FOREIGN INVESTMENT, DEMOCRACY AND THE 1994 MEXICAN CRISIS
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Introduction

The main objective of this article is assessing the effects of foreign capital inflows on macroeconomic policy making and/or democracy. The case of Mexico is particularly interesting in this respect for two reasons: First, it captured from 1990 to 1993 more foreign flows than any other developing country, 52.8 billion dollars. It was followed by China with 49.2 billions and Argentina with 24.5. A significant percentage of this was portfolio investment, which made capital flows particularly sensitive to any event that could impact short term profits. This enormous flow was possible thanks to a process of economic reform that was perceived as creating the basis for long term growth and a liberalization of the financial markets that helped financing some modest growth.

By 1994, however, foreign flows started to contract as a result both of international conditions, a rise of US interest rates, and domestic ones, mainly the imbalances in the current account, more acute than originally expected, and the uncertainties regarding the political stability of the country. By December 1994 capital flight became unsustainable, forcing the new government to devalue the peso. The devaluation triggered a deep financial crisis not only in Mexico, but in other emerging markets, that could only be controlled thanks to a more than 50 billion US sponsored international package of financial aid.

The second reason making Mexico an interesting study case is the nature of its political system. In Mexico democratization has gone far slower than in most of Latin America. However, it does not come from a military regime, but from an

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3 From 1991 to 1993 portfolio investment in Mexico went from 12.74 to 28.91 billions of dollars, falling to 8.18 in 1994. In 1991 Mexico captured 54.5% of all portfolio investment directed to Latin America, this amount fell to 18.6 % in 1994. From 1991 to 1994 the percentage of the current account financed by direct investment amounted to 57.5% in Argentina, 46.8% Brazil and 24% in Mexico. Data is from Banco de México, INEGI and the Sixth Annual Government Report (1994); GEA Económico, January 1995, p. 20; Baring Securities, The Mexico Crisis: Analysis and Implications for Financing; Preliminary Views, January 1995, table 3.

inclusive authoritarian political system that has been dominated by a single party since 1929. As it is well known Mexico is formally a democracy. It has regular elections, a party system, and an elected president and Congress. After the 1917 Revolution, however, peasants, workers, other “popular” sectors (ranging from bureaucrats and taxi-drivers to street vendors and urban poor) and, albeit differently, even businessmen were organized from the top in a corporatist agreement that is not only a system of interest representation, but more importantly a way of controlling the popular sectors.

Mexico's political system, however, has undergone significant changes in the last two decades. Although the power of the President was strengthened during the Salinas administration, which enabled him to conduct economic reform from above, during his administration important reforms in the electoral law took place, leading to more open and competitive elections and to a more plural party system. In the 1994 presidential elections, the PRI (Partido Revolucionario Institucional) candidate won by a large margin of votes in an electoral process that was far cleaner than in 1988. Votes were not stolen, although the process was still plagued with inequalities that gave the PRI an obvious advantage in terms of financial resources, access to the media, and government support, which included an expansive monetary policy that seems to help explaining the 1994 December devaluation.

The PRI triumph was perceived by opposition parties as illegal due to an alleged fraud (PRD) or illegitimate due to the inequity of the competition (PAN). While new democratic rules were still not legitimated by the opposition parties, the old rules of the game, were already ineffective creating a margin of uncertainty that has undermined the confidence of investors.

In the first part of this article I will analyze how the inflow of foreign capital affected the process of democratization in Mexico during the last three years of the Salinas administration. I will argue that by opening Mexico to international trade and increasingly relying on foreign investment the government was obliged to deepen political reform by the end of the sexenio, when a new president had to be

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7 The PRI won with 50.7% of the votes, the PAN (Partido Acción Nacional, a conservative party) and PRD (Partido de la Revolución Democrática, a left wing party) obtained 25.6% and 14.2% respectively. Data from GEA.

elected. Although democracy implied uncertainty, the lack of credible elections was even more uncertain.

However, this large dependence on foreign resources, and the feeble institutionalization of economic reform, favored the maintenance of the PRI or in any case a conservative transition. The PRD could not construct an economic program attractive to its political supporters that would not be perceived as risky by investors and therefore undermine economic stability. Even the PAN candidate was less attractive than the PRI one, as the latter was perceived as more capable of ensuring continuity and of having the technical capacity to manage the economy.

In the second part of the article I will analyze how the inflow of foreign capital and the pressure of stronger opposition political parties competing under more democratic conditions led to an extremely risky monetary policy that became unsustainable by December 1994. I will argue that the nature of Mexico's political system and political calendar explain in part the monetary and fiscal policy that was followed. Political constraints, however, are not enough to explain the policies followed. To sustain them it was needed that a significant number of investors and public officials believed in the long term virtues and stability of the program, which was widely seen as a case study of exemplary economic reform.

