



**Australian Government**  
**Productivity Commission**

Political Economy of  
Reform in Mexico

Roberto Newell

Richard Snape Lecture  
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Melbourne

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# Foreword

Richard Snape capped a long and distinguished career as Professor of Economics at Monash University with a new and accomplished career at the Industry Commission, and then as Deputy Chairman of the Productivity Commission. In the eight years that he spent at the Commission before his untimely death in October 2002, he played a pivotal role in overseeing our research program, as well as participating in major public inquiries.

This is the ninth in a series of lectures in memory of Richard Snape. With Richard's own interests and high standards in mind, the lecture series elicits contributions on important public policy issues from internationally recognised figures, in a form that is accessible to a wide audience.

Roberto Newell, our 2011 Lecturer, is an eminent economist with a distinguished career in the public and private sectors. Dr Newell was the founding President of the Mexican Institute for Competitiveness, an independent think tank which promotes policies to enhance Mexico's performance in the global economy. For many years he was a senior partner with McKinsey & Co. advising corporations and governments on regulatory issues, including in the financial sector.

I am grateful to Dr Newell for agreeing to come to Australia to present the Richard Snape Lecture for 2011.

Gary Banks AO  
Chairman

September 2011

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## **Richard Snape 1936 – 2002**

Richard Hal Snape was Deputy Chairman of the Productivity Commission and Emeritus Professor of Monash University. He was a Board Member of the Australian Research Council, Fellow of the Academy of the Social Sciences in Australia and a Distinguished Fellow of the Economic Society of Australia.

## **Roberto Newell Garcia**

Roberto Newell was founding President of the Mexican Institute for Competitiveness, an independent think tank which promotes policies to enhance Mexico's performance in the global economy.

He was for many years a senior partner with McKinsey & Co. advising corporations and governments on regulatory issues in the financial and telecommunications sectors. He has acted as an adviser to several governments during financial crises. Dr Newell has also held senior positions in Mexico's Federal Government, including as Deputy Secretary for Agriculture.

Roberto Newell was a Public Policy Scholar at the Woodrow Wilson Centre in Washington DC in early 2011. He is the author of two books and many journal articles, and writes a weekly column in *Reforma*, Mexico's leading newspaper.

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# Political economy of reform in Mexico<sup>1</sup>

## **Roberto Newell**

My lecture in this series in honour of Professor Richard Snape, will explore why the Mexican economy is not growing more rapidly. The underlying hypothesis is that the current political and economic structures function in ways that satisfy the interests of key political and economic interest groups that are able to influence political decisions, whether these coincide with the interests of the majority of Mexicans or not. I will show that despite significant changes to the political structures of country, the majority of Mexicans are locked out of critical policy decisions by institutional arrangements that were shaped, sometimes unintentionally, over the course of several decades by political and economic challenges that had to be accommodated by the leaders of Mexico's political economy.

I believe that until the mid-1990s, the changes to the political and economic structures of Mexico were managed reform processes intended to prolong the life of the political system. Even the most significant reforms (such as decision to have Mexico fully participate in the global economy) were intended to extend the life of the existing economic and political structures. However, simultaneous political and economic crises in 1994-95 made it impossible to further extend the existing political order. In 1997, after a final set of reforms to the electoral systems of Mexico, the Institutional Revolutionary Party (PRI) lost control of the lower chamber of Congress. Three years later, Vicente Fox was elected president, ending seven decades of uninterrupted control by PRI of the principal political institutions. Many of the changes wrought during the relatively chaotic period that preceded the end of PRI's role at the head of the political economy were unplanned and unanticipated. The new reality that emerged was distinctly different from the one that prevailed until 1997. Mexico's political system changed suddenly from a strong presidential system where the head of the Executive was the final arbiter of most key decisions, into a system characterised by a weak president whose leadership and authority has been contested ever since by a relatively large number of independent

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<sup>1</sup> This paper is part of a broader research effort focused on exploring the economic and political reforms that Mexico must make to achieve high sustained growth.

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actors that have sufficient political strength and economic resources to prevail in contested decisions.

The unintended consequence of the reforms of the 1990s was to create a new institutional arrangement that throws up formidable obstacles to further reform. The role of the president as the leader of change and the final arbiter of key decisions was lost during that period and is not likely to be resurrected any time soon. New institutional and political arrangements will have to be defined and negotiated before Mexico can restore its ability to move rapidly in the global economy.

## **Structure of this paper**

This paper traces Mexico's current political economy to institutions that were designed during the 1930s in order to deal with the political aftershocks of nearly two decades of violence and political instability. Said institutions were designed to peacefully channel the participation of politically significant actors. Many of these institutions subsist to this date. Their continuing existence partially explains why Mexico's political institutions are so resistant to change and why needed political and economic transformations have been delayed for so long.

In the first section of the paper I describe the political institutions that ensured the durability of PRI and its pre-eminence in the country's political life.<sup>2</sup> The political arrangements negotiated during the 1930s created a centralised political system that endowed the country's presidents with an unusually broad array of formal and informal sources of authority in exchange for an ironclad understanding that the president's term would not be extended beyond six years.

In the second part of the paper I will show that Mexico's political economy introduced economic reforms that transformed the economy and allowed resources (especially, labour and land) that were trapped in unproductive circumstances to find new, productive uses. This period of high growth and income redistribution provided legitimacy to the political system and created a virtuous circle leading to further rapid economic growth and development. Between 1935 and 1980, Mexico's economy grew rapidly, at rates comparable to those of the Asian Tigers today. While the underlying political arrangements were often challenged, the long-term stability of the new arrangement was never seriously at risk because the

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2 This section and the following, draw heavily on research published earlier. Newell and Rubio 1984, *Mexico's Dilemma: The Political Origin of Economic Crisis*, Westview Press, Boulder, Colorado, USA.



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economy's growth provided political support to the regime and made it possible to create economically rewarding circumstances for politically restive groups.

In the third section, I will discuss the results of a more than a decade (1970 to 1982) of populist measures intended to overcome the inherent weaknesses of Mexico's political economy. In this section I show that the failure to make room for new players to participate in politics and weigh in on critical decisions made crucial population segments restive. The legitimacy of Mexico's political economy hinged entirely on the system's ability to co-opt these groups with rewards large enough to overcome their dissatisfaction. In 1968, the political economy of Mexico was unable to avert conflict using peaceful means. The confrontation between the government and protesting youths led to the violent repression of the student movement causing the deaths of more than 300 students. Luis Echeverría and José López Portillo addressed these political issues using populist economic methods to buy off the disaffected groups. The unsustainable conditions that this approach created led to economic crises in 1976 and 1982, further undermining the foundations of the political arrangements crafted in the 1930s and exposing additional weaknesses of the political economy of Mexico.

In the fourth section of the paper, I describe the adaptive reforms introduced by Miguel de la Madrid and Carlos Salinas. These changes were intended to modernise the economy by integrating Mexico into the world economy and liberalising product markets. Once again, the purpose of these reforms was to extend the life of the political economy of Mexico. Product markets (and a few service markets) were thoroughly liberalised, unleashing waves of change that led to significant productivity gains, especially in the manufacturing sector. However, domestic input markets (energy, labour, telecommunications, land, water, some agricultural commodities and all other non-tradable services) did not change enough to make the de la Madrid and Salinas reforms self-sustaining: the intention of de la Madrid and Salinas was to extend the life of the political economy, not transform it.

Investments were made in anticipation of the opening of the Mexican economy, and growth seemed to be restored and with it the re-legitimisation of the PRI's political economy. However, reality intruded. Political conditions unravelled rapidly: first, with a peasant uprising in Chiapas, and later with the assassination of Luis Donaldo Colosio, the PRI's presidential candidate, which shook the system to its core. Subsequent political conflicts, and numerous political scandals and rumours led to capital flight and caused enormous turbulence in the economy. During 1994–95, Mexico was in the midst of a full-fledged economic and political crisis that led to bank runs, capital flight, devaluation and serial bankruptcies throughout the economy.

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In the fifth section, I describe how the simultaneous political and economic crises in 1994–95 created conditions that made further institutional reforms inevitable. In this section I explore how these changes set the stage for the current political economy of Mexico, by forcing the speed of change to accelerate: political institutions, such as the Federal Electoral Institute (IFE) were reformed, making it impossible to foil the will of the electorate; the PRI lost control of the lower house of Congress, and with this change it lost the ability to introduce fundamental reforms to input markets (such as electricity sector reform). Nonetheless, during this period, Ernesto Zedillo introduced reforms that enhanced the role of the Judicial branch in the political economy of Mexico and strengthened its role as the arbiter of conflicts between the Executive and Congress (the judicial branch's functions were also extended to electoral disputes, and in 2000, the political economy of Mexico was restructured when an opposition party candidate won the Presidency.

In the sixth section, I review the change-resistant nature of the current structure of the political economy of Mexico. In this section I describe how Mexico's new political system was transformed into a weak presidential system, based on institutions that make it very difficult to accelerate the pace of change and reform due to a number of political obstacles and institutions that slow the rate of change and reward factionalism and radical behaviours, making profound political and economic reforms unlikely. In this section I identify the new players in the political economy of Mexico and show why the role that they play makes it hard to make fundamental reforms.

## **1. Political institutions served control needs of Executive**

The current structure of Mexico's political economy cannot be understood without referring to the challenges that Plutarco Elías Calles and Lázaro Cárdenas faced at the time that they 'invented' Mexico's modern political economy.

In 1929, Mexico was reeling from the combined effects of a decade of civil war that had decimated Mexico's population; an armed conflict between government forces and Catholic radicals who wanted to restore the preeminent role of the Church in civilian life; the subsequent murder of President Elect Álvaro Obregón by a member of the *Cristeros* and the political turbulence caused by José Vasconcelos' decision to challenge the political order in the 1929 elections.

These circumstances made it clear to Calles (and later, Cárdenas) that the country needed a political structure to channel and control the speed, nature and intensity of change. The solution that Calles designed — and Cárdenas perfected — was

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embodied in the structures and processes of the *Partido Nacional Revolucionario* (PNR), an early incarnation of the *Partido Revolucionario Institucional* (PRI). The PNR served a dual purpose: it stopped the violent struggle for power between the diverse factions of the winners of the Revolution and it provided a process for the future transmission of power to loyal members of the new political order.

The institution that Calles created fulfilled these conditions by defining structures and procedures that changed little until 1997.<sup>3</sup> The new party was organised around three mass organisations that represented the interests of labour unions, farm organisations and the armed forces, respectively. Each of these organisations was charged with ensuring broad based political support for the party and maintaining discipline among the rank and file members of the party. In exchange, the leaders of these organisations were provided with economic rewards and political roles so long as they behaved loyally.

The new political economy functioned due to the creation of a powerful Executive whose influence and authority derived from his direct control of the functions performed by the economic and political institutions of the country. Using these instruments strategically, the PRI presidents were able to ensure that their instructions were followed to the letter.

The structures designed by Calles ensured that party members would act in a disciplined manner, but long-term incentives were required to guarantee their loyalty over time. The solution to this conundrum was to formally (and informally<sup>4</sup>) guarantee that no president would serve more than six years. By establishing rules that guaranteed periodic rotation at the top, the system provided advancement opportunities for ambitious individuals and the factions that they represented.

The system that Calles and Cárdenas established created a set of rules that provided stability to the newly created system: violent behaviour was not tolerated and corrupt practices were tolerated so long as the resulting benefits were shared with others in the party's leadership group.

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<sup>3</sup> Cárdenas, in 1938, restructured and renamed the PNR, replacing the military in the Party's structure with the *Confederación Nacional de Organizaciones Populares* (CNOP), which was designed to serve as the vehicle to channel the participation of government bureaucrats and other groups closely allied with the party, included business sector organisations.

<sup>4</sup> The informal rules of the game were established by Cárdenas when he exiled Calles shortly after becoming President, in so doing firmly establishing that the authority of past Presidents came to an end when the Presidential term expired.

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## The PRI presidents drew their authority from multiple power sources

The president's authority derived from three critically important roles. The president simultaneously was:

- De facto head of the party. During their tenures the PRI presidents had enormous influence and power over party members. They had:
  - Sole authority over key political roles and appointments in the Executive branch of government.
  - Final authority in defining which individuals would stand for elections throughout the country. This influence extended to decisions related to who would serve (or be allowed to serve-out a term of office) in government offices at all levels:
    - ... Executive positions in the Federal government
    - ... State governors
    - ... Congressional seats and Senate positions
    - ... Municipalities
    - ... Appointments to the Supreme Court and Federal courts
    - ... And, most important of all, the president was also the key decision maker designating who would be his successor, in so doing guaranteeing continuity at the top.
  - Key decision maker regarding which individuals would fill key leadership roles in PRI and its affiliated organisations, including unions, *campesino* (farming) organisations and CNOP organisations. In addition, the PRI presidents had significant influence in determining who would lead influential albeit non-affiliated business sector organisations, such as CONCAMIN, CANACINTRA, CONCANACO and CNA.<sup>5</sup>
- The PRI presidents were also the *de facto* head of all branches and levels of government. This role meant that during their tenure the PRI presidents had significant informal political authority over:
  - State governors, who *de facto*, were employees of the president.

