviet Union it seemed that the route to
economic progress was obvious. It was just a question of opening the economy and
privatizing public owned firms. There was a basic agreement between political and
economic elites, both national and international, that the path being followed was the
correct one. They shared a paradigm on how things should be. Their optimism
clouded their vision. The institutional development needed to support effective
markets were, at best, left to the future. The logic of previous crises was taken into
account by policy makers, but a new and apparently different imbalance was
justified by the reforms being pursued.
Even if weaknesses on programs of economic reform are detected, those that
support economic reform in international financial organizations find it difficult to
stop reformers. An extreme example was provided by the Asian Development Bank
officials in a private interview. Kahaztan was conducting a profound reform of their
pension system. Asia Development Bank thought it was too early, as capital markets
were not properly developed, but the bank had to support the reform because
politicians usually do not want to follow this kind of policies. Once the President of
Kahaztan announced they would reform the pensions system, the bank had to
support him. If someone takes seriously the Bank's credo, they have to support him
or their credibility will be eroded vis à vis those they are constantly urging to follow
the credo.
In a world of fixed exchange rates, as it was for most countries up to the mid
nineties, the idea of floating the currency went against the standard view of how to
manage currencies. This increased the appeal of pegs, in spite of the obvious risks, especially for countries with a rich history of devaluations.

It is argued that developing countries were guilty of financial repression and that the proper recipe - i.e., financial liberalization - had to be taken in order to promote investment. More open financial markets can lead to more and better allocated investment. The medicine was swallowed and it allowed those countries to capture foreign resources. The medicine, however, is bitter. If swallowed too fast it can lead to serious errors in the allocation of resources (that the pegged exchange rate facilitates). If swallowed with the wrong mixture, i.e. with protected, weak, and poorly regulated domestic banks, the involved risks are even higher.

After the Thai crisis, the IMF argued, that in order to bring benefits from opening financial sectors a country should take several steps "before liberalizing its capital account: cutting government borrowing, inflation and current account deficits to safe levels, strengthening domestic financial markets and tackling other structural economic distortions".¹⁶

A current account deficit, nevertheless, is the result of inflows of capital. At least this was the official explanation in Mexico, Thailand and Brazil. Moreover, opening the capital account before implementing further structural reforms, although risky, was necessary to give political support for the reforms. The incoming resources allowed the government to justify further measures that affected powerful domestic interests such as highly protected industries.

It is now commonly accepted that weak banks and poor banking regulation and supervision are behind the Asian crisis.¹⁷ This, should not come as a surprise. The same logic that made public enterprises ineffective, i.e. a weak and paternalistic state, leads to inoperative banks in light of poor regulation potentially and juicy short-term gains. If risks are mainly skewed against the government that either provides full insurance for deposits or tacitly recognizes it will bail out bankers that tend to exhibit their strong political ties and benefits to the private sector (banks, savers, and lenders), resources are likely to be allocated inefficiently. Bank deregulation created serious problems in developed countries,¹⁸ it was clearly destined to do the same in less developed ones, but with a vengeance as institutions are weaker.¹⁹


¹⁷ See Sachs, Tornell and Velasco for the case of Mexico and Argentina. It is worth underscoring that this article, written before the Asian crisis, puts East Asia countries, including to some extent Indonesia, as example of much better regulation, see p. 192. Jeffrey Sachs, Aaron Tornell and Andrés Velasco “Financial Crisis in Emerging Markets: The Lessons from 1995”, Brookings Papers on Economic Activity, 1:1996, pp. 147-215.


¹⁹ Guillermo Ortiz Martínez explains how banking credit, as the result of liberalization, exploded from 1989 to 1994: "Unfortunately, this happened at a time when there was inadequate financial supervision and regulation by the monetary authorities...". He was then the Undersecretary of
The theory of how to strengthen banking regulation is clear, but implementing it is much harder. If these reforms are not in place, policy makers should not assume they are and proceed with the liberalization. Unfortunately, the need of institutions to underpin markets was neglected in the first wave of economic reform. In the beginning liberalization brings juicy benefits as resources pour into the country, which justifies opening up in spite of weak institutions. However, the lack of solid institutional frameworks can lead to violent explosions afterwards.