In the conclusion I will analyze the implications of the current Mexican economic crisis in its process of political democratization and economic reform. The crisis has undermined the democratic legitimacy of the government and decreased the political support behind the program of economic reform that was initiated in the De la Madrid administration, ten years ago.

**Foreign Investment and Democracy**

The tension between democracy and private property is an old theme of political theory. A democracy implies the risk of having property rights, at any level, altered by a majority. To avoid this risk, most liberal democracies originally limited the right to vote to property holders.9

The process toward universal suffrage varied greatly, but the underlying conflict was how to protect property holders from the tyranny of the majority. The masses had access to the vote after intense political pressures, but also by taming their demands in order to satisfy investors and avoid economic stagnation.10

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Capitalists can always move their assets abroad to protect them if democratic pressure implies too high taxation or a risk of expropriation. This structural power to limit state interference in property rights is explained by an area of autonomy over private resources which is easier to protect by its holders due to the fact that one single state does not have the monopoly of power in the world. Resources can be moved, and this limits the capacity of each national state to regulate private property.

How easy it is to move resources from one country to another, is a crucial variable explaining the constraints to manage the economy faced by the government. In Mexico, a country with more than 3100 km of border with the United States, the veto power of domestic capitalists has been historically high. This border has made control over capital exports virtually impossible, regardless of the policy objectives of the state elite.

Mexican financial markets have historically been extremely liquid, a significant proportion of financial savings are deposited abroad, and there have been barely no exchange controls. For Mexican savers the dollar is not only a means of exchange, but also of storage. This preference for liquidity and for holding US dollars is the result of historically feeble property rights, numerous devaluations of the peso, and various periods of high inflation which have taught investors of the importance of having the possibility of a quick “exit”.

“Exit” has remained legal for most of the post-revolutionary regime. Even during the most acute conflict between government and businessmen, during the Cárdenas sexenio (1934-1940), exchange controls could not be introduced. In Cárdenas’ words: “Exchange controls can only work in highly disciplined countries where customs rules are well organized and borders can be effectively watched; exchange control in Mexico would surely be undermined by the black market”.

Structural power is understood as the crucial role played by those that control private capital. How they use their capital, whether they invest or consume it, and in which particular way they invest it, affects the growth of the economy and therefore everybody’s material situation.

They still are. The IMEF (Instituto Mexicano de Ejecutivos de Finanzas) asserts that by September 1995 “80% of the national financial savings are constituted of resources placed in terms lower than one year and the largest part is concentrated in terms that expire in 28 days”, La Jornada, October 10, 1995.


Quoted in S. Maxfield, Governing Capital: International Finance and Mexican Politics, Ithaca, 1990, p. 72. Cárdenas argument is very similar to the defense of freedom of exchange by Miguel Mancera, president of the Banco de México, in April 1982. Structural conditions, not the links between bankers and government officials, seem crucial to explain freedom of exchange. Even Maxfield, that favors throughout her work the idea that an alliance between bankers and members of the government explain major policy issues with respect to the financial sector, seems to accept this argument when she states: “The impracticality of imposing exchange control in a country sharing a 2000-mile border with the United States has helped bankers prevent imposition of exchange controls
In 1982, with the bank nationalization exchange controls were imposed. However, they were quite ineffective, as capital flight continued to leave the country through the long and porous border with the United States.

The structural power of local property holders is a key variable in explaining economic policy in any country. However it is not an exaggeration to affirm that Mexico is “virtually the only developing country in which the economically powerful classes have the privilege of such an open capital market”. But it is also the only developing country sharing such a long border with a developed country with freedom of exchange. Contrary to what happens with other goods, controls over the exports of capital can only work when the main trade partners and neighbors follow similar policies consistent in achieving this end.

The liberalization of financial markets that took place under the Salinas administration increased the costs to the government of abrupt exports of capital, as speculative capital that swiftly came could leave equally fast. The government, however, gained the advantages derived from the inflow of capital, mainly having more resources to control in the short run financial instability and to promote financial markets.

The establishment of an integral exchange control implied that banks could not sell foreign currency and could buy only by order of the central bank. Credits and deposits in foreign currency were also suppressed. This control led to an overestimation, anticipation or falsification of payments of foreign currency related to imports; underestimation, retention or falsification of foreign currency earnings related to exports; contraband in exports; and increased corruption in customs and in the administrative personnel of exchange control. Also, a large buy and sell parallel market of pesos and dollars with higher exchange rates developed on the other side of the US frontier which undermined exchange control.

Moreover, money that went out and earned a profit as a result of the devaluation was not taxed for this capital gain. Although this taxation is contemplated in the tax law, it is impossible to collect without United States help, and banking secrecy makes this extremely unlikely.

To promote the return of capital the government has consecutively legalized tax evasion. Since May 1990, the government has charged capitalists returning an almost symbolic tax equivalent to 1.0% of money brought back if the “exit” was before that date. This measure has been renovated year by year. El Financiero, April 22, 1994. In order to encourage repatriation of capital, the SHCP (Secretaría de Hacienda y Crédito Público) announced on October 1995, a new fiscal pardon for resources maintained abroad before September 30, 1995. The tax will decrease to 0.5% if the repatriation occurs before March 31, 1996, if it returns after that day the tax will be 1%. Reforma, October 19, 1995.