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<sup>5</sup> Respectively, these were the *Confederación de Cámaras Industriales* (industrial sectors), *Cámara Nacional de Industrias de Transformación* (manufacturing), *Confederación de Cámaras de Comercio* (commerce) and *Confederación Nacional Agropecuaria* (agribusinesses).

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- ... While their subordinated status was unofficial, there was no question about where real political authority lay. As a consequence, for several decades, the day-to-day overseer of the states' governors was the *Secretario de Gobernación* (Secretary of the Interior), who fulfilled this role acting on behalf of the President. *Gobernación* played a similar role vis-à-vis Congress and key municipal governments, including Mexico City. The governance issues of smaller municipalities were normally delegated to the political officers of state governments unless the issues were so delicate that they warranted handling at a higher level.
  - ... The political subordination of state governors was reinforced by other means: during the 1970s local governments gave up their authority to levy sales and income taxes in exchange for a share in taxes raised by the federal government.<sup>6</sup> This made state spending decisions dependent on the quality of the relationship between the local and federal government<sup>7</sup> and affected the development of local governance capabilities and infrastructure. As a consequence of the subordinated status of state governments, governors lacked the incentives (and resources) to develop local institutional capabilities to ensure the rule of law. When major issues arose that threatened to disrupt peace and local order, the problem was referred up the line to be managed directly by members of the federal government. Obviously, this stunted the development of local legal institutions and capabilities.
  - The two chambers of Congress were also subordinated to the PRI presidents. As in the case of the state governments, the key influence lever was the president's role in the selecting the candidates for election, but other mechanisms helped to reinforce this subordinated status:
    - ... The most important was that the constitution barred the re-election of elected officials. This meant, in effect, that congressmen and senators were employees of the president and the party. Their political fortunes depended on their behaviour in the roles they were designated to fill. This had the effect of divorcing these individuals from any sense of accountability to the voters who elected them.
    - ... Another key control element was the fact that until the 1990s there was no employment alternative for most of the people in the Congress. They either observed party discipline, which was virtually indistinguishable

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<sup>6</sup> *Ley de Coordinación Fiscal* (1978).

<sup>7</sup> The centralisation of revenue and spending decisions undermined the development of fiscal disciplines at the local level and destroyed local authorities' accountability to voters.

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- from the president's wishes, or they were certain to be overlooked when new lists of candidates were drawn to serve in other capabilities.
- The judiciary was also subordinated to the PRI presidents and had very limited impact on public affairs. In the words of a famous jurist: 'the judiciary is not the third branch of government, it is a third rate branch of government.'<sup>8</sup>
    - ... As in the case of other appointed (and elected) roles, members of the federal judiciary served at the pleasure of the president. As a consequence, their terms tended to coincide with those of the presidents, even at the Supreme Court level. For that same reason, even justices felt obligated to choose political roles (in the Senate and elsewhere), over roles in the judicial system.<sup>9</sup>
    - ... This was further reinforced by the fact that the Attorney General and State Attorneys General were part of their respective executive branches. Because the role of attorney generals was political, technical considerations were secondary, especially when assignments to new roles were being considered.
    - ... Until the judicial reforms of 1994, and the subsequent reforms of 1999,<sup>10</sup> the autonomy of the Supreme Court was very limited, as was its role. The court was constrained not only by political realities, but by budgetary limitations as well. Moreover, the quality of members of the judicial branch was uneven and the ranks and processes of the branch were riddled with corruption, leading to a history of embarrassingly bad judicial decisions. Mexico's judicial branch performed very poorly at all levels; personal power and political influence were far more important than the rule of law.
  - The third role of the PRI presidents was as head of state. The ceremonial roles that PRI presidents fulfilled and their role at the centre of Mexico's economic and political life vested them with enormous symbolic prestige that made them stand apart and above the rest of Mexico's society.
    - ... The president was by far, the most visible politician, and during his term it was understood that he was not to be criticised publicly, especially in mass media. Exceptionally brave and independent journalists sometimes

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<sup>8</sup> Fix-Fierro, H. 2003, *La Reforma Judicial en México: ¿De dónde viene? ¿Hacia dónde va?*, trans. R. Newell.

<sup>9</sup> One such celebrated case was Salvador Rocha who left the Supreme Court to run for the Senate in 1990.

<sup>10</sup> Fix-Fierro (2003).

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criticised presidential decisions publicly, but they usually did so in ways that were so circumspect that one had to be deeply involved in the inner workings of PRI to be able to decipher the criticism. Instead, it was far more common for criticisms of the presidents to be made indirectly, blaming members of the cabinet and inept bureaucrats for unpopular presidential decisions.

- ... The PRI presidents were also the focal point of elaborate ceremonial roles: unveiling public works, inaugurating significant events, leading civic ceremonies such as the *Grito* (to mark Mexico's War of Independence) and the *Informe* (the annual address to a joint session of Congress to discuss the state of the nation), and so on.
- ... What held this together was the role that *Gobernación* played ensuring that mass media companies and newspapers adhered to informal but well established rules of self-censorship. Government spending on ads and other less subtle ways of bringing pressure to bear on journalists were also used to ensure that the PRI presidents' image remained untainted during their terms in office.

### **Economic instruments available to the PRI presidents**

The indispensable complement of the PRI presidents' political influence was their role managing the economy. The chief instrument of the PRI executives was government spending, but it was far from being the only tool at their disposal.

- The *Ley de Coordinación Fiscal* (Fiscal Coordination Law) meant that as much as 95 per cent of state and local government revenues first passed through the hands of the federal government. The bulk of these resources were allocated on the basis of the size of the states' populations and the number of poor living in each state, hence local authorities had little latitude determining the total amount spent. State governments also had very limited authority over the use of these resources; these were earmarked previously at the federal level. The balance of the resources that had not been earmarked previously was allocated based on priorities established by PRI presidents. Hence, the good will of the president was decisive to allocate free resources.
- In a similar vein, substantial sums were used to reward unions affiliated with the PRI (especially teachers, and workers in the oil sector, electric sector, government bureaucrats, and so on). The largesse of the president was also extended to other groups closely related to government, such as the *Confederación Nacional de Campesinos* (a national farming interest group). The

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generosity of these rewards was proportional to their political significance to the president.

- The PRI presidents made other critical economic decisions that allowed them to extend their patronage networks across the entire economy:
  - During the golden age of the PRI (roughly 1940–1980), the federal government controlled the spending decisions of *Petróleos Mexicanos* (PEMEX), *Comisión Federal de Electricidad* (CFE)<sup>11</sup> and hundreds of other public sector companies and agencies of the federal government, such as *Compañía Nacional de Subsistencias Populares* (CONASUPO)<sup>12</sup>, *Nacional Financiera* (NAFIN) and *Banco Nacional de Crédito Rural*<sup>13</sup> that channelled resources and patronage to favoured individuals and companies close to government.
  - The government could also dispense its favours by granting concession rights (*concesiones*) that authorised private citizens to use all or part of government owned assets. Examples of the above included:
    - ... The use of the radio spectrum which enabled companies to transmit news and entertainment programs on the radio and TV, and later, to operate telecoms companies.
    - ... Sub-soil rights needed to carry out mining operations in a country that has a wealth of resources in this sector.
    - ... Use of surface and sub-soil water resources in agriculture and industrial activities.
    - ... Banking, air transport and trucking which were all tightly regulated by the government, and so on.
- The PRI presidents also directly and indirectly controlled monetary policy and exchange rates.
  - Operational autonomy was not granted to the *Banco de México* (the country's central bank) until 1994. Throughout the previous period, the Executive held sway over key financial markets:
    - ... As will be discussed below, throughout most of the PRI's tenure, the federal government attempted to regulate exchange rates. During most of

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11 Monopoly suppliers of petroleum (PEMEX) and electricity (CFE).

12 CONASUPO imported and distributed grains and other foodstuffs.

13 Respectively, the national development bank which financed thousands of private industrial investment projects, and the agricultural sector development bank which channelled credit to agricultural producers.



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that period, the exchange rate was pegged to the dollar and served as an anchor for the rest of the economy's prices. During the 1980s a crawling peg was introduced in order to signal inflation expectations and smooth exchange rate fluctuations.

... During most of the PRI's rule interest rates were also managed, with an eye to their impact on currency movements. When inflation became an issue in the 1970s, real deposit rates were often negative with the consequent impact on currency flows and the growth of banks. Subsequently, banks were allowed to set deposit rates in order to retain deposits.

- Pricing decisions of products and services that were deemed to be highly sensitive were also managed to achieve political purposes. As a consequence, the prices of key goods and services (such as electric tariffs, potable water and the Metro in Mexico City) were very sticky and quickly lost any relationship with the cost of providing these goods and services during inflationary periods.
- The opposite tended to happen with salary increases. The political priorities of PRI presidents frequently were decisive in determining how much to increase salaries and were a key determinant of what the increases should be in collective negotiations between labour and management. The competitive damage done to the sectors affected by these negotiations depended on the exposure of the sector to foreign trade. During the period that the economy was closed (until the late 1980s) the damage tended to be slight.

In sum, the PRI presidents controlled vast swaths of the economy. Their influence was most significant over input markets, where the federal government could intervene directly, in the energy sector, the labour market, the agricultural land market, the financial sector, and so on. But for an extended period the PRI presidents also had significant impact over the performance of product markets, which they could affect directly and indirectly.

- During the peak years of the PRI presidents, the government had indirect control of entire sectors of the economy, using tariffs and import licenses (which were dispensed discretionally) to control the level and intensity of foreign competition.
- Foreign investment was also tightly regulated and discretionary authority could be used to regulate competition in a very wide variety of sectors. Hence, domestic incumbents could be sheltered from competition not only through trade barriers, but also through foreign investment regulations. However, inasmuch as the federal government controlled both trade and investment conditions, domestic incumbents knew that their welfare was in the hands of individuals whose

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objective was to fulfil the wishes of the president. This kept the business sector aligned with the priorities of the PRI presidents.

### **Political legitimacy derived from economic performance**

The political economy that Calles and Cárdenas designed depended on continually estimating the costs and benefits of presidential decisions. The conditions governing individual players' conduct were fairly explicit: Due to the authority and power vested in the presidency, companies and persons had little hope of influencing outcomes through individual initiatives. Hence, individuals were strongly motivated to join forces with others to gain additional political leverage and influence. Even then, the rules of the political economy required the disciplined acceptance of the federal government's decisions, at least for the duration of presidential term.

Inasmuch as the game was designed to ensure the long run stability of the political economy, experienced players recognised that transformational changes would usually be delayed as long as possible. As long as the PRI regime lasted most presidents avoided needlessly inducing transformational changes. This caused important decisions to be delayed even when the evidence was clear that making reforms might head off significant future problems or minimise long-term economic costs. Frequently, this caused economic and political pressures to rise and created significant opportunity costs in the economy, but it fulfilled the objective of avoiding disruptive changes that might destabilise the system.

Analysts frequently confused shifts in the political fortunes of diverse groups and individuals as signs that deep transformational changes were taking place. Retrospectively, it is clear that these interpretations were incorrect. A better representation of reality is found in Martin Needler's pendulum model,<sup>14</sup> which suggested that in order to maintain the long-term stability of the system, PRI presidents periodically shifted the weight of their office to compensate existing disequilibria and restabilise the system.