Not only the importance of institutions to underpin the markets was neglected. How previous crises were understood led to minimize macroeconomic imbalances. The Mexican financial crisis of 1982 was explained as the result of a large public deficit of more than 15% of GDP in 1981 and of 17% in 1982. The Mexican authorities (in 1993-94), thought the current account deficit, of nearly 8% of GDP, was not problematic because public finances were balanced. A similar delusion was faced by the Thai authorities. After the Mexican crisis, when the blame, according to Mexican government officials, was laid on low domestic savings and real exchange rate appreciation, Thai authorities argued their country could sustain the deluge as they had high domestic savings and the appreciation of their currency was not serious. Brazilians also thought their situation was different as direct foreign investment was pouring into the country, domestic banks were in relatively strong position and Mercosur would create the third largest world market. Brazil, forgot lesson one: maintain a fiscal balance.

When macroeconomic imbalances become very serious, some economists will show that the trend being followed cannot be sustained, but there is always a clever financier or a creative authority suggesting a new instrument to cope with these pressures, which are perceived as temporary. No new risks are expected in the future. Governments may think they can avoid adjustment.

Economists and investors know well the risks of large flows of resources to developing countries, but they tend to foster arguments that minimize the risk involved in the country they have been investing. There is always an economist defending the imbalances as transitory and urging the authorities to protect the currency even without major policy changes. With so many divergent theories for justifying the correct economic policy, a "sound" justification that is consistent with the shared paradigm can be found by whom ever eagerly wants to hear it. The cost

the Treasury. Either this problem was then unknown in the academic literature and among policy makers or political incentives explain why the government allowed credit expansion in the light of poor regulation and supervision. See Guillermo Ortiz Martinez, "What Lessons Does the Mexican Crisis Hold for Recovery in Asia?", in *Finance and Development*, June 1998, p. 8.

20 Mishkin, pp. 38-45.


of jumping the peg is so high that any solution to avoid jumping has large chances of being accepted.

Managing pegs is based on credibility. Money has value if investors give credit to policy makers. To achieve this, governments hire high powered economists or financiers with a good technical reputation within the financial community. They also seek support of the IMF. These actors usually share a paradigm with investors of how to manage the economy. As everybody believe in the model, as long as it is credible it works, it attracts capital flows. Government officials, IMF staff, and private investors discard imbalances, which their mental framework considers unimportant, until it is too late.

As economic models as they become more complex, many times they defy common sense. Just as in the Long Term Capital Management hedge fund failure, the best minds, two Nobel Prize winners included, can develop sophisticated models apparently risk free that are unsustainable when the unexpected, called external shocks, do take place.

Critical to policy makers is the fact that there are actors that profit from a pegged exchange rate that pour money into a country with a “credible” pegged exchange rate. Markets can share the government’s official’s erroneous perceptions for a long time, enough to convert any imbalance into a time bomb, thus paving the way for disaster. As countries follow policies based on economic models advised by public international financial organizations with the acceptance of major private investors as the “correct” ones, a positive reaction is created from international markets that validate the policies implemented.

As markets become more integrated, investors cannot fully grasp the problems of each market. They follow gross indicators -simplifiers based on previous crises, but are nonetheless incapable of anticipating new crises- that can hide real problems, and when the devaluation comes they can easily overreact. After the 1994 Mexican crisis it was argued, including the IMF, that the government concealed information from investors, or even worst, that it was only given to some domestic investors. As French-Davis argues, the relevant information was there, but investors did not pay attention. Just like the government, many local and foreign investors ended up believing that the unbalance was temporary and justified by a

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23 Within the government and international organizations such as the IMF, those that perceive the imbalances find it very difficult to argue in favor of their ideas as if such a position were to be leaked to the press, defending the currency would more difficult. Any position against the peg tends to be silenced.


sound economic reform. Little did they seem to know that even a minor change in the perception of anticipated returns can lead to a stampede of investors abandoning a market. But not even after the Mexican cruel punishment other markets seem to have learned from it. The Russian punishment was even more virulent.