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19 This included the lifting of restrictions to foreign investors in the market of public bonds which had existed up to 1990, and the removal of several controls on foreign investment in the stock market. See Banco de México, Informe Anual 1990, México, 1991.
growth. Although direct investment also increased, the lion share was financial investment.\(^{20}\)

Moreover, as a different group of investors started to participate, the government could also negotiate with more actors, thus gaining some margin of manoeuvre. As an economy opens to foreign financial flows, the relative power of the state \(\text{vis à vis}\) the domestic financiers can increase if it can get hold of these flows. Domestic financiers might initially favor more links with foreign investors, but as the economy continues to open, foreign financiers bypass them and become actors with their own agenda.

The different perceptions and interests of domestic and foreign financial investors can give the government more capacity to manage the economy. Anecdotal evidence after Colosio's murder suggest domestic capitalists were more likely to export their capital.\(^ {21}\) Without the higher stability of foreign investors and the support of international financial organizations, maintaining at that moment the value of the peso would have been much more difficult.\(^ {22}\) A document by the International Monetary Fund also suggests Mexican exports of capital explain the run against the peso in December.\(^ {23}\)

Of course once a run against the peso starts and foreign capital follows, the potential instability it generates is enormous. The capacity to impose controls is also less likely. In 1982 a similar run against the peso ended in the partial confiscation of deposits denominated in dollars, which were paid at an exchange rate fixed by the government. With the Tesobonos the costs of such a policy was much larger, as by the end of 1994, 16 billion dollars of Tesobonos,\(^ {24}\) of a total of 29.2 billion dollars,\(^ {25}\) was in the hands of powerful foreign investors, not individual ones, but mostly

\(^{20}\) See note 3.

\(^{21}\) The author advised a Mexican security firm from 1993 to 1994. During this period I had several interviews with important fund managers of New York. My statements regarding their reactions and their political perceptions are based in this experience. After the murder of Colosio, foreign funds were not major sellers through this security firm.

\(^{22}\) The same day Colosio was murdered US President William Clinton offered a credit of almost 6 billion dollars. Treasury Minister Lloyd Bensen and other officials also gave their public support. International financial organizations and foreign bankers approved the program and offered help in avoiding a stock market crash. The invitation for Mexico to be part of the Organization for Economic Cooperation and Development, sooner than originally expected, had also a positive impact in terms of investors' confidence. \textit{El Financiero}, March 25, March 29, and April 18, 1994.


\(^{24}\) Figure from Baring Securities, \textit{The Mexico Crisis}, table 7. This source also indicates that: "Total holdings, by both foreigners and Mexicans, of short-term dollar denominated Mexican securities issued by the Mexican government, banks and corporate sector, and of peso securities held by foreigners and therefore susceptible to conversion into dollars, amounted to US$43bn at the end of 1994 (n.p.)." Short-term peso securities held by Mexicans are also susceptible to conversion into dollars.

\(^{25}\) Data obtained from GEA (Grupo de Economistas y Asociados).
through foreign brokerage houses. This same fact, however, increased the interest of the United States in avoiding Mexico's insolvency, avoiding the rupture with the financial community experienced in 1982.26

Such a power of money could lead to pressures to avoid more democratic political institutions which could endanger property rights. Democratization, however, was not slowed down to accommodate to the demands of foreign investors. Quite the contrary. A more open economy was an additional factor forcing the government to ensure a more credible democratic process in the 1994 Presidential election that could give more political stability to the country.

International markets, in particular financial markets, demand information regarding the political stability of the country. Transaction costs are relatively low, so any event that can potentially lead to lower profits is quickly reflected in the market.

Mexico became, therefore, a more monitored country than in the past. Domestic political conflicts not only had to be solved effectively, but within the norms expected in the more developed countries. Becoming members of NAFTA (North American Free Trade Agreement), which formally did not include democratic provisions, did impact the margin of manoeuvre of the Mexican government, increasing the costs of authoritarian solutions. Critics of NAFTA were keen to point out any violation of human rights, and President Clinton wanted to avoid a weak Mexican flank.27

Foreign investors participated in the demand for more democracy. They did it not for ideological reasons. What they wanted was political stability. Without credible elections this was less likely, given the erosion of PRI's monopoly of power and the strengthening of opposition parties.

The 1988 presidential elections had implied a severe political tension due to the lack of credibility of the process. Although Salinas could legitimize his administration thanks to an effective economic policy in terms of inflation control, predictable exchange rate, and some growth, political events in 1994 had made

26 According to government sources, a decree imposing exchange controls was ready to be implemented in case no agreement was reached with the United States government; 1994 almost became a repetition of 1982.