Throughout most of the 20th century, the leaders of Mexico's political economy used reactive strategies, introducing the smallest changes consistent with the resolution of the political and economic issues that could no longer be avoided. Hence, the overriding concern of designers of public policies was to find ways of prolonging the duration of the *status quo*, avoiding changes that would upset the

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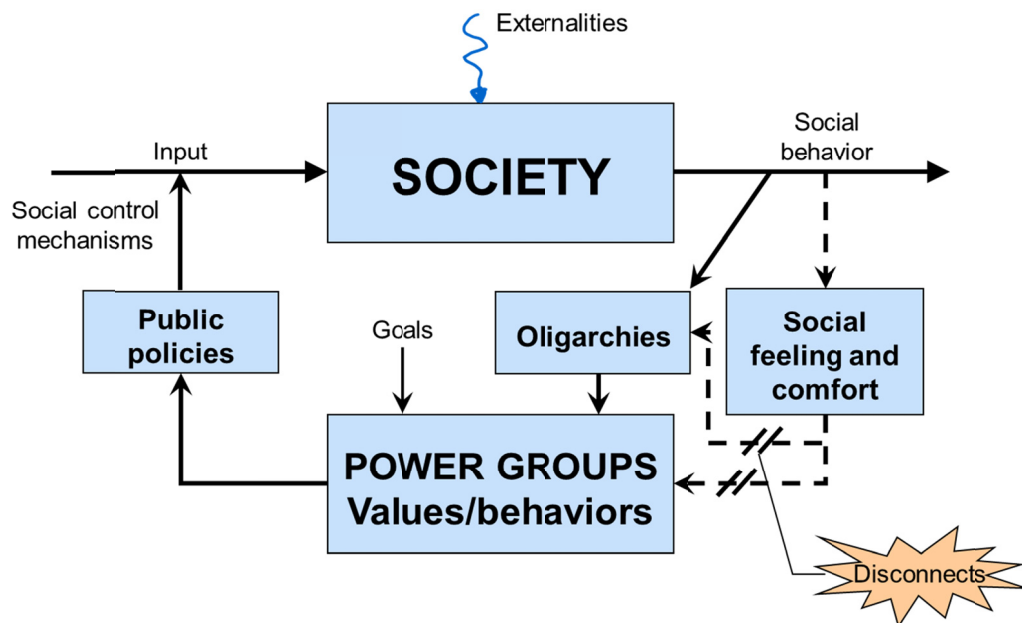
<sup>14</sup> Needler, M. 1971, *Politics and Society in Mexico*, University of New Mexico Press. Raymond Vernon makes a similar argument in *The Dilemma of Mexico's Development*, Wiley (1963).

fundamental stability of the system, even if this meant sacrificing the welfare of society as a whole.

As is common in most autocratic systems, the underlying motivation of decision makers was to ensure the structural integrity of the system by satisfying the minimum expectations of key constituencies. Throughout the years of the PRI regime this meant seeking outcomes that served the interests of the interest groups that composed its corporate structure.

Antonio Purón describes Mexico’s current political economy as a complex dynamic system whose social feedback loops are broken or have been taken over by interest groups.<sup>15</sup> His model, with slight changes, can also be used to characterise the operation of the political economy of the PRI regime. The only change necessary is to replace the role that Mexico’s current ‘oligarchy’ plays in his model, with the PRI presidents.

Figure 1 **Feedback control loop of our political complex dynamic system is broken**



Source: Purón, Antonio, 2011.

The most critical challenge facing an autocratic system such as the one described in the graph above is to ensure that the policies that it adopts are sufficiently aligned with the desires of a broad swath of society so as to maintain its political legitimacy.

<sup>15</sup> Purón, A. 2011, *Ten Years of Failed Transition to Democracy: the Struggle between Modernism and Feudalism in Society*, Presentation document, Stanford University.

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What this boils down to is to making sure that the rewards are sufficiently attractive to pacify all key segments of society.

During the PRI regime the *quid pro quos* provided by the political economy were: first of all, stability and peace; second, a piece of the pie for critical players in the game and, last but not least, the possibility of influencing future outcomes through disciplined participation in the political system, channelling demands through ‘representative structures’.

Throughout most of the period that PRI presidents governed Mexico, the population grew rapidly and migrated from rural areas to the cities. In order to fulfil the welfare expectations of the population and maintain the political legitimacy of the system, the economy had to grow rapidly, creating employment opportunities for the growing urban population and providing improved social services and public goods for all. All along, the legitimacy of the political economy of the PRI was vulnerable to periods of slow growth. Such periods invariably had political consequences, making significant groups restive and creating conditions that had to be dealt with either through coercion or cooptation.

As we shall see below, for four decades the political economy of Mexico was capable of meeting this challenge. In so doing, the PRI regime fulfilled its objective function as a system that guaranteed peace and provided stability and economic opportunities. By providing millions of Mexicans with a higher standard of living the PRI achieved political legitimacy. It had a success record that was so impressive that later when it had difficulties fulfilling the promise of economic growth and employment generation, it continued to have the support of a broad segment of the population. This is an accomplishment that deserves to be recognised and analysed.

## **2. Institutional structure functioned well between 1940-70**

The institutions created by Calles and Cárdenas were remarkably successful throughout the period 1940–80. During these years, the Mexican economy grew at rates similar to those of the emerging market ‘tigers’, averaging 6.4 per cent per annum, as is shown in table 1.

Table 1 **Growth of the Mexican Economy**

<i>Period</i>	<i>GDP growth</i>	<i>EAP growth</i>	<i>Labour productivity growth</i>
1940's	6.90%	3.51%	3.27%
1950's	5.84%	2.97%	2.79%
1960's	7.02%	3.02%	3.88%
1970's	5.82%	3.97%	1.77%

Source: INEGI, Banco de México, OXLAD, 2010.

During these years, the economy's performance was so good, that there was talk of a Mexican economic miracle. Between 1940 and 1980, the economy grew by more than one order of magnitude.<sup>16</sup> Two motors propelled its growth:

- The economy was able to employ a labour force that grew almost four times during that period.<sup>17</sup> Employment growth, alone, accounted for more than half (53 per cent) of the total growth of the economy.
- But this was not the only good news: the political economy of Mexico provided conditions that made it possible to engage this labour force with growing productivity rates. Labour productivity grew at an average annual rate of 2.9 per cent, accounting for 47 per cent of the economy's accumulated growth.

Welfare grew *pari passu* with the growth of the economy:

- Infant mortality rates dropped throughout the period<sup>18</sup>, by 1980 it was less than half what it had been in 1950, albeit still quite high international standards, standing at 53 deaths per thousand children born.<sup>19</sup>
- Life expectancy grew, from 38.8 to 66.2 years during that period.<sup>20</sup>
- Adult literacy improved throughout the period, having started at less than 50 per cent of the adult population in 1940, and rising to more than 75 per cent by 1980.<sup>21</sup> By the latter year, basic education was virtually guaranteed to all new school entrants.

<sup>16</sup> The exact multiple is 12.3 times.

<sup>17</sup> Numbers for labour force are the Economically Active Population, taken from OXLAD.

<sup>18</sup> Unless otherwise noted, all data used in this article are taken from INEGI or Banco de México.

<sup>19</sup> Estimates by CONAPO, cited in [conapo.gob.mx/00cifras/00salud/República/RM089.xls](http://conapo.gob.mx/00cifras/00salud/República/RM089.xls).

<sup>20</sup> INEGI 2005, *Los Adultos Mayores en México: Perfil sociodemográfico al Inicio del Siglo XXI*, Mexico.

<sup>21</sup> Lazarín Miranda, F. 2000, *Las Campañas de Alfabetización y la Instrucción de los Adultos*, pdf document.

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## Early reforms contributed to rapid economic growth

As shown above, one of the principal sources of growth was labour productivity. But this growth did not happen magically: growth during the 1940s and 1950s was the result of reforms introduced by Cárdenas, in a move that also helped to seal the political pact with farmers and labour:

- The first of these changes was the agrarian reform. Despite the fact that the Constitution written by the victors of the Revolution incorporated land redistribution as one of its core principles, until the mid-1930s little had been done to fulfil this promise. Starting in 1936, Cárdenas stepped up the efforts to distribute land<sup>22</sup> among *campesinos*, and this policy was maintained by his successors in the presidency. The agrarian reform was bound to have significant impact on the Mexican economy: In the 1930s, roughly 80 per cent of the population was rural and participated in activities closely related agricultural production. Similarly, land was the principal source of asset of wealthy Mexicans, but was highly concentrated in the hands of a few. Between 1936 and 1950 more than 50 per cent of the cultivable lands were distributed.<sup>23</sup> Three things happened due to land redistribution:
  - Agricultural output exploded in growth incentivised by the new conditions and supported by the creation of institutions that provided financing, irrigation infrastructure and technical assistance to *campesinos*.<sup>24</sup>
  - The growth in agricultural output caused rural incomes to rise creating markets for the urban products.<sup>25</sup>
  - A large number of *campesinos* were freed to migrate to the cities in search of the higher standards of living than could be obtained from in rural employment. These migrant workers found employment opportunities in Mexico's industrial and service sectors that were then beginning to grow as a

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<sup>22</sup> Mexico's *reparto agrario* was unusual in that it created a new form of land tenure: Individual plots were distributed to farmers. The families that received this land were given the right to use the land for the rest of life; this right was also part of their legacy to future generations of the same family, but they could not sell or mortgage this property. Communal land grants were also made to collectives with the proviso that this land be exploited collectively.

<sup>23</sup> Thiesenhusen, W.C. 1996, *Broken Promises: Agrarian Reform and the Latin American Campesino*, Westview Press.

<sup>24</sup> Solís Manjarrez, L. 1971, *La Realidad Económica Mexicana: Retrovisión y Perspectivas*, Siglo XXI Editores.

<sup>25</sup> Solís (1971).

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result of the opportunities provided by the Second World War, and the early stages of Mexico's industrialisation.<sup>26</sup>

- The second change introduced by Cárdenas was to intensify the campaign to raise the educational levels of the population; as a result:
  - Over the course of the following two decades, literacy and numeracy rates improved dramatically.
  - School enrolment multiplied several times during the period 1940–60 reflecting the PRI governments' decision to make schooling available to children throughout the country.
  - University enrolment also exploded, growing much more rapidly than the general population and consuming growing quantities of spending on education.<sup>27</sup>

Much of what Mexico experienced during this period was economic development driven by multifactor productivity growth, as has been demonstrated elsewhere.<sup>28</sup>

### **1940–1970: An era of 'efficient' import substitution**

The intention to modernise the economy expressed itself in another way: the decision was made to develop Mexico industrially. Retrospectively it is clear that this decision fit well with the era. The engagement of the principal industrial powers in a world war meant that throughout the 1940s there were recurring scarcities of industrial products and manufactured goods. Hence, the conditions were ripe for domestic entrepreneurs to substitute imports with goods produced locally. Over the three decades concluding in 1970, value added in the industrial sector significantly outpaced the growth of the economy.

But, import substitution as an official policy was appealing for two other reasons: first, because it fit well with the political economy of Mexico, and second, because during the 1950s a patina of intellectual support was provided by the policy recommendations being made by Raúl Prébish and other economists associated with

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<sup>26</sup> Solís (1971).

<sup>27</sup> Osborn, T.N. II 1976, *Higher Education in Mexico*, Texas Western Press.

<sup>28</sup> Fajnzylber, P. and Lederman, D. 1999, *Economic Reforms and Total Factor Productivity Growth in Latin America and the Caribbean (1950-95): an Empirical Note*, World Bank Policy Research Paper No. 2114, May 1999.

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the structuralist school at the Economic Commission for Latin America (ECLA).<sup>29</sup> The import substitution strategy rested on four pillars:

- Tariff barriers were erected and import licensing and other commercial barriers were implemented in order to encourage the development of domestic industrial producers. During the 1960s, government intervention caused effective protection rates on all manufactured goods to be more than 40 per cent; and they were much higher in the case of consumer durables and capital goods — more than 80 per cent — at that time.<sup>30</sup> During the 1970s, Mexico's commercial policy was complemented by legislation that limited the role of foreign investment in many sectors, thus providing additional protection to domestic manufacturing firms.
- Development banks also played a role in support of the government's industrial policy. The key player in this role was NAFIN, but several specialised institutions came into existence to complement its financing to Mexico's burgeoning industrial sector. By 1960, the loan portfolio of the development banks accounted for a significant share of total loans made by the financial sector.<sup>31</sup>
- PEMEX, CFE and Telmex<sup>32</sup> also played a supporting role. Refining capacity and petrochemical production both ramped up, especially in the late 1970s, when oil was discovered and developed in Cantarell. Industrial tariffs on electricity were also managed so as to stimulate the growth of industrial value added.<sup>33</sup>
- The country's infrastructure (roads, ports, electricity, and so on) also grew rapidly in support of the government's industrial policy.

The accumulated effects of these policy supports were to cause the output of the secondary sector to expand briskly throughout the period. As a consequence the output structure of the economy changed significantly over time.

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<sup>29</sup> Prébisch, R., 1949, *El Desarrollo Económico de América Latina y Algunos de sus Principales Problemas*, Fondo de Cultura Económica.

<sup>30</sup> Ros, J. 1993, *Mexico's Trade and Industrialization Experience since 1960: A Reconsideration of Past Policies and Assessment of Current Reforms*, OECD, Working Paper 186.

<sup>31</sup> Brothers, D. and Solís, L. 1996, *Mexican Financial Development*, University of Texas Press.

<sup>32</sup> *Teléfonos de México*, a national telecommunications provider. Until, its privatisation, it operated as a monopoly SOE.

<sup>33</sup> Solís (1971).