V. Mexico

Mexico, it is well known, “... is a cyclical country par excellence. Most presidents inherit an economic disaster at the beginning of their six-year term, work hard to improve it, only to see things fall apart in their final years of office”. Mexican presidents have learned to fear the political cost of a devaluation that would upset the most important political groups in Mexico. In López Portillo’s words: “Devaluation...is the most serious political problem a President of the Republic has to face... This phenomenon of economic adjustment that seems to be normal in other nations, in Mexico, was truly a national tragedy”.

Since taking power in December 1988, Carlos Salinas de Gortari was particularly aware of the importance of avoiding this cycle of devaluation and crisis that had destroyed the credibility of outgoing presidents between 1976 and 1982. He made stability one of his prime objectives, pursuing both a macroeconomic policy that would, in his view, ensure low inflation through fiscal caution and a tight monetary policy, and a structural reform that would transform the Mexican economy and, therefore, it was thought, eliminate the deeper sources of currency instability: a large public sector, a closed economy, and excessive government regulation.

By any standards Salinas was successful. Inflation went down from 159.2 per cent in 1987 to 7.1 in 1994. The public sector shrunk from 617 public enterprises in 1987 to 215 in 1994. The economy was opened. The public sector deficit went from 8.64% of GDP in 1988 to a superávit of 0.68% in 1993. By 1994 North America Free Trade Agreement (NAFTA) was a reality that not only succeeded in lowering the
tariffs even more and providing access to the US market, but, more importantly, strengthened the institutional foundations of trade liberalization and pro market economic policies. The almost complete liberalization of the financial markets enabled the Salinas administration to finance the dark side of this story: an increasing current account deficit and the overvaluation of the peso.  

Economic reform was the result of a new alliance within the government. By displacing other groups with more state-oriented policies and responsible of the 1976 and 1982 devaluation's high inflation and serious imbalance of public finances, a new group of technocrats reinforced themselves in power during the Salinas administration, with an agenda of market oriented reforms and the simultaneous need to gain the confidence of private investors, in particular foreign ones. They were considered by The Economist as "perhaps the most economically literate government in the world". Each time the government felt investors' confidence was diminishing, its response was a new dramatic coup towards liberalization such as privatizing the state owned banks, and proposing (NAFTA) to the United States.

The Salinas administration took power with very veable electoral legitimacy. Controlling inflation and stabilizing the exchange rate was its initial political success, as it increased private consumption of dollar-intensive goods, ensured high dollar-equivalent interest rates to savers and reduced the unfair inflationary tax. By making possible urban middle class dollarized consumption and making sure the rich's savings received high yields in dollar terms, Salinas gained their political support. It is worth observing that a low dollar increased the purchasing capacity of all consumers. This explains why the Salinas administration gained popularity so quickly once the economy was stabilized. By 1991, in sharp contrast with the contested 1988 elections, the Partido Revolucionario Institucional (PRI) won easily the mid term elections.

If stabilization gave Salinas a broad social support, privatization was the vehicle for recasting a new coalition with large businessmen. This enabled Salinas to forge a new class of businessmen that profited from economic reform, and thus

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33 The current account deficit began to increase beyond governmental expectations, which were based on optimistic elasticities. In 1989, the current account deficit was 6 billion dollars, although the government projected a deficit of 4,000 million dollars. By the end of 1991, the expected deficit was 6,000 million, but it reached 13,700 million dollars. By 1994, these numbers were 19,700 million dollars and 30,000 million dollars, respectively. Only in 1993 governmental expectations were pretty close to reality, but the cost was less growth than expected, data from SHCP, INEGI and Banco de Mexico, quoted in Carlos Elizondo, "Tres trampas: sobre los orígenes de la crisis económica mexicana de 1994", Desarrollo Económico, No. 144, Vol. 36, Enero-Marzo 1997, p. 961.


55 For Salinas relationship with bankers see Carlos Elizondo, "The Making of a New Alliance: The Privatization of the Banks in Mexico", Working Paper No. 5, Political Studies Department, CIDE, Mexico, 1993, pp. 5-27.
could help imposing the painful side of the new economic model to a larger group of Mexican businessmen.