27 The opening of the economy probably helped in fact some of the anti-government political movements of 1994. According to some authors, to destabilize the country through an uprising such as the one the EZLN (Ejército Nacional de Liberación Nacional) started January 15, 1994 the best moment would have been before NAFTA was approved by the United States Congress. See, for example, G. Zaid, “Chiapas sin resolverse ni aclararse”, Reforma, November 13, 1994. In my view, because of NAFTA and the need to calm foreign markets, the government had to react with an unusual restraint, and this was calculated by the EZLN leadership which knew it required the support of domestic and foreign press to have some success. The EZLN leadership also knew the fragility of the peso and announced on December 8, 1994, its breaking off from the temporary cessation of hostilities, and staged a “troop movement” on December 19, 1994, which precipitated the devaluation.
evident the erosion of the inclusive authoritarian political system that had ensured a significant degree of political stability and certainty to Mexico's political life.

The January 1st, 1994 EZLN uprising in Chiapas and the murder of PRI presidential candidate, Luis Donaldo Colosio on March 23, confirmed to most analysts on the need of seeking a more open political system that could accommodate better the demands of a more complex society. The old political agreement was perceived as ineffective and the difficulties to achieve political stability put great emphasis on having clean elections in the August presidential elections.

Most investors, specially large domestic ones, however, clearly preferred the candidate of the PRI, Ernesto Zedillo, to win in credible elections. And some of them made this obvious, trying to influence the electorate in favor of Zedillo.

For example, Roberto Hernández, President of the AMB (Asociación Mexicana de Banqueros) and of Banamex-Accival, the most important financial group, declared four weeks before the elections that in his view democracy implies uncertainty. This uncertainty, he affirmed, had impacted financial markets pushing interest rates up. His conclusion was clear, only if Zedillo won interest rates could go down. In his words, Zedillo is “the candidate that gives us certainty”.

Roberto Hernández’s message was correctly seen by the press as a warning of the risks, in terms of financial stability, of voting against the PRI. Potential financial instability, therefore, became an element in favor of Zedillo.

Contrary to what Boylan argues, the fact that the Mexican government did not grant sufficient and credible autonomy to the Central Bank went against the interests of the opposition parties. It is true that this weak autonomy helped the government to avoid higher interest rates, even at the cost of losing international reserves, and this made a significant expansion of the economy in the last semester of 1994 possible, but in the absence of a strong and credible Central Bank the risk of a defeat of the PRI in terms of economic stability became stronger.

This helped Zedillo to win the elections based on a promise: that he knew how to manage the economy. Zedillo became the symbol of continuity on what was by then perceived by investors and important sectors of the electorate as a successful program of economic reform.

30 According to an exit poll conducted under the advice of Warren Mitofsky, and that was extremely precise in anticipating the results, 62% of voters thought that the more important personal asset of Zedillo was his experience, which was linked, at least in PRI propaganda, to his capacity to manage the economy. However, the most visible element in explaining the triumph of the Zedillo, is party identification 65% voted for him because they always vote for the PRI. See L. Mercado Gasca and L. Zuckermann Behar, “La encuesta a la salida de las casillas”, Nexos, September 1994.
With an autonomous and strong Central Bank, an opposition candidate, although having less margin of manoeuvre to impose a different economic policy in case he won, would have threatened less economic stability thus being electorally more attractive. As institutions were weak, the technocratic elite that was competing with the PRI banner, became politically more attractive.\footnote{A similar logic seems to be behind the electoral success of Menem in Argentina. The lack of institutionalization is so acute that not only the President was the symbol of reform, but also the Treasury Minister, Domingo F. Cavallo. Pedro Aspe played a similar role in Mexico during the Salinas administration and his absence in the Zedillo cabinet went against the expectations of investors.}

Markets, however, were nervous not only because the PRI might lose, or even worst the PRD might win. An illegitimate triumph of the PRI would have also been unsatisfying. For financial markets the uncertainties regarding a political system in the midst of a profound transition was equally serious.\footnote{Financial markets seemed most frightened by the end of March, not only because of the uncertainty surrounding the electoral process due to the unfortunate political events mentioned before, but also because the United States monetary policy varied in order to defend the value of their currency, which implied an increase in short term interest rates. This affected emerging markets, including Mexico's. Nevertheless, results from the elections in August brought back some certainty. The interest rate for CETES of 28 days of maturity was 9.45 in February, 9.73 in March, 15.79 in April and reached 17.07 in July, it went down to 14.46 in August, 13.76 in September and 13.74 in November. A similar pattern can be found in the Mexican Stock Market index; 2,585.4 in February, 2,410.4 in March, 2,294.1 in April, it came up to 2,702.7 in August, reaching 2,746.1 in September and 2,591.3 in November. Data from *Agenda del Economista*, No. 9, 1995.}

To confront this, some businessmen made an effort to collaborate in the legitimization of the process. For example, Coparmex, a businessmen organization closer to the PAN than to the PRI, organized and financed a quick count with the aim of giving certainty to the electoral process.\footnote{See H. Rebollo Pinal, “Mesa de negocios”, *El Financiero*, July 22, 1994.}

Not only economic reform gave the government a positive financial flow and the tacit menace by investors to the electorate that only Zedillo guarantied stability. By following an economic policy that was perceived as appropriate by large investors, the government was also capable of constructing a new relationship with major domestic businessmen based on a shared ideology and a degree of trust with no precedent in contemporary Mexico.