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## **Cautious management of economic aggregates**

The policies of the golden period of the PRI were rounded out by a cautious approach to the management of economic aggregates, especially after 1954. Consequently, for an extended period, the economy's development was supported by a macroeconomic environment that kept prices stable and worked well with the fixed exchange rate that the government established that year. Between 1954 and 1972:

- Mexico's government ran a primary surplus. Consequently, the financing needs of the Federal government could be satisfied quite readily.<sup>34</sup>
- Monetary policy was also carefully managed. The key policy objective was to keep the exchange rate stable. A strong peso helped to anchor all prices in the economy and helped to keep inflation low, roughly on par with inflation in the United States.

The policy lynchpin during this period was the highly effective coordination between the finance ministry<sup>35</sup> and Banco de México. The successful coordination of policies was the result of a shared view of how aggregates should be managed, and many years working closely together.

## **Economic performance rewarded politically**

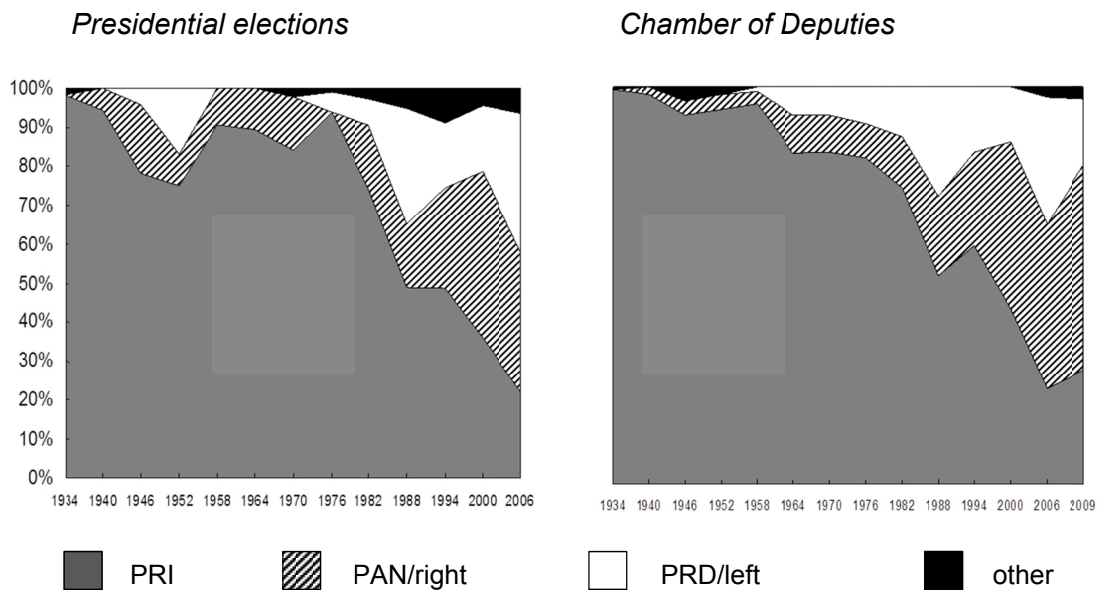
The stunning economic success of Mexico was rewarded by strong political support for the PRI government's policies. As can be seen in figure 2, at its peak, support for the PRI was broad based; more importantly, it was also genuine.

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<sup>34</sup> Rubio, L. and Gil-Díaz, F. 1987, *A Mexican Response*, Priority Press Publications.

<sup>35</sup> *Secretaría de Hacienda y Crédito Público*

Figure 2 Share of votes: presidential and congressional elections



Data source: Purón, 2011.

### 3. PRI experimented with populism: 1970–82

Despite the indisputable success of the PRI regime modernising Mexico and improving the welfare of its citizens during the period 1940–80, storm clouds were gathering that augured that all was not well. Issues of a varied nature were cropping up:

- Twice in a very short period (1968 and 1971), university students organised mass protests that repudiated the results of the political economy of the PRI. The key concern that they voiced was the very unequal distribution of income in Mexico.<sup>36</sup> They were joined in their ranks by professors of the national university (UNAM), who provided them with analytical support and the ideological content of many of their protests.<sup>37</sup> Tragically, in both of the cases,

<sup>36</sup> Hernández Laos, Enrique, estimates that in 1963, the Gini coefficient for México was .61. Data were taken from Castellanos Elías, J. 2003, *Relación del Endeudamiento Público con la Distribución del Ingreso en México: 1950-1999*, Facultad de Contaduría y Administración, UNAM.

<sup>37</sup> Javier Barros Sierra, who had previously served as Secretary of Public Works (*Obras Públicas*), was Rector of UNAM during the 1968 student protest. He figured prominently during this conflict providing students with leadership, publicly supporting their protests. Others playing a dual role during this and subsequent confrontations with government included: Pablo González Casanova, Pablo, author of *La Democracia en México*, (Era, 1965)

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the protests were repressed violently. More than 300 students died in these confrontations.

- Productivity growth in the private sector was slowing<sup>38</sup>: reflecting an end to the period of ‘easy’ import substitution; growing issues of international competitiveness that affected the performance of Mexican businesses; and early signs of the overvaluation of the peso. As a consequence, during the 1970s, import demand grew rapidly for all manufactured products.

To stave off a political crisis and allay the concerns of key PRI constituencies, Echeverría decided to ‘prime the pump’, substituting private sector demand with increased government spending. Echeverría justified his actions blaming the private sector for the mounting economic pressures. In so doing, he inaugurated a period of tension between the PRI presidents and members of the private sector that intensified during the 1980s and lasted until the 1990s.

As a consequence of Echeverría’s policy decision, government spending grew rapidly for the rest of the 1970s. Echeverría’s decision ended the fiscal prudence that had characterised earlier PRI governments. Mexico’s Flow of Funds changed drastically during the *sexenio* (the six-year presidential term); federal government borrowing crowded the private sector out.<sup>39</sup>

The lack of fiscal discipline spilled over into the management of monetary aggregates, causing prices to also rise sharply<sup>40</sup> and bringing pressure to bear on the peso. Ultimately, this caused the current account deficit to swell until it could no longer be financed through incoming capital flows, as shown in figure 3.

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who later was Rector of the UNAM; Ifigenia Martínez de Navarrete, who authored *La Distribución del Ingreso y el Desarrollo Económico de México*, (UNAM, 1960), served in various roles in government and later was a founding member of the *Partido de la Revolución Democrática* (PRD), the leading political party on the left.

38 Solís Manjarrez, Leopoldo, (1971, 1999 revised)

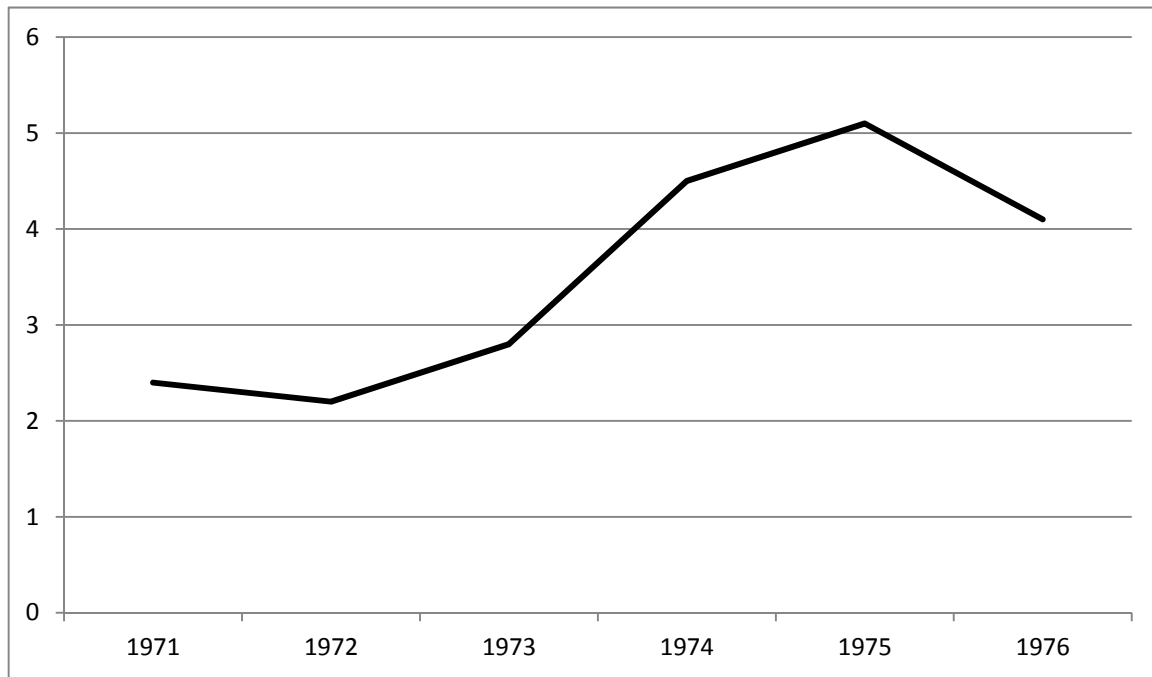
39 The swing from the first year of the *sexenio* to the last was roughly 10 per cent of GDP; Newell, Rubio (1984).

40 Consumer prices rose rapidly, as shown in the table below, taken from Newell, Rubio (1984):

<u>Year</u>	<u>CPI growth (%)</u>
1971	5.3
1972	5.0
1973	12.0
1974	23.8
1975	15.2
1976	15.8

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Figure 3      **Current account deficit as a percentage of GDP**



Source: Newell, Rubio (1984).

On 31 August 1976, the golden period of the PRI regimes came to an end:

- During the first half of 1976, international reserves fell from 1.6 billion U.S. to less than 750 million U.S. On the eve of the *Informe*, the peso suffered a catastrophic devaluation, falling from 12.50 pesos to the dollar to more than 20 pesos; but the damage did not end there.
- The federal government's finances were shattered as the peso value of its foreign debt rose, damaging future fiscal accounts.
- The financial wellbeing of the private sector was also affected because Mexican companies had taken on dollar debts, in the absence of peso financing. Their financial health was damaged even further by the effects that the 1976 crisis had on general economic conditions.

Despite the fact that the economy grew during all the years of the Echeverría administration, the economic strategies that he innovated failed to restore the health of the political economy of Mexico. In fact, they had the opposite effect, causing the size of the disaffected population to grow and damaging the legitimacy of the PRI regime.

The economic crisis at the end of his administration left the political economy reeling:

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- Growth during the two years 1976–77, was the lowest that it had been since the early 1950s.<sup>41</sup>
  - Inflation was also higher than at any time since the 1940s, averaging 24 per cent during the two years that the crisis lasted.<sup>42</sup>

The malaise caused by the crisis and Echeverría's rhetorical excesses reignited political conflicts that had been dormant for forty years. Echeverría's legacy was to make it clear to everyone that key population segments (business<sup>43</sup>, the middle classes, religious organisations and the military) were unhappy with PRI and the president, felt excluded from participating in vitally important policy discussions, and were vulnerable to the caprices of the president and other political insiders. In fact, Echeverría's populist utterances and his management of the economy created conflicts within the PRI itself.<sup>44</sup>

### **López Portillo also failed to restore the system to health: 1976–82**

The crisis conditions inherited by Echeverría's successor had to be dealt with. The priority in 1976, and for the two decades after that, was to modernise the political economy of Mexico, but without damaging the structure that it relied on for stability.

It was immediately clear that López Portillo understood the challenges he faced. His brilliant inaugural speech made it clear that he believed that restoring political consensus and civility to public life had to be the first order of business. He provided substance to the contents of his speech by selecting Reyes Heróles (an outspoken critic of Echeverría) to serve as Secretary of *Gobernación*. This appointment underscored that López Portillo felt that it was necessary to make stability-enhancing political reforms to restore the historic political compact of Mexico.

- In 1977, the Constitution was amended to provide the opposition parties with seats in congress by adding 200 new seats in the legislature on the basis of proportional representation. The architect of this reform was Reyes Heróles.

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<sup>41</sup> OXLAD database.

<sup>42</sup> Newell, Rubio (1984).

<sup>43</sup> Monterrey businessmen were the most outspoken opponents to Echeverría, but others in the Northwest echoed their sentiment.

<sup>44</sup> The most significant sign of such conflict was Reyes Heróles' speech of February 2, 1975 (at the time Reyes Heróles was President of the PRI) in which he expressed clear opposition to Echeverría's intention to seek reelection.

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- At the time the reform was interpreted as an olive branch held out to political dissidents on the left, especially those that had been repressed during the protest marches of the 1960s and 1970s. Retrospectively, it is obvious that the decision was needed to make room not only for angry dissidents on the left, but to soothe tensions with many others that felt disenfranchised by the historic political formula.