By the end of the sexenio, however, the capacity to continue with bold structural initiatives that could have created new incentives to invest in Mexico and make the economy more efficient diminished, as the short term political agenda gained priority. The President needed to ensure a positive political environment in order to promote his presidential candidate. With a short-term time limit on the horizon, financing imbalances through risky measures became more attractive.

This implied postponing measures that could be opposed by vested interests wanting to profit from the tension filled months before the destape. Potential presidential candidates had to ensure their own role was not questioned, which created incentives for covering up any problems and postponing difficult decisions. The leitmotif of this game is to impede conflicts and potential problems.

During the Salinas sexenio, the fifth year of his administration (1993), and the year of the destape, was also the year of NAFTA approval. The value of the peso was shielded and the economy was halted through high real interest rates in order to avoid a devaluation that would have made it more difficult for getting NAFTA through the United States Congress, risking the fury of American Trade Union leaders that felt Mexican wages were already far too low.

In the past, after the destape, the government regained some margin of maneuver as elections were less important. De la Madrid, the previous president, began his economic shock therapy that gave Salinas the opportunity to commence his administration with a stable economy after the destape, but before the elections (which were, almost lost, as political life in Mexico had changed more than the government cared to admit).

After the murder of his hand picked successor, Luis Donaldo Colosio in March 23, 1994, it became evident that the exchange rate regime was under a strain. Why did Salinas risk his image, his candidacy as Secretary General to the World Trade Organization (WTO), and his economic program?

It is difficult to ascertain whether Salinas just wanted to “pass the buck” to the new government. True, the devaluation came 16 days after the Zedillo government took office, but Salinas’ prestige was completely destroyed by the devaluation, just as the prestige of the presidents before him responsible for previous devaluations had been. The devaluation destroyed not only his prospects as an international figure, but also the possibility of being influential in the Mexican political arena. More dramatically: it obliged him to live in a sort of exile in Ireland and could do nothing when in 1995 his brother was imprisoned on murder charges.

36 For negotiations with large businessmen to impose a new tax law see Carlos Elizondo, “In Search of Revenue: Tax Reform in Mexico under the Administration of Echeverria and Salinas”, Journal of Latin American Studies, No. 26, 1994, pp. 159-190.
37 The unveiling of the PRI presidential candidate by the President. As the PRI dominated the electoral process, the PRI candidate was virtually the future president.
Zedillo's government must have also perceived the situation was manageable. Although apparently asking for a devaluation in November 1994, his appointed Secretary of Finance, Jaime Serra presented an optimist economic plan for the year 1995 which did not include a new exchange rate policy nor a program of economic reform.

The clumsy way the peso was devaluated 15% in December 17th, without proper negotiation with foreign financiers, nor with a credible new economic program led to more capital outflows and to a new and more dramatic devaluation two days afterwards. Many reasons have been given in order to explain why the devaluation took place and why it was instrumented in such a clumsy way.

The favorite explanation of Mexican political and economic analysts is that the devaluation was deliberately postponed not to affect the August elections. For David Bartlett, Salinas “missed the opportunity to undertake an orderly devaluation before financial speculators sent the currency into a free fall...” because he was “Distracted by the Chiapas rebellion, political assassinations, and the 1994 electoral campaign.”³⁸ For Timothy P. Kessler political objectives distorted economic policy leading to inconsistencies with the logic of economic reform.³⁹

Political factors did limit government’s margin of maneuver. After the Colosio assassination, devaluation could have triggered more social unrest. This could have eroded PRI’s support. However, this does not explain why a preemptive devaluation or a harsh stabilization program was not conducted after the elections, when the government had some margin of maneuver.

Contrasting Argentina and Mexico, Star has argued that electoral coalitions explain Argentina’s successful defense of the peso and Mexico’s failure.⁴⁰ Yet strong political coalitions impeded a preemptive devaluation. The “pacto” scheme, where government and leaders of the private sector, labor and peasant agreed on the level of the wages, public sector prices, and the exchange rate, was a strong institutional limit to devalue that made any change in the value of key prices politically very costly.⁴¹ But if Salinas after the election or Zedillo after taking power were still insisting that no currency adjustment was necessary and that the economy could grow and finance a large current account deficit it was because both did not fully perceive the risk involved. Actually, they had had low reserve levels in the past, like in 1988, and by defending the peso they had avoided a costly devaluation. Many thought reserves would be accumulated again with the new government.