Traditionally large businessmen in Mexico have enjoyed privileged access to policy making. To their advantage, the popular sectors were controlled by an inclusive authoritarian state that followed from 1940 to 1970 an economic policy that tend to favor the most important business groups.

When the Echeverría administration (1970-1976) pursued policies that threatened business interests, large businessmen organized themselves through the creation of the CCE (Consejo Coordinador Empresarial), an umbrella organization that put together the most important businessmen organizations and that was
controlled by the largest businessmen. The political opposition of businessmen and severe capital flight contributed significantly to the incapacity of the Echeverría administration to control the economy. The devaluation of the peso on September 1st, 1976 was the most evident signal of this.

The successor of Echeverría, José López Portillo, initiated his 
sexenio (1976-1982) with a new agreement with businessmen which thanks to oil revenue worked initially. However, by the end of his administration a new conflict with businessmen arose, which led to the September 1st, 1982 bank nationalization and to the imposition of exchange controls. Businessmen opted, once again, for a more open participation in politics to confront the government. This time, some of them chose to participate with the PAN, in order to compete electorally against the PRI.34

Nevertheless, most businessmen, including many of those that sympathized with the 1988 PAN presidential candidate, Manuel Clouthier, supported the government (or at least remained silent) in its defense of the electoral results of 1988, when the left-wing Cardenista coalition, very successful in mobilizing the electorate, challenged the official results. Contrary to the expectations of those businessmen supporting the PAN, the elections of 1988 showed that most Mexicans were in 1988 unwilling to support the PAN. As most Mexicans voted for the PRI and for the Cardenistas (in what proportion it is difficult to know), businessmen realized it was better to trust the Salinas government which seemed to be a better alternative than an unpredictable populist coalition.

When large businessmen realized that Salinas gave them access to policy makers35 and was prepared to go further than expected in major economic issues, as for example, with respect to privatization, deregulation and trade liberalization -and even in issues previously considered unchangeable, such as the laws regulating the relationship between government and the church which was modified in a way closer to business' preferences- most important businessmen accepted it was time to build a new relationship that has increasingly implied being involved in PRI activities. By the elections of 1994, most major businessmen openly supported the PRI presidential candidates in a more explicit alliance than in the past. Foreign investors were less open, but equally supportive.

Businessmen participation in the PRI was initially promoted by the government as a way to rob the PAN its "natural" support. Once the relationship with businessmen was radically transformed into a more or less open alliance between

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34 The last paragraphs of this section are drawn from C. Elizondo, "Constitutionalism and State Reform", presented at the meeting Beyond Economic Reform: Mexico Under Zedillo, Institute of Latin American Studies, University of London, November 1994.
government and the more important businessmen, the political role of these businessmen changed. The government expected businessmen to financially support the party, especially as elections become more competitive and state resources were increasingly more difficult to channel into the PRI.

Businessmen participation in funding the PRI has been mostly dependent on government initiative, and not always in the way the private sector would prefer. Funding the official party is a cost many businessmen are not eager to pay, but has been difficult to avoid in a political system where power remains so concentrated, the party system so dominated by one party, and benefits were likely to be expected from the new government.36

As businessmen started to participate in the PRI, which followed a similar trend in the PAN that had started in the 1980's, it made democratization a less menacing process, as these two parties where businessmen participated, clearly led the polls37 and got more than three quarters of the total votes of the presidential elections of 1994. Contrary to 1988, democratization did not imply the risk of empowering a party that opposed economic reform.

The Politics of the 1994 Devaluation38

Overvaluation of the peso followed by an abrupt devaluation has been one of the most visible economic fiascoes of Mexican government economic policy making of the past 20 years. The roots of an economic policy that favored overvaluation can be found in the logic of the so-called “stabilizing development” (1958-1970). Import substitution was easier with a cheap dollar partially financed by agricultural exports.39

What was initially economically sound to finance industrial development, became politically very difficult to avoid as this strategy benefited urban groups, particularly industrialists, financiers, specialized workers in capital-intensive industries geared to the domestic market, and the middle class. Savers also became

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36 The study of businessmen involvement in PRI politics is still underdeveloped. For a brief discussion see C. Elizondo, “Privatizing the PRI?: Shifts in the Business-PRI Relationship”, Mexico, 1995, unpublished manuscript.

37 Polls were used systematically for the first time in Mexico. Most of these polls showed the advantage of the PRI and the distant third place of the PRD.