## **Mexico caught Dutch disease**

It is interesting to speculate how history might have been different if PEMEX had never discovered Cantarell, a super-sized oil field<sup>45</sup> in the Gulf of Mexico, whose production came on-stream in 1978. Instantaneously, the lessons learned during the crisis of 1976 were forgotten. As soon as it became clear how vast the new-found wealth was, fiscal discipline was abandoned. The new purpose of government became ‘administering prosperity’.<sup>46</sup>

The resulting oil bonanza changed economic decision making for the worst:

- On the strength of the oil discoveries, the finance ministry borrowed vast quantities in international capital markets. These resources were used to finance: current spending, which grew at a dizzying pace<sup>47</sup>; major capital investments, mostly spearheaded by state-owned corporations; and capital flight, stimulated by the overvaluation of the peso.<sup>48</sup>
- Fuelled by these resources and others that it borrowed domestically, the government’s consolidated deficit rose from 5.2 per cent of GDP in 1977 (very high, but a level that was to be expected given the crisis of 1976) to an astonishing 14.7 per cent in 1982. During the administration the consolidated deficit averaged 8.0 per cent of GDP<sup>49</sup>, oil revenues notwithstanding.
- The deficit that the administration incurred crowded the private sector out of domestic financial markets. The Flow of Funds Matrix for 1981 shows that the

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<sup>45</sup> Cantarell was the second largest oil field ever discovered, after Saudi Arabia’s Ghawar Complex.

<sup>46</sup> This phrase is attributed to Jorge Díaz Serrano, the Director of PEMEX during the early years of the Cantarell oil boom.

<sup>47</sup> Newell, Rubio (1984).

<sup>48</sup> Newell, Rubio (1984), in 1981, Mexico lost roughly 8.3 billion dollars of reserves; in 1982, an additional 6.6 billion were lost. Total capital flight was roughly equivalent to 20 per cent of the economy.

<sup>49</sup> Newell, Rubio (1984).

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private sector was a net supplier of funds to the government to the tune of 8.5 per cent of GDP.<sup>50</sup>

- Based on the expectation of growing oil revenues that were projected far into the future, in 1979, the president rejected the proposal to join GATT, thus eliminating the possibility that market discipline would serve to constrain the runaway populism of his administration. The debate was joined by participants from all sides. Predictably, domestic manufacturers and labour unions sided with those that opposed GATT.<sup>51</sup>

### **López Portillo's bet failed**

López Portillo bet everything on future oil revenues. Oil prices, which had nearly doubled between 1979 and 1981, began to decline rapidly as production in Iran stabilised and that of other producers increased.<sup>52</sup> Mexico could probably have avoided the worst effects of this drop had it followed other producers and dropped prices, but López Portillo's cabinet reversed Díaz Serrano's<sup>53</sup> decision to follow the market. This decision marked the beginning of a calamitous year. The new crisis was much worse than that of 1976 as it prolonged the period of economic mismanagement for six more years. The months that followed the decline in oil prices were nightmarish:

- Capital flight continued unabated. As pressure on the peso grew, the president publicly committed to 'defend the peso as a dog (defends a bone)'. Nonetheless, between February and August 1982 Mexico's remaining foreign reserves fled the country.
- Starting in the second half of 1981 and throughout 1982, monthly inflation averaged more than 50 per cent at annual rates.<sup>54</sup>
- Issues also materialised in the real sectors of the economy.<sup>55</sup>
  - Output in the manufacturing sector dropped by more than 7 per cent over the course of 1982.

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50 Newell, Rubio (1984).

51 Newell, Rubio (1984).

52 Wikipedia, "Chronology of World Oil Market Events (1970-2005)".

53 Díaz Serrano was head of PEMEX at the time.

54 Newell, Rubio (1984).

55 Newell, Rubio (1984).

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- Hours employed in manufacturing accompanied the drop in production, falling more than 8 per cent.
  - Total output fell.
  - The banking system lost a significant part of its deposit base.

The crisis of 1982 had catastrophic effects on the economy. In the best of cases, it would have deeply wounded the compact that held the political economy of Mexico together, but worse damage was still to come packaged in a series of announcements that the president made during his *Informe* of 1 September. In that event he announced:<sup>56</sup>

- Exchange controls.
- The replacement of a key central bank official who had publicly opposed exchange controls and had been critical of other policies espoused by insiders close to the president.
- The forced conversion of dollar deposits into pesos; and most significantly,
- The expropriation of the commercial banks.

### **Bank expropriation betrayed compact with business**

The political and economic ramifications of the banks' expropriation were enormous. As is the case in most market economies, bankers historically had been close to the financial authorities of the government. While bankers, together with other private sector players, were excluded from directly participating in PRI, their role in the economy made them participants in most economic decisions.

Commercial banks in Mexico also played a role in the economy that went beyond the role normally played by financial intermediaries. To begin with, there weren't very many of them.<sup>57</sup> As a consequence, the institutions themselves and their owners and managers were highly visible and respected players who carried out central roles in most major economic decisions. Second, Mexican banks — formally and informally — were the financial hubs of extended financial-industrial groups whose economic interests were tightly woven together. This was the case of Bancomer, Banamex, Serfin and of many smaller commercial banks. In this capacity they played an enormously important role financing the growth and liquidity needs of a significantly large part of the private sector. Put simply:

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<sup>56</sup> Newell, Rubio (1984).

<sup>57</sup> Sixty institutions were expropriated by López Portillo's decree.



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commercial banks in Mexico were much more than mere financial intermediaries; they were the flagships of the private sector.<sup>58</sup>

The expropriation of the banks abruptly ended that role and destroyed the already frayed relationship between leading institutions of the private sector and the PRI regime. It had other intended and unintended consequences.

- By expropriating the banks, the Federal government ended up vastly extending its presence in the economy, both in the role of financial intermediaries and because banks were the holding companies of hundreds of private sector firms in all sectors of the economy. By expropriating the banks the government became a significant shareholder in these companies.
- In so doing, the government also implicitly became responsible for their economic wellbeing. Hence, the expropriation of the banking system had the unintended consequence of making the government responsible for heading the financial workouts that many of these companies required as a consequence of the crisis.

Under these circumstances, the political ramifications of the banks' expropriation were enormous. López Portillo's decision to make the bankers pay for his mismanagement of the economy drove a wedge between the private sector and PRI that affects this relationship to this day.

#### **4. De la Madrid and Salinas tried to modernise the political economy: (1982–95)**

The damage done to the economy in 1981–82 was enormous. De la Madrid faced very grim conditions:

- The economy shrank by more than 5 per cent during 1983 and inflation was more than 100 per cent that year.
- Relations with international creditors were so damaged and the foreign debt of Mexico so large that access to external financing became impossible. To serve its external debt Mexico had to run a current account surplus. To do so, it had to

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<sup>58</sup> In an attempt to mend relations between Mexicans that played a role in the bank expropriation, the *Centro de Estudios Espinosa Yglesias* has recently published two very handsome books that recount the expropriation and later privatisation of the banks. The first book, *1982: En Busca de Reconciliación: Reflexiones sobre la Nacionalización de la Banca*, CEEY (1997), was published at the initiative of the foundation established in memory of Manuel Espinosa Yglesias, owner and chairman of Bancomer when the banks were expropriated.

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contain the growth of the domestic economy, maintain a peso exchange rate that stimulated non-oil merchandise exports and it also had to commit a considerable amount of PEMEX's oil revenues to pay off the international debt.

- If this were not enough, domestic debt was close to 90 per cent of GDP. Servicing this debt required massive fiscal deficits that were financed by expanding the money supply. Consequently, conditions in domestic financial markets had an inertia that caused prices to rise very rapidly; inflation during the de la Madrid administration averaged more than 50 per cent.

The outlook was also grim in another dimension. In just a few years, the incomes of Mexicans had twice been hit by the consequences of economic crises. The outlook for the economy made it clear that the workers' incomes would not recover until the economy was able to grow. The combined effects of these conditions damaged the political covenants of the Presidency with other members of the political establishment, as did the expropriation of the banking system. Urgent measures were required to restore the equilibrium of the political economy that held Mexico together.

### **De la Madrid tried to turn the system around**

De la Madrid did everything he could to reverse the damage done by López Portillo. He introduced changes that were intended to signal a change of style and decision making dynamics: where López Portillo was flamboyant and spent freely, de la Madrid was under-stated and frugal; where López Portillo moved dramatically and decisively, de la Madrid projected a methodical and careful style. The new president also introduced changes that showed that he differed from López Portillo in manners of substance.

De la Madrid faced two challenges simultaneously: the first was to restore order and stability to the economy. Without a more stable economy it was impossible for the economy to regain its health, and with restored economic health, the legitimacy of Mexico's political economy. To achieve this purpose de la Madrid made it clear that he thought it was indispensable to restore good relations with the private sector. This required making concessions on things that mattered to them and acting in a manner that signalled conciliatory intentions and prudent behaviour in all issues related to the economy. Throughout the *sexenio* he worked to achieve these twin objectives.<sup>59</sup>

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<sup>59</sup> Cornelius, W.A. 1985, *The Political Economy of Mexico under de la Madrid: Austerity*, Mexican Studies/Mexican Studies, No.1, UCSD.

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Several of de la Madrid's early decisions signalled his intention to change the course of the economy: In short order, de la Madrid:

- Appointed Miguel Mancera as head of the Banco de México.<sup>60</sup>
- Eliminated exchange controls in 1984.
- Set to reprivatising assets involuntarily in the hands of government as a consequence of the expropriation of the banks. The latter was a two-step process that involved, first, reimbursing the shareholders of the expropriated banks with bonds (*Bonos de Indemnización Bancaria*) and then auctioning these assets to holders of the bonds.

De la Madrid made significant administrative reforms that were intended to strengthen the quality of economic decision making and improve the outcomes of public policies. These included a broad range of changes:<sup>61</sup>

- A believer in economic planning, he strengthened internal decision making processes, conferring significantly more importance to the deliberations of an interdepartmental expenditure and funding commission (*Comisión Intersecretarial de Gasto-Financiamiento*), whose role was to bring rigorous analysis to the costs and benefits of all major spending decisions, in so doing trying to ensure that the financial and economic implications of said decisions were carefully evaluated before scarce federal resources were committed.
- De la Madrid also believed in good staff work of the sort that only highly qualified technocrats can prepare. Hence, decision-making processes were reinforced. High priority was given to the recruitment and development of qualified technocrats, mostly young economists and finance specialists with strong quantitative backgrounds. Hence during de la Madrid's tenure there was a wholesale renovation of the professional ranks of the finance ministry, Banco de México, NAFIN, PEMEX and other institutions with critical roles in the economy. It was during this period that talent-rich teams led by Carlos Salinas, Jaime Serra Puche, Pedro Aspe, Herminio Blanco, Ernesto Zedillo, Adrián Lajous and many others, were put together.
- In order to dilute the impact of political priorities in economic decisions, de la Madrid established controls that subjected the federal government to rules-based decision making. These were applied when public sector prices (such as electricity, public transport, gasoline and other government-controlled prices)

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<sup>60</sup> Mancera had publicly opposed exchange controls and manifested his discomfort with decisions being made by the President.

<sup>61</sup> The author personally witnessed many of these changes while working at McKinsey & Co. Inc., which served the new government on many projects.

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were reviewed. This approach was also extended to decisions related to *concesiones*, licensed services and so on.

The result of the administrative reforms was to improve the quality of decisions, re-establish fiscal discipline and reinforce meritocracy, all virtues that had been sorely missing during the two earlier administrations.

### **De la Madrid's administrative reforms alienated PRI functionaries**

The rapid development of a technocratic culture and the rise of young, empowered technocrats had political consequences.

- Individuals who cast their lot with López Portillo were alienated and shunted off towards minor roles in which they had diminished influence.
- Economic rationales so dominated decision making that important tradeoffs between political and economic objectives were side-lined. The departure and diminished influence of the political specialists of PRI led to a significant loss of skills and experience, especially later when several politically significant leaders decided to leave PRI to create a new political party — the *Partido de la Revolución Democrática* (PRD).

As the balance, influence and composition of the PRI shifted in favour of technocrats associated with de la Madrid, party members that had sided with López Portillo and who had welcomed the expropriation of the banking system manifested their opposition in ways that became increasingly ideologically charged. In this manner, the reforms instituted by de la Madrid came to be viewed as part and parcel of a process to weaken the political sovereignty of Mexico and defeat the redistributive objectives embedded in the Constitution.