³⁸ David Bartlett, p. 206.
⁴¹ It was also difficult to negotiate inside the “pacto” devaluation, as all sectors would have demanded increases in prices and salaries destroying any real term advantage provided by a nominal devaluation.
In November in a private conversation, Salinas argued that in 1995 the problem would be how to manage an overheated economy. Many investors did not perceive the risk either, as shown by the growth of the stock market after the elections. The IMF still defended by late 1994 the virtues of the Mexican model of economic reforms. Any political cost Zedillo would have had to paid for a recessionary economic program in November is minute compared with the cost he paid with the uncontrolled December devaluation and the financial crisis that followed. In March 1995, Zedillo could force the PRI to defend his recessionary program including a VAT raise from 10% to 15%. Is it credible that in December, as Star argues, he had no strength to pursue a recessionary policy, but he could impose a more heroic one four months later? How can we explain a clever group of technocrats allowing the peso to blow up in their face the way it did?

Economists have provided several explanations as to what went wrong and why. Gil Díaz argues that the problem was the weak banking system and the reluctance of the authorities to raise interest rates. According to Sachs, the explanation lies in the incompatibility of an exchange rate in the ceiling of the band, and the reluctance to raise interest rates. Sachs, Tornell and Velasco, point out that when banks are weak and the currency appreciation is significant, governments will be reticent to protect the currency through high interest rates, as they do not want "to endure a recession due to a period of overvaluation and high interest rates. A key determinant of the latter decision is the health of the banking system". This argument does provide a strong case as to why the government opted not to raise interest rates. The government had just privatized the banks and did not want to hurt the new owners. Nevertheless, government officials must have thought that the policies they followed were compatible with stabilizing the exchange rate, as by not acting on time, the government later faced an even more serious banking crisis later, which will cost the taxpayers more than 16% of 1998 GDP.

Just as policy makers miscalculated the weakness of the peso and were forced to devalue, they miscalculated the cost of the devaluation. This implied a much larger recession than expected. It is of great significance that even after this recession, economists still argue that the alternative is either devaluation or recession. The devaluations of Thailand, Malaysia, Indonesia, the Philippines, and Russia have also triggered a financial crisis and a recession.

Gil Díaz and Carstens state: "the crisis had a political origin and (...) some of the financial disequilibria, including the maintenance of the nominal exchange rate in the face of the recent explosion in international transactions, contributed to the

42 Private interview with public official close to President Salinas
43 Foreign reserves at the Central Bank remained stable from July to September and grew 7.65% in October. They started collapsing in November, Banco de Mexico, Información Económica, 1995.
45 Sachs, Tornell and Velasco, pp. 147-215.
46 Sachs, Tornell and Velasco, p. 149. See, however Coopers comments of these article, p. 205.
According to the Central Bank political shocks are also the main explanation. The government initially expected that after the Colosio assassination, no new political shocks would take place. The murder of Francisco Ruiz Massieu, second on board of the PRI, and more important the statements by his brother Mario, the person in charge of the police investigation that he was being blockaded by prominent priistas, initiated a new speculative attack. It was hoped that once Zedillo took power, political and economic instability and uncertainty would diminish. They miscalculated the fragility of the currency vulnerable to any sign of uncertainty, or even to a staged "troop movement" of the zapatistas.

Calvo and Mendoza argue that volatility is an unavoidable global tendency of integrated markets. Policy maker's should closely follow not only "traditional vulnerability indicators (such as the size of the current-account deficit and the stock of reserves)" but also "financial vulnerability such as monetary and debt imbalances". However, this imbalance was the result of the government's defense of the peso, just as the large M2 when compared to foreign reserves, used by Sachs, Tornell and Velasco to explain the crisis, was the result of the failed defense of the peso that led to increasing emissions of Tesobonos and lower international reserves.

Just after the crisis, some analysts argued that the only problem had been the decision to devaluate and that returning the peso dollar parity to $3.50 was the only way out. You still find former public officials that in private defend this view, an extreme version of a view that believes that as long as investors have confidence any rate can be defended. The problem, in their view, was not being a radical defender of the peg. These critics seem to forget that the government devaluated with virtually no foreign reserves.