38 Some parts of this section are drawn from C. Elizondo “Three Recurrent Traps: on the Origin of the 1994 Mexican Economic Crisis” presented at the “Southern California Workshop on Economic and Political Liberalization”, University of Southern California, Los Angeles, Ca., April 6, 1995.

used to a predictable value of the dollar. This strategy was at the expense of peasants and the unemployed, but the former had more political clout.

Mexican presidents know the political cost of a devaluation that would upset the most important political groups in Mexico and lead almost for sure to financial instability. In López Portillo 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.”

Fighting inflation through an almost fixed exchange-rate during the Salinas administration, led the government to promote the opening of the economy. The partial liberalization of the financial markets enabled the Salinas administration to finance the current account deficit and the overvaluation of the peso. The strategy worked initially because markets believed it would be successful, and therefore poured resources in to Mexico.  

Controlling inflation and stabilizing the exchange rate was the initial political success of Salinas. This monetary and exchange rate policy increased private consumption of dollar-intensive goods at a subsidized rate, ensured high dollar-equivalent interest rates to savers, and reduced the unfair inflationary tax.

Once a band of devaluation of a currency is imposed it is very difficult to abandon it while it works, as there is a risk that when pulling out of it, what has been gained in terms of stability, and therefore of popularity, can be lost. International confidence was also built on the predictable value of the peso. Any abrupt devaluation would destroy it.

Each time the government felt investors' confidence was diminishing, which could undermine the exchange rate policy that anchored the whole program, its response was a new dramatic coup towards liberalization, such as selling the national banks, and proposing NAFTA to the United States. These liberalizing policies were perceived by foreign and domestic investors as creating the conditions for stable economic growth and therefore helped maintaining the value of the peso.

By the end of 1992, however, the capacity to continue with bold structural initiatives that could have created new incentives to invest in Mexico and made the economy more efficient was diminished, as the short-term political agenda gained priority. Many key decisions such as reforming the labor law, making Pemex and the Comisión Federal de Electricidad more efficient or perhaps privatizing them, putting the Comisión de Competencia Económica to work, drastically reforming social security, maintaining a more competitive exchange rate, and opening the banking sector more drastically were not implemented. Any of these measures would have led to more direct foreign investment, and therefore less potential volatility.

40 José López Portillo, quoted in Exceltior, April 9, 1982.
41 See P. Krugman, “Dutch Tulips...”.
42 For many economists this was not a serious problem.
President Salinas conducted reforms in spite of the opposition of important segments of his party. This was possible thanks to the concentration of power of the Presidency. By the end of 1992 Salinas, however, seems to have felt he had to avoid confronting more his own party. The President needed to ensure a positive political environment to promote the candidate that would likely become his successor, according to the then prevailing rules of the Mexican political system. It seems that the President perceived that any radical initiative of economic reform could have led to a nationalistic reaction that could have been used by those opposing his project.

Potential presidential candidates had also to ensure their own role was not questioned, which creates incentives to cover up any problem within their responsibilities and postponing difficult decisions. The leitmotif of this game is freezing conflicts and potential problems.

During the Salinas sexenio, 1993, the year of the unveiling of his successor (the destape), was also the year of NAFTA. With two years of delay, but finally there was a chance that NAFTA could be approved by the United States Congress.

No new radical measures that could lead to a nationalistic reaction within the PRI were implemented. The value of the peso was defended and the economy was put into a halt by means of high real interest rates in order to avoid a devaluation that would have increased the difficulties of getting NAFTA through Congress, as it would have infuriated Trade Union leaders that felt Mexican wages were already too low.

In the past, once the destape took place, elections were less important, thus allowing the government some margin of manoeuvre. De la Madrid started an economic shock therapy, which included a devaluation that gave Salinas the capacity to start his administration with a stable economy, before the elections.

With the increasing importance of elections, the Salinas government sought propitious economic conditions for one more year in order to make his candidate a better electoral option, which, as argued above, also helped to promote the confidence of foreign investors. This was an incentive for following one year of short term policies that made a booming economy possible.

After the elections President Salinas had a powerful personal incentive not to devalue: winning the direction of the World Trade Organization, although he must have believed the peso could be defended beyond his election to the direction of the WTO. Apparently the Zedillo economic team asked for the devaluation in November,

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43 On December 1992 the government estimated the economy would grow 2.5 to 3.0% in 1993. The economy only grew 0.6%. Data from Criterios generales de política económica para 1993, and GEA Económico, February 1995.
44 Which were, however, almost lost, as political life in Mexico had changed more than what the government then acknowledged.
but at the end it was decided to see if the markets could be stabilized by sending a strong signal by the future President of his commitment to defend the parity.\footnote{According to some versions Aspe threatened to resign if the peso was devalued. \textit{Reforma}, July 6, 1995. According to Aspe maintaining the value of the peso was decided with the support of Zedillo. \textit{Reforma}, July 14, 1995.}

In the nearly 16 months that elapsed from the final months of the destape to the inauguration address of the new president, the only thing left was risky mechanisms for retaining financial resources in Mexico. President López Portillo played a similar game in 1981 increasing short term debt by more than 20 billion dollars in a desperate bet that oil prices would return to its upward trend in 1982. During the turbulent 1994, which pushed the peso to the ceiling of the band for most of the last three quarters of the year, the government transformed most of its internal debt denominated in pesos into a debt denominated in dollars, the Tesobonos, although paid at pesos at the market exchange rate. Investors accepted this new paper.