### **Mexico finally joined GATT**

Perhaps the most courageous decision that de la Madrid made was the decision to join GATT, coming as it did in the middle of an economic crisis that had debilitated hundreds of companies' finances, caused the loss of thousands of jobs and which was vehemently opposed by most members of PRI. Yet the crisis had also served to make it clear that one of the principal issues facing the Mexican economy in 1981 had been the lack of market forces to encourage higher productivity and stimulate changes in anticipation of economic problems and opportunities.

The earlier debate over GATT, had caused labour and Mexico's manufacturing companies to ally against the opening of the economy; they did so again when de la

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Madrid opened the discussion, but in this case, the administration acted with resolve. The decision to unilaterally liberalise trade marked a paradigm shift for the Mexican economy.

Observers and business leaders commenting the implications of joining GATT recognised that by opening the economy, de la Madrid was changing the rules of the game. They acknowledged that significant efforts would be required to improve the productivity of labour and capital; they also recognised that a more open economy would require that companies improve the quality of output and the variety of product offers.<sup>62</sup> And because they understood how far reaching these changes were, many were not happy with the economic impacts that this decision augured.

De la Madrid's decision to join GATT signalled the intention to shift the economic development strategy from import substitution to full integration with the global economy. In this context, the decision a few years later to join the United States and Canada in a free trade agreement was a natural extension of the step taken by de la Madrid in 1986. In very short order,

- Tariffs were dropped unilaterally and a schedule for further reductions was put in place.
- Import licenses were abolished on all but a few agricultural products.
- Import quotas were eliminated altogether, with the exception of a handful of agricultural products (grains, sugar and life-stock). In these cases tariffs were set at zero, but quota mechanisms were maintained in order to protect domestic producers from import surges. Ultimately, the quotas came to be managed with an eye to ensure that domestic prices did not rise significantly above world prices.<sup>63</sup>

The new trade conditions provoked immediate changes. Serra Puche refers to the decision to enter GATT as the first structural reform since the 1930s<sup>64</sup>, and this is not an overstatement.

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<sup>62</sup> For instance, Bucay, Benito (then head of Grupo Sabre, a diversified holding company with interests in several sectors), who recognised that production processes would have to change radically in order to gain competitiveness), *Cambiar para Exportar*, Expansión, April 2006.

<sup>63</sup> A similar approach was followed after NAFTA was signed, thus domestic markets were generally aligned with the regional market, which were also aligned with world prices. The key exception to this was sugar, where cartel conditions in the U.S. have led to high prices in Mexico and the U.S.

<sup>64</sup> Serra Puche, J. 2010, 'La Apertura Comercial' in *Los Grandes Problemas de México: X*, Colegio de México.

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- Manufacturing was the sector most affected by Mexico's entry to GATT as imports of all types of manufactured products surged.
  - Over the next five years, imports grew from roughly 20 per cent of GDP, to about 30 per cent. While the change was very significant, it is likely that the depressed conditions of the economy kept the effects of the trade liberalisation from being even larger.

### **FDI was liberalised and rules for *maquiladoras* established**

The entry to GATT was accompanied by a more liberal and positive attitude towards foreign investment and by a clearer definition of the rules corresponding to *maquiladoras* ('in-bond' manufacturing plants, specialising in labour intensive products). While these changes were not explicitly a part of the institutional reforms that Mexico agreed to upon joining GATT, Mexico's adherence to GATT's rules dispelled some of the uncertainty regarding the permanence of Mexico's long term development strategy. Trade liberalisation also affected the structure of relative prices stimulating higher FDI flows and leading to a greater specialisation in the production and export of manufactured goods. Mexico's trade specialisation would come even more clearly into focus after NAFTA was signed.

### ***Pacto* established to control inflationary spiral**

Late in the de la Madrid *sexenio*, because inflation and financial instability had not yielded to orthodox measures of the sort normally doled out by IMF, de la Madrid launched the Stability and Economic Development Pact (*Pacto de Estabilidad y Desarrollo Económico*). The *Pacto* was established in order to interrupt the inertial effects of the inflation that Mexico was experiencing. Government provided the lead in price formation by agreeing to not raise public sector prices and by committing to a maximum tariff of 20 per cent on all trade inputs, thus creating a credible price trajectory for all tradable goods. In response, businesses and labour agreed to moderate price and wage increases.

The *Pacto* was a hands-on affair led by the federal government, with meetings regularly scheduled with representatives of business and labour to review price and wage behaviour and to agree, as circumstances warranted, to price and wage adjustments. Because the *Pacto* was introduced fairly late in the *sexenio* there was not much time for its effects to become apparent, but because there were early signs that the formula was working, the *Pacto* was carried over into the following administration.

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## Economic results were disappointing

Most assessments of the economy's performance during the de la Madrid administration focus on the poor performance of the economy during his tenure. There are good reasons for this:

- During the de la Madrid administration the economy had an accumulated growth of less than one per cent. Obviously, this was far less than necessary to keep pace with population growth, let alone with the growth of the labour force. For that reason, by 1990, output per worker was only 85 per cent of what it had been at the beginning of the decade. Despite the administrative and structural reforms introduced by de la Madrid, there were legitimate reasons to call the 1980s the 'lost decade'.
- Inflation was also brutally high during most of his administration, as stated earlier.
  - Prices and wages were indexed throughout the period.
  - At the conclusion of the administration the number of pesos required to buy a dollar had grown by two orders of magnitude.
  - Interest rates also soared, making it virtually impossible to finance anything in pesos.

At the conclusion of the de la Madrid administration, Mexico still was burdened by an enormous debt to its foreign creditors.

- Moreover, these economic mishaps were compounded by an enormous earthquake that hit Mexico City in 1985, destroying hundreds of buildings, causing more than 10 000 deaths and unleashing the wrath of the general population due to the slow response of the federal government to this new crisis.

To this day, many observers attribute the poor economic performance to the crisis conditions that de la Madrid inherited and to the policies prescribed by the IMF and the country's creditors. While these criticisms are partially grounded in truth, many of these same analysts overlook the fact that powerful forces were unleashed during the de la Madrid administration that would eventually reshape the economy of Mexico — albeit perhaps less than would be desirable — as has been shown by the retrospective analyses of Serra and others.<sup>65</sup>

- By joining GATT, de la Madrid transformed the Mexican economy radically. From that moment forward, participants in the economy would have to contend

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<sup>65</sup> Aspe A., P. 1993, *El Camino Mexicano de la Transformación Económica*, Fondo de Cultura Económica.

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with the challenges that an open market economy normally faces, or pay the consequences of not doing so. The decision to join GATT was a very significant departure from the policies followed by previous PRI presidents. It launched Mexico, kicking and screaming, in the direction of modernity.

- Comparisons to the recovery of other economies, such as Chile's, show that Mexico's economy lacked the resiliency to recover rapidly from crisis conditions. Mexico's slow response revealed that even more changes were needed. For the country to succeed it would have to incorporate a full range of additional reforms that were neither contemplated nor adopted during the de la Madrid administration.<sup>66</sup>

### **Political elites went along kicking and screaming**

A very large fraction of political elite was angered by the economic conditions in the country and disappointed with the economic and administrative reforms that de la Madrid introduced. The political conflict expressed itself in many ways:

- The debate was fed by academic literature and tracts by academics who favoured structuralist interpretations of the causes of the crisis. They argued in favour of unilateral repudiation of Mexico's international debt and a return to the closed economy model of the past. They also rejected any role for multilateral organisms such as GATT or IMF shaping policies for the economy. They viewed these organisations as tools of United States economic and political interests that were not to be trusted.
- The debate within the PRI grew so rancorous that a large group of left-leaning politicians (including Cuauhtémoc Cárdenas, who had served as governor of Michoacán; Porfirio Muñoz Ledo, who had been a cabinet member during the López Portillo administration; Andrés Manuel López Obrador, who would later govern Mexico City; Ifigenia Martínez, who had served on the Senate and was a revered professor of economics at UNAM; and many others), left the PRI, together with their closest collaborators and followers.
- The PRI dissidents allied with members of the Communist Party and other even smaller political parties that had emerged in response to the earlier political reform to form the PRD. The new party competed in the presidential election in 1988, with Cuauhtémoc Cárdenas as its presidential candidate.

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<sup>66</sup> Bergoeing, R., Kehoe, P. and Kehoe, T. 2010, *A Decade Lost and Found: Mexico and Chile in the 1980s*, Federal Reserve Bank of Minneapolis.

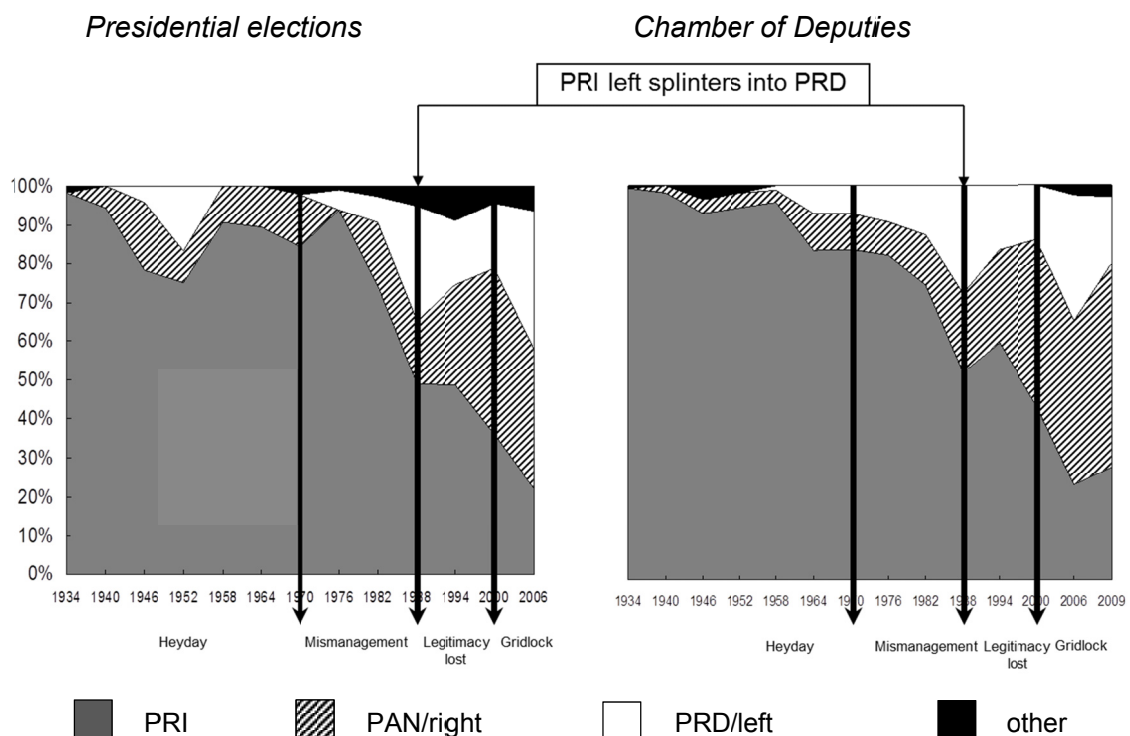


The presidential elections of 1988 were won by the PRI candidate, Carlos Salinas de Gortari. Salinas followed the traditional campaign tactics of previous PRI candidates, visiting all parts of the country to garner support for his election, but the effects of the economic crisis were too visible for him to gain a clear win. Against all expectations, PRD ran a very successful campaign, especially in Mexico City, reminding voters at every opportunity that the crisis conditions were the fault of the PRI and its failed policies.

As can be seen in figure 4, the official tallies gave Salinas a tiny majority of the total presidential votes cast. This result was hotly contested by the two opposition parties. For weeks there were protest marches in Mexico City against the electoral results, which finally abated as a result of a political negotiation between the *Partido Acción Nacional* (PAN) and PRI.

Salinas started his administration under a cloud. By 1988, the one-party system of PRI had lost its historic legitimacy; the writing was on the wall: Unless PRI could regain the right to govern Mexico, it was all over for the PRI.

Figure 4 **Power balance and gridlock**



Data source: Purón, 2011.

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## **Salinas reforms were ambitious but incomplete: 1988–95**

Salinas and his Cabinet understood that without significant changes the traditional political economy of Mexico had run its course. To restore the political legitimacy of PRI it was indispensable to restore the Mexican economy to health. As in the case of his predecessor, Salinas understood that he needed to make symbolic and substantive changes in order to gain time and the degrees of freedom to introduce reforms that had long been postponed.

During the first weeks of his administration Salinas assertively demonstrated that he was willing to be as tough as circumstances warranted. Thus, he ordered the incarceration of the powerful head of the petroleum workers, on charges of illegal possession of firearms. In jailing Joaquín Hernández Galicia (*La Quina*), Salinas sent a message to other labour leaders that he was not willing to tolerate political adventurism on their part.<sup>67</sup> Simultaneously, he sent an equally strong signal to the private sector by charging Eduardo Legorreta, the younger son of a politically prominent banking family, with tax fraud.