For Dornbusch and Werner the crisis was the result of an overvalued currency that was impeding growth. In their view, a preemptive devaluation should

47 Francisco Gil-Díaz and Agustín Carstens, "One Year of Solitude: Some Pilgrim Tales About Mexico's 1994-1995 Crisis", *AER Papers and Proceedings*, Vol. 86, No. 2, May, 1996, p. 164. Undoubtedly maintaining the nominal exchange rate made the devaluation and the ensuing crisis possible. Explaining why the nominal exchange rate was maintained, in spite of political and economic imbalances, is precisely the question I want to address. Gil and Carstens conclude that a currency board is the solution, that is maintaining a nominal exchange rate, but with the appropriate monetary institutions. This apparent solution was not any longer defended by Gil Diaz in 1997.


49 One day before the devaluation the rebels of Chiapas announced a "troop movement" into some of the territory around San Cristóbal. It was just a propagandistic show of a fake "liberalization" of territories, but had a profound input on investors, which seems to have been the target of the show.

50 Calvo Guillermo and Enrique Mendoza, "Petty Crime and Cruel Punishment: Lessons from the Mexican Debacle", *AER Papers and Proceedings*, Vol. 86, No. 2, May, 1996, p. 174. For these authors "the attempt at correcting the misalignment of the exchange rate triggered a deep and protracted economic crisis..." But the attempt was not voluntary, it was unavoidable once the reserves reached less than 10 billion in the days prior to the devaluation. The government did not devalue freely, it was forced to do it.

have taken place in early 1994. Edwards also argue that a devaluation as early as 1992 would have been necessary as trade liberalization is very costly to sustain with an appreciated real exchange rate. Villarreal also gives a structural explanation for the 1994 devaluation. According to him, by 1992, when inflation had been controlled the currency should have been left free to float. Allowing the Mexican economy to face a swift liberalization with an overvalued exchange rate led the economy into an unsustainable imbalance. However, this view was neglected or incorrect by several government officials.

What is not clear is why competent officials did not address these tensions on time, as by not acting they just magnified them. Even more inexplicable Mexico has had a long history of recurrent devaluations that would magnify any mistake. Only in a few countries (i.e. Argentina) domestic savers are so sensitive to a devaluation, having learned from the past that getting out quickly is crucial. Salinas’s success depended on an extremely well marketed strategy. Any surprise would be alarming for investors confronting problems they thought could “never” occur in Mexico, (the new member of the Organization for Economic Cooperation and Development (OEC) and NAFTA.

Similar crises in other countries following similar policies had taken place in Latin America less than 15 years before. These crises could also have served as an example. The case of Chile in 1978-1982 is particularly enlightening, because the Chilean success story that came after 1985 was quoted so many times by government officials as having been an inspiration for Mexico’s reform.

Chile, as argued above, did learn from its previous crisis and used a crawling peg, and also imposed some controls on short-term capital inflows. This contrasts with Mexico’s quasi fixed exchange rate with no adjustments to inflationary

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54 The Central Bank argued in 1995 that “The economic reactivation registered in 1994 has to be considered as satisfactory, specially if we consider the internal and external turbulence that took place during that year”. Banco de México, “Exposición sobre la política monetaria”, January 1995, p. 5.
57 “Reform, restructuring, the opening of trade, stabilization, privatization, and openness to capital are all features that Mexico and Chile have in common. The critical difference lies in the fact that in Chile the real exchange rate is the key price for long-term performance, while in Mexico it is the primary variable to be manipulated for short-term gain”. In Dornbusch Rudiger, Ilan Goldfajn,
differentials and no capital controls as restrictions to foreigners to invest in CETES and some other governmental bonds were lifted in December, 1990. This decision was accepted by the Mexican Central Bank “in attention to the petition of the Public Finance Secretary”. If many European countries could not sustain their pegs, what was to allow Mexico to succeed?