Although there were important political reasons not to devalue, many high level bureaucrats and local and foreign investors believed the model was sound and could be sustained, as the economic imbalances were not perceived as serious.\footnote{Many in fact still believe that the mistake was devaluing.} Mexico was then widely seen as a case study of proper economic management -the best example of how the "Washington consensus" policies could work- and financial markets were eager to pour resources into the Mexican economy. Although, for example, the current account deficit started to increase well beyond government projections, it never became, at least openly, a serious problem that required a significant change of policy.

The government publicly argued it was not a problem because the public sector deficit was very low, and private investors did not seem to worry either. The initial economic program for 1995 assumed an even larger deficit and did not suggest any difficulties in financing it.\footnote{The government estimated a current account deficit of -7.8\% of GDP, the equivalent to 30 billion dollars. Data from \textit{Criterios generales de política económica para 1995}.}

The government argued that imports were financing an increasing capacity to export in the future. Consumption goods accounted in 1994 to nearly 12 per cent of total imports, (which was, however, still 2 billion dollars more than total oil exports). Capital goods were 17 per cent of total imports in 1994, but a significant percentage of this investment was geared to the internal market, as the result of the overvaluation of the peso that made investment in the non-tradable sector more attractive.\footnote{Data is from \textit{GEA Económico}, February, 1995. From 1989 to 1993 foreign investment to manufacturing industry went from 69\% of total to 50\%, the proportion of investment to services was
Recent evidence seems to show that the strategy was not increasing net manufacturing exports, defined as total exports not including maquiladoras, minus imports required to make this exports possible (not including capital imports). As a result of the liberalization of the economy the integration of non maquiladoras manufacturing export production decreased from 84.7 in 1985 to 61.4 in 1990 and 39.0% in 1994. Net non maquiladoras manufacturing exports went from 4.2 billion dollars in 1985 to 8.5 in 1990 and to 9.4 in 1994.49

It was thought that as long as the liberalization of the economy was done once public finances were in balance there would be no problem.50 In the words of The Economist: 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”.51

In spite of these 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?”52 Within the political debate in Mexico criticism was also relatively unimportant.

The most important party of the opposition, the PAN, coincided with most of the government’s economic policies. They in fact claimed that Salinas was just stealing the economic program they had defended for decades. They also lacked expertise to discuss the details of the program, as most sophisticated economists were working for the government or in institutions close to the government. The PAN chose to concentrate its attention on the electoral agenda and to confront the government on charges of corruption.

The PRD by definition opposed most government policies, its criticisms were too crude and included most of the package of economic reform, and was not considered at all by the government. As elections came close, even the PRD diminished its criticism, at least in front of investors, against an economic policy that


50 The real value of this deficit, however, is not clear. The government did not include financial intermediation of public banks which amounted to -4.4% of GDP at the end of 1994, nor private projects in infrastructure that were guaranteed by the state and that could be seen as future public spending if the economy did not perform under the optimist projections of investors. In 1995 the government had to pay 2/3 of the guaranteed flow of vehicles it had promised. GEA Información: Prospectiva, May 1995.


52 P. Krugman, “Dutch Tulips…”, p. 36.
was still perceived as successful in terms of financial stability by a significant proportion of voters.

Conclusions

Portfolio investment is extremely volatile, and obviously risky. Many governments, however, believe they can control the beast and have enormous political and economic benefits while capital imports are booming. In the case of Mexico, capital came because the government was implementing what was seen as the appropriate economic reform that would enable the country to achieve growth with stability, although, as argued, there were signs that the economy was not as healthy as assumed by government officials and investors.

Moreover, the pressures faced by a political system in the midst of a transition of having to cope with the demands of liquid investors was enormous. Political events uncommon in Mexico for decades frightened investors.

The new administration, elected under the banner of economic continuity, could not manage these pressures and had to devalue. Initially the band was moved 15%. However, the clumsy way this was conducted, far from calming investors led to a new attack against the peso which led to a further devaluation and to a serious financial crisis.

With the devaluation, the international aid package, and a very contractionist monetary policy that led the economy into a profound recession, the current account deficit virtually disappeared. However, with the devaluation, illusions regarding the virtues of Mexico's economic reform were seriously damaged. If before the devaluation foreign investors made economic growth possible, now they are demanding clear prospects of growth before investing.