### **Foreign debt burden was made lighter**

Salinas moved rapidly when the opportunity arose to restructure Mexico's debt, especially with smaller foreign banks, by trading Brady bonds for bank debt. Since these bonds had a secondary market, they could be made liquid and banks could rid themselves of unwanted Mexican debt.

The effect of these and subsequent negotiations were to restructure Mexico's foreign debt, making it possible for the country to access international financial markets once again. Thus, a major obstacle to the growth of the economy was removed. This debt renegotiation was an indispensable precondition for the reforms that followed.

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<sup>67</sup> Hernández Galicia was rumoured to have supported Cuauhtémoc Cárdenas during the presidential elections. Later he would substitute the equally powerful leader of the teachers' union, Jonguitud Barrios, with Elba Esther Gordillo, and he co-opted the leader of the telecommunication workers so that he would not be an obstacle that would impede the privatisation of Telmex. At the political apex of his presidency, the labour movement was again totally subordinated to President Salinas.

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The effect of the debt restructuring on the psyche of investors was instantaneous and gained Salinas support among a new wave of private sector leaders who later enthusiastically supported the wave of reforms that he introduced.<sup>68</sup>

On the strength of these substantive and symbolic steps, five reforms were made that significantly altered the traditional approach to the management of the economy. These reforms have been written about extensively elsewhere, so they will only be discussed briefly below.

### **Mexico joined NAFTA and signed other trade agreements**

After months of negotiations that included many moments of tension and frustration, the governments of the United States, Canada and Mexico negotiated a trade treaty that was sent to their respective legislatures for approval. When NAFTA negotiations were approved, Salinas' power and prestige was at its highest point, hence its passage was guaranteed in Mexico and was also readily obtained in Canada. Passage of the treaty in the United States was a political nail-biter that was resolved only after extended negotiations between the executive, members of congress and representatives of business and labour. To close the deal, further concessions were extracted from Mexico regarding the sugar sector and commitments to reform the labour market and management of the environment.

The US labour movement and their allies in the US Congress were strongly opposed to NAFTA from beginning to end. However, their resistance was neutralised by strong support from the US business community who recognised that a trade treaty with Mexico would lead to further integration of the two economies, strengthening trade and investment relations between businesses on both sides of the border and improving the competitiveness of the manufacturing sector of the United States, which was already feeling cost pressures.

NAFTA came into effect 1 January 1994. Bilateral trade grew explosively after that,<sup>69</sup> as did foreign investment, mostly from the United States, to take advantage of the newly liberalised trade and investment conditions. Total trade in goods and services grew from roughly 30 per cent of GDP in 1994 (the post-GATT level) to nearly 60 per cent in less than three years.<sup>70</sup>

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<sup>68</sup> Among those that made up this renewed group of leaders were Carlos Slim, Claudio X. González, Roberto Hernández, Roberto González Barrera and several others.

<sup>69</sup> The entire energy sector was exempted from NAFTA at the request of the Salinas administration.

<sup>70</sup> Serra Puche (2011).

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Mexico negotiated other trade agreements during the subsequent period. An agreement with Chile preceded NAFTA, and shortly after that, trade treaties were signed with the Andean Pact countries and with members of the Central American trade block. Eventually, Mexico's network of trade agreements would extend to Brazil, Europe, Israel and Japan.<sup>71</sup>

The trade flows that followed the signing of these trade agreements stabilised at roughly 60 per cent of GDP, signalling that the stimulus derived from correcting relative prices in the Mexican economy had been exhausted. This meant that additional increases in the relative size of bilateral trade would have to wait until further structural reforms were (are) implemented. Indeed, during the early part of the 2000s, total bilateral trade flows diminished in relative importance as a consequence of the loss of market share to Chinese exporters, especially in the production of labour intensive manufactured goods.

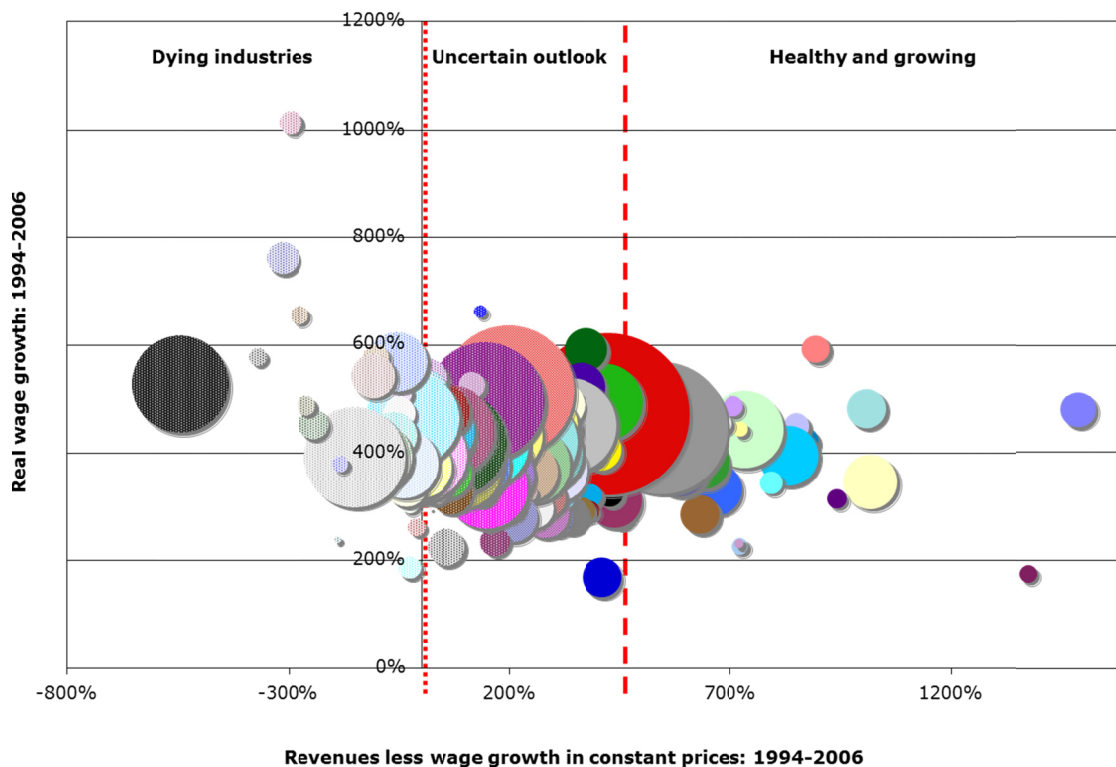
The rapid growth of imports combined with the effects of the new crisis that Mexico experienced in 1994–95, led to the rapid annihilation of a large number of companies that could not or would not adjust to the new conditions. Nonetheless, the surge in exports fuelled by investments in new manufacturing companies compensated many of the job losses that occurred in sectors that were not competitive.

This point is made forcefully by IMCO in figure 5. Since 1994, the revenues of industries to the left of the dotted line in the graph have grown more slowly than wages. This situation can be maintained for a while, but if this situation is sustained for long, eventually, the companies in that quadrant of the graph will be forced into bankruptcy.

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<sup>71</sup> Serra Puche (2011).

Figure 5 **Industry performance: 1994–2006**  
 In many industries, wages have grown more rapidly than revenues.



Data source: IMCO, using data from INEGI; 205 industries, employ roughly 10.7% EAP.

### Partial liberalisation of product market

The challenges posed by a rapid opening of the economy, triggered by GATT and NAFTA, caused the government to look for ways of improving the efficiency of domestic product and service markets. During the Salinas administration:

- Policies regarding regulated prices were reviewed.
  - Where price regulations could be eliminated, as in the case of staple foods and imported grains, they were lifted altogether.
  - In other cases, where public policy distorted the functioning of markets, efforts were made to reduce or eliminate the role of government. A case in point was the decision to change the role of CONASUPO, eliminating its role importing grains and substituting it with other less intrusive policies.
  - The prices of goods and services provided by the public sector were also reviewed, and where needed, adjusted in order to bring price and costs into closer alignment. In some cases, the adjustments were quite large due to high

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accumulated inflation and/or sticky official prices that were lagging as a consequence of *Pacto* negotiations. These price reviews continued during most of the Salinas administration and were extended to electricity rates, gasoline prices, potable water rates, fares for public transportation, and so on.

- Management practices of state-owned enterprises continued to improve and efforts were made to modernise the practices of these companies to improve labour productivity and costs. To support this effort, Salinas redoubled the efforts underway since the de la Madrid administration to ensure that talented managers were named to key positions in government owned companies. Special attention was given to ensuring the quality of appointments to PEMEX, CFE, *Comisión Nacional del Agua* (National Water Commission), and commercial and development banks. Indeed, during this period, the competition for talent between the public and private sectors became intense causing the real wages paid to talented individuals to soar.

As a consequence of all these changes, between 1989 and 1993, labour productivity finally started to rise again, at an average annual rate of 1.3 per cent.<sup>72</sup> This level was still far below what had been achieved during the early years of the PRI regime, but it signalled that the economy was responding to improved conditions in product and service markets.

### **Privatisation: another leg of the stool**

Salinas continued the work that de la Madrid had started<sup>73</sup>, intensifying the process that his predecessor had started. Salinas' administration sought to restructure Mexico's public sector, primarily focusing it on the provision of public goods and the management of strategic assets (such as PEMEX, CFE and a few other significant entities). At the time, members of the Salinas administration argued<sup>74</sup> that earlier administrations — those of Echeverría and López Portillo — had confused an obese government with a strong government. Hence, under the leadership of his highly competent secretary of finance, Pedro Aspe, the government established a program whose purpose was to privatise the large number of state owned corporations whose activities were not core to the functions of

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<sup>72</sup> OXLAD, 2011

<sup>73</sup> During the de la Madrid administration, 155 companies were privatised, and hundreds more liquidated, including a large number of *fideicomisos públicos* (trusts) which were vehicles commonly used to operate government owned companies. Sacristán Roy, E. *Las Privatizaciones en México*, <http://www.ejournal.unam.mx/ecu/ecunam9/ecunam0904.pdf>.

<sup>74</sup> See for instance, Rogozinski, J. 1993, *La Privatización de Empresas Estatales: (Una Visión de la Modernidad de México)*, Fondo de Cultura Económica.

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government and whose economic performance was often a drag on government's finances.

Jacques Rogozinski headed the area of the finance ministry that was in the charge of privatising companies that did not fit within the government's ownership framework.<sup>75</sup> He executed this role with brio. When all was said and done, hundreds of companies had been privatised; more than two hundred were executed by Rogozinski's team.<sup>76</sup>

The changes introduced by the earlier administration had already caused the government's exit from a large variety of sectors. The de la Madrid administration had privatised companies that produced a wide variety of products: industrial chemicals (*Tereftalatos de México*); automobiles and trucks (*Dina Renault*); railway cars (*Constructora de Carros de Ferrocarril*); and dozens of other products in a wide variety of sectors.

Selling these companies was relatively easy since few people were willing to dispute that the natural owners of these companies were private investors. But the Salinas administration pursued a bolder agenda, stepping up the pace of the privatisation process and extending the restructuring process to sectors that could be characterised as strategic. Two privatisation processes were destined to become iconic symbols of the Salinas administration.

- The first was the sale of Telmex in 1990. Telmex was sold after several changes were made to make its acquisition more attractive.<sup>77</sup> Control of the company was sold to a group of investors headed by Carlos Slim, who partnered with South Western Bell and France Telecom. The bidding process was competitive and was closely followed by the domestic and international financial press.<sup>78</sup>

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<sup>75</sup> The framework contained in the law narrowly defined what constituted a strategic sector and defined the nature of vehicles that could be used to carry out economic activities. In so doing, it also defined the governance rules that applied to the remaining state-owned companies, *Ley Federal de las Entidades Paraestatales*, Government of Mexico (1986).

<sup>76</sup> Rogozinski, J. 1998, *High Price for Change: Privatization in Mexico*, IADB, Distributed by Johns Hopkins University Press.

<sup>77</sup> These changes included integrating the tax on long distance calls into the tariff; a totally restructured labour contract that simplified the management of labour relations and made it possible to reward productivity improvements. It also included a new Concession title that established the service conditions that the privatised Telmex would have to fulfil. Herein, too, was established the price cap mechanism that would define future tariffs.

<sup>78</sup> The quality of service provided by Telmex was so deficient, that most observers were sympathetic with the decision to privatise the company. The expected *quid pro quo* was a leap in the quality and availability of service.

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The sales price was within 5 per cent of estimates that had been prepared prior to the sale.<sup>79</sup>

- The privatisation of eighteen commercial banks was the other iconic privatisation process. These banks were what remained of the institutions that had been expropriated in 1982. Hence, their sale was replete with symbolism. The expectation was that their sale would bring closure to this incident, healing enduring hard feelings between some members of the private sector and government.

In addition, many other companies were sold. As a consequence, the structure of a wide variety of sectors was radically transformed by these privatisations. For instance,

- Sugar production was privatised, selling blocks of assets that included several mills at a time. Many of the buyers of these mills were companies that produced soft drinks and saw these acquisitions as part of a backward integration process that would eliminate uncertainty regarding the supply of sugar and the effects of sugar prices on soft drinks' costs.
- Similarly, the government sold two airlines that it had in its portfolio, in so doing restoring these company to more normal operating conditions; and so on.

As a consequence of these sales, the government's role in the economy became smaller and more focused. This was a change that was badly needed. However, today, privatisation has become a dirty word. This is so, because the two most visible privatisations (Telmex and the banks) had unintended consequences that were partially related to how these privatisations were carried out.

- The most questionable aspect of Telmex's privatisation was the decision to sell the company as an integrated monopoly. Implicitly this decision entailed accepting the risk of future regulatory capture. In the opinion of many observers, including a Secretary of Communications and Transport<sup>80</sup>, OECD analysts<sup>81</sup>

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<sup>79</sup> The author of this paper was the Engagement Director of the McKinsey team that assisted the privatisation process. He had a similar role in the sale of the commercial banks, having participated in the sale of 10 institutions.

<sup>80</sup> Luis Téllez, quoted in the *Financial Times*, April 2007.

<sup>81</sup> OECD, 1969, *Recomendaciones para Promover un Marco Regulatorio más Favorable a la Competencia en la Interconexión de Redes de Telecomunicaciones*, Junio, pdf.



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and regulators at the *Comisión Federal de Competencia* (Federal Competition Commission)<sup>82</sup>, this risk eventually materialised.

In retrospect, it is obvious that to ameliorate this risk it was necessary to ensure that the entities established to regulate the sector were equal to that task and capable of resisting capture, in so doing ensuring a level playing field in the sector and/or regulating prices until competitive conditions improved.

- The privatisation of the banks also had unforeseen consequences. Several observers agree that that the government's obsessive focus on selling the banks at high prices<sup>83</sup> created perverse incentives that caused the new bankers to make poor credit decisions during the two years that followed their privatisation.<sup>84</sup> Murillo<sup>85</sup>, for instance, points out that the loan portfolio grew explosively, from roughly 24 per cent of GDP at the beginning of the privatisation process, to more than 43 per cent in 1994. Such rapid growth probably caused underwriting criteria to become lax and led banks to make risky<sup>86</sup> loans of the sort that would make them financially vulnerable if a crisis occurred.

Retrospectively, it is also clear that the qualitative filters established to discriminate between potential bidders were not as effective as they should have been. Fortunately, none of the larger bank failures were caused by unscrupulous behaviour, but the behaviour of the individuals that acquired Confía, Cremi-Unión and BanPaís, all small banks, would later cast a pall of the moral quality of everyone in the sector.

In hindsight it is clear that the key error made in the privatisations of Telmex and the banks was failing to greatly strengthen the quality of the entities that oversee the two sectors; Mexico would pay a high cost for this error.

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<sup>82</sup> The many disputes between Telmex and the Competition Commission led Telmex to request that the President of the Competition Commissions be recused from a decision that is still pending related to interconnection charges.

<sup>83</sup> The banks were sold at 3.1 times their collective book value. Ortiz, G. 1976, *La Reforma Financiera y la Desincorporación Bancaria*, Fondo de Cultura Económica.

<sup>84</sup> Barton, D., Newell, R., and Wilson, G. 2002, *Dangerous Markets: Managing in Financial Crisis*, Wiley. The authors found that prior to the crisis, most of the companies quoted on the Mexican *Bolsa* (stock exchange) were not earning their weighted cost of capital, indicating that they were increasingly vulnerable to a downturn in business conditions.

<sup>85</sup> Murillo, J. A. *La Banca en México: Privatización, Crisis y Reordenamiento*, Banco de México.

<sup>86</sup> Personal experience of the author, assisting private banks to create loan work out areas, suggested that at least two of the largest banks made loans based on faulty premises, and poor documentation.

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## Devolution of public sector functions to States

In 1992, the Salinas administration also started the process of decentralising functions carried out by the federal government to the states. The most important of these decisions was the decentralisation of the administrative and operating functions of the *Secretaría de Educación Pública* (Public Education Ministry).<sup>87</sup>

Earlier, during the de la Madrid administration, some of the operating functions of *Secretaría de Salud* (Health Ministry) had been partially decentralised. However, in this case, most major decisions continued to be made in Mexico City. Hence, the decision to decentralise the education sector's operations was a bold step in the direction of the devolution of functions to the States.

The administration hoped to achieve several purposes by decentralising education.<sup>88</sup>

- The key motivation was to involve local governments (and local communities and parents) in the day-to-day education of children. It was expected that by involving the states in this function closer attention would be paid to children's education and quality standards would rise, thus enhancing the legitimacy of the government's role in the sector.
- There was also an expectation that state governments would devote more energy and resources to basic education than the federal government could, in so doing strengthening the educational agenda of the country and fostering competition between the states to improve children's education.
- The quality and efficacy of education spending was also expected to rise by delegating operating decisions to functionaries who were closer to local circumstances and could make better decisions based on their greater familiarity with specific situations.
- Last but not least, it was expected that the decentralisation of operations would engage local authorities in the management of labour relations with the union. It was expected that by forcing the teachers' union to simultaneously sustain 32 relationships, its grip on the sector would be weakened.

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<sup>87</sup> A similar decision would be made later (1996), pertaining to the functions of the *Secretaría de Salud* (Public Health). A similar rationale was provided in this case; see Merino, G. *Descentralización del Sistema de Salud en el Contexto del Federalismo*, [funsalud.org.mx/casesalud/caleidoscopio/](http://funsalud.org.mx/casesalud/caleidoscopio/).

<sup>88</sup> Ornelas, C. 2003, *Las Bases Federalistas de la Descentralización de la Educación*, *Revista Electrónica de Investigación Educativa*.

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In the opinion of some education specialists, such as Ornelas cited above, some of these objectives were partially fulfilled. But the decentralisation of the education sector had paradoxical effects:

- The delegation of hiring and firing decisions to the States made the relationship between the States and the teachers' union more political than it had been before. Hence, the objective of weakening the grip of the powerful union was defeated. If anything, the power of the union grew as a consequence of this decision.
- Salinas' administration resisted fully decentralising key functions of the educational sector. It maintained control over the size of the budget; curriculum design and course contents. By not sharing authority over these issues with the states, the latter were not made accountable for the quality of educational outcomes. And, since there were no provisions made to recentralise education operations if the states failed to meet minimum standards, there was no way to reverse the decision if things worked out badly.

Once a firm commitment was made to decentralise a major part of government operations, there was really no going back. State governments were bound to enjoy the power that limited discretionary authority provided them, hence it was indispensable to ensure that with the decision to decentralise came accountability for outcomes. But as in the case of the privatisation of banks and the phone company, insufficient provisions were made to improve the quality of regulatory institutions.

Since then, state governors have fought to increase the share of total spending under their control. As Mexico's political system has become more plural and central authority has weakened, governors have sought to control a greater proportion of government revenues, especially since institutionalised accountability for the use of these resources has lagged.

Viewed in hindsight, the net effect of the Salinas' decentralisation experiment in education was to further weaken the traditional controls present in the political economy of Mexico. The long-term consequences of this decision would become clearer in the years to come.

### **Banco de México: autonomy and mission defined**

Very near the end of Salinas' *sexenio*, the Constitution was amended making the Banco de México an autonomous entity with a single purpose: to maintain the purchasing power of the peso. With this institutional reform, Banco de México was also freed from the obligation of financing fiscal deficits.

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The rules established at the time of this reform ensured the autonomy of the central bank: once elected, the members of the Board of Governors cannot be removed, except for gross dereliction of duty; appointments are not concurrent and last ten years; and to ensure operational autonomy, the central bank determines its own budget. Short of a new constitutional reform, the central bank of Mexico was provided with more de jure and de facto autonomy than is normally found in most OECD countries.

The reform of Banco de México's functions came too late for it to have much of a role heading off the crisis of 1994, but it had a major role during the banking crises and after that it became a stalwart defender of price stability and the maintenance of a floating foreign exchange rate.

### **Salinas de Gortari's legacy was positive**

Probably no president of Mexico is more personally reviled than Carlos Salinas de Gortari. This is due to the fact that the final year of his administration was chaotic and culminated with twin crises: in the political realm and in the economy, causing enormous damage to his personal reputation.

The long term effects of most of the reforms that he promoted were positive. Salinas' failures were not so much in what he did, but in what he failed to do. Salinas intended to restore the long term viability of the PRI regime. Hence, he set out to make reforms that would restore growth in the economy without upsetting the fine political equilibrium that had historically held the political economy of Mexico together.

Seen in this light, the decision to liberalise product markets and privatise banks and the phone company make sense. While they challenged the status quo of 1988, they did so in ways that were not directed against the interests of the core constituencies of PRI. The election results of 1988 and the ensuing political crisis gave Salinas a mandate to make profound changes, yet the changes that he made were designed to avoid damaging the interests of labour unions, farmers and bureaucrats. Viewed from the perspective of Salinas' role as the head of the party, it is easy to see how reforming either the labour or energy markets, which most modern economists would have recommended, would have meant breaking the political compact that held the PRI together.

At the apex of his administration, Salinas probably could have forced either of these reforms through Congress. But in doing so he would have entered into conflict with some of the most powerful constituencies of PRI. The lessons learned from the

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schism in the party during de la Madrid's administration must have left an indelible mark in Salinas' perceptions of risk.

However, Salinas failed to make other less politically contentious reforms:

- He did not invest the energy and resources needed to create institutions capable of overseeing and regulating key sectors of the economy: telecoms, banking, energy, the labour market and surface transportation.
- He should have also foreseen the need to endow the newly established Federal Competition Commission with the instruments and authority to oversee the efficiency of all input markets (including telecoms, banking, oil and electricity).
- His administration also failed to recognise the risks inherent in attempting to manage the exchange rate market, attempting to keep the peso within a relatively narrow band even in the face of significant inflation and economic turbulence. This decision made the economy extremely vulnerable to sudden changes in risk perceptions, as the collapse of the peso in 1994 would later prove.
- The Salinas administration also failed to recognise the need to modernise the judicial sector, not only to ensure that its institutions were equal to the challenges of a more open market economy, but in order to prepare the way for further decentralisation of authority of the sort promoted during his administration.
- Last, but not least, Salinas failed to recognise that with rising economic freedom would come demands for greater political freedoms. Hence he failed to create the institutions needed to ensure that future elections would not be contested as his had been. This is a stunning failure of imagination, but perhaps one that can be forgiven of a person who spent his entire life as an insider of the political economy of the PRI. Nonetheless, in failing to create these institutions he made Mexico's transition to pluralism less easy and complete than it might have otherwise been.

## **5. Twin crises killed the PRI Presidency**

In November 1993, Salinas anointed Luis Donaldo Colosio as his successor. In the views of news analysts of that period, the three contenders for the presidential chair were Pedro Aspe, Manuel Camacho and Colosio, all members of Salinas' cabinet. The choice of Colosio was interpreted as a decision to select a candidate with deep

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roots in the PRI<sup>89</sup>, who could restore good relations with groups that Salinas' reforms had offended.

In direct contradiction with the traditions observed during previous succession processes, Camacho refused to close ranks behind Colosio, creating unexpected tension during the period following the announcement, which was a period traditionally used to mend fences and ensure broad based loyalty. Hence, 1993 concluded with more political acrimony in the air than was normal in prior presidential succession processes, but with a clear expectation that these tensions would dissipate and be forgotten in the celebrations that accompanied Mexico's entry into NAFTA, which was inaugurated with the new year.

This was not to be the case. The weaknesses and contradictions inherent in the structures of Mexico's political economy were to be on display throughout 1994.

### **Political crises led to economic crisis**

The year started off with a bang. The same day that Mexico formally (and proudly) became a part of NAFTA, there was an uprising in Chiapas that dampened everyone's festive spirits and demonstrated how far some segments of Mexico's population were from feeling represented and well-served by the existing economic and political order. Salinas' response was to deploy the Army, but he simultaneously made it clear to the rebels that he hoped to avoid violent means to deal with their grievances.<sup>90</sup> As it turned out, the revolt in Chiapas was the first of several politically motivated crises that assailed the Salinas administration throughout this election year.

- During the first quarter of the year, there was a public perception of growing tensions between Colosio