“Fundamentals” are difficult to judge. After each crisis, policy makers and economic agents tend to concentrate in only a few indicators. Some policies, such as some sort of capital controls, as in Chile, were discarded. It was thought that as long as the liberalization of the economy occurred once public finances were in balance and the markets were left to work, there would be no problem in financing the current account deficit. In the words of The Economist following the argument defended by the Salinas government, Mexico “had a big current account deficit, but since this reflected private (as opposed to public-sector) decisions about saving and investment, it seemed to pose no danger.” It was believed the market would adjust automatically to any change in investor’s preferences.

In spite of serious imbalances there were few open criticisms against the logic of the model within the government and among domestic and international financial investors. In the words of Krugman: “Views contrary to the immense optimism of the time were treated not so much with hostility as bemusement. How could anyone be so silly as to say those gloomy things?”

The group of technocrats managing economic policy, certainly shared this immense optimism. They had an economic model in mind consistent with what they were doing. They thought that, as long as they followed economic reform, markets would sustain the peso. Imbalances were not perceived as risky, and within the government those not convinced by the virtues of the model, those that thought the risks were too high, had virtually no space to defend their position.

During Mexico’s political debate prior to the 1994 elections, criticism was also relatively unimportant. The most important opposition party, the Partido Acción Nacional (PAN), coincided with most of the government’s economic policies. They in fact claimed that Salinas was just stealing the economic program they had been promising for decades. They also lacked the expertise to discuss the intricacies of the program, as most top economists were working for the government or in


59 Gil Díaz and Carsten argue “if quasi-fixed European currencies collapsed during the 1992 attacks, there is no reason to believe that Mexico could have experienced anything different”, p. 169. Why was not this evident before the authorities of the Central Bank -where both had high positions- decided to use the country’s reserves to defend the peso?


61 Paul Krugman, “Dutch Tulips and Emerging Markets”, Foreign Affairs, Vol. 74, p. 36, No. 4, July/August 1995. Silly also politically. Any government offered suggestions pre-emptive devaluation risked being punished by the President, or even worst provoking a speculative attack.
institutions close to it. The PAN chose to focus on the agenda for electoral reform and to confront the government on charges of corruption.

The leftist Partido de la Revolución Democrática (PRD) by definition opposed most government policies and strongly criticized the economic reform package. It was not taken into consideration at all by the government. With elections close at hand, even the PRD softened its criticism (at least in front of investors) of an economic policy that was still perceived as successful in terms of financial stability by a significant proportion of voters.

In this atmosphere, the devaluation came as a surprise to many, including the government, international financial organizations and many investors. The government reacted slowly, almost with panic. This was not only the result of the surprise and lack of some alternative plan, but also the lack of organization that comes with a new government in a system where there is no civil service and thousands of positions change every sexenio. After three months of chaos the government, with the support of the United States’ bail out, finally introduced an orthodox recessionary plan, but without pegging again the currency. At least this lesson seemed to have been learnt. The country, however, paid a very high price for betting, once again, that imbalances could be sustained with the support of sophisticated economic arguments.
Under current worldwide volatility, it is easy to blame all guilt of currency crises to the unfettered action of speculators. Structural conditions, that is, open capital accounts where money can react swiftly to mere rumors, where conditions in one emergent market can affect adversely a country following "sound" policies, seem to leave few space for adequate domestic policies. But even in this volatile world, the choices of policy makers can make a difficult situation unsustainable. These choices, I argued, are the result not only of political or personal interests of policy makers, but of their perception of how to enhance their interests. Misperception based on some dogmatic ideal, help explaining why so many countries fall in the same trap. Policy makers should avoid dogmatic approaches that defy common sense.

Once a country enters the trap of a currency peg, it is difficult to get out, as imbalances can be dismissed or temporary by a clever technocrat. So unless other countries experience is completely useless, the current world volatility should at least make pegs more unpopular. As the Euro option is not open to most countries, and some sort of Monetary Board requires a complex political and economic arrangement, a flexible rate might be the only policy at hand. A world of floating currencies can also be risky. All exchange rate regimes have its costs. Volatility causes uncertainty, can lead to higher inflation, blockade the development of long term, deposits and credits, and implies a serious cost to economic actors, that do not make mechanisms to protect themselves against volatility. However, at least it forces governments to confront problems as they come on risk of immediate movements of the currency. This will, hopefully, lead to a more pragmatic and prudent set of policies.
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