Moreover, the floating of the peso has increased the uncertainties of domestic and foreign investors, which were convinced to invest in Mexico during the Salinas administration in part because there was predictability in the exchange rate. This stability is now lost, and financial markets, in spite of an orthodox monetary policy, are still extremely volatile, apparently under the influence of very short-term speculative capital. Although fixing the exchange rate ended in the overvaluation of the peso and an abrupt devaluation, a free floating peso can lead to instability which is now even more difficult to control due to the liberalization of the financial sector, as foreign banks in Mexico are increasingly important in foreign exchange transactions.

53 Up to December 1995, the economy suffered a contraction of 6.9% of GDP. INEGI: Indicadores oportunos del PIB, February 1996. It is estimated that the current account deficit came to 1.1 billion dollars in 1995, as opposed to 30.2 billion dollars in 1994. GEA Económico, January 1995, p. 27.
To confront the crisis, the Mexican government has sought to deepen economic reform. Railroads, airports, ports, highways, satellites, electric power plants and petrochemical plants will be privatized. The privatization process of ports and warehouses has already begun. The telephone long distance market will be liberalized starting January 1997 and the domestic one is planned to take place afterwards. Social Security was reformed. The transportation, distribution and storing of natural gas has been liberalized. The financial sector is being liberalized quicker than envisaged by NAFTA legislation.

The crisis, however, undermined the popularity of economic reform. Former President Salinas left office with great popular support. His administration was associated with successful economic reform. Now he is seen as the example of corruption, and economic reform is being linked to corruption.

Although no clear alternative economic strategy is visible, and this has given the government significant margin of manoeuvre, there are more resistance against economic reform than in the past. The Congress, for example, in an unusual step, introduced some qualifications to the legislation that was proposed by the government to liberalize the banking sector. Qualifications for the new Social Security were also introduced by Priistas in the Congress.

This signaled a still underground, but increasingly strong opposition against economic reform even within the PRI. Salinas' reform went against the interests and ideological position of many important members of his party. Salinas, however, used the power of the Presidency to conduct the reform, assuming its benefits would end softening the resistance.

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54 The administration of ports and warehouses used to be directly managed from the Federal Government. Since 1993 a decentralization process was implemented, the privatization started on June 1993, but it has not been concluded yet. Reforma, February 14, 1996. The decentralization process of warehouses started on May 1995. El Financiero, May 17, 1995.
57 NAFTA put a limit of 15% of total assets on foreigners, as a result of the crisis it was raised to 20% in brokerage houses and 25% in banks. In NAFTA no foreign bank could have more than 4%, now 6%. El Financiero, February 18, 1995.
58 The Federal Executive sent a bill to Congress to reform the laws which regulate financial groups, credit institutions and the stock market, in order to enlarge foreign capital participation in the Mexican financial system. In a meeting without precedent in Mexico, senators and deputies (from the PRI, PAN and PRD) got together with prominent bankers. Even though national bankers gave their support for the proposed reforms, and expressed confidence on the fact that corporate control of these institutions would not be entirely held by foreigners, legislators revealed their worry that banks would end under the control of foreigners. They proposed the establishment of "locks". The most important one limits foreigners to buy banks whose net capital does not exceed 6% of the sum of the net capital of the entire banking system. El Financiero, January 11, 12, 14, 21, 25, 28, 1995. Reforma, January 11, 21, 25, 1995.
The crisis destroyed this strategic timing. Some reforms have been approved with significant opposition within the PRI. Others, such as the selling of the petrochemical industry, are still uncertain. Nevertheless, there is no coherent alternative within the opposition parties, and the PRI's opposition is still weak and disorganized as the President still has great influence over their political future.

With the crisis, the basis of legitimacy of the new President, in spite of relatively clean and credible elections, was severely undermined, not only with the population in general, but with businessmen. Government and businessmen could no longer agree on the basic elements of the program to confront the financial crisis. The pacto schemes, where government, businessmen, and trade union and peasant leaders agreed upon major economic policy issues were suspended for more than a year, and when renewed, they did not impact positively financial markets.

To confront this crisis of legitimacy, the government negotiated with the PAN and the PRD a political reform to ensure more credible elections and a more open political environment. However, it is worth underscoring that with the legal changes that had already taken place and the more activism of Mexican society, elections are already the main mechanism to get hold of power.

The crisis is politically being capitalized by the PAN, not the PRD. This has made investors less worried about democratic transition than what they are about political instability resulting from fights within the PRI. What is critical, however, is that investors are also worried by the potential social unrest that can accompany the stringent monetary policy needed to stabilize financial markets. Although some growth is expected in 1996, social pressure remains very high.

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59 For local elections in 1995 the PAN obtained 37.4% of votes, the PRI 44.1% and the PRD 12.4%. Data obtained from GEA. The PAN, however, is winning most governments of large and medium size cities. Foreign investors are starting to flirt with the PAN. See, for example, D. Solís, "México's "Other" Party Flexes Its Muscle", The Wall Street Journal, September 21, 1995.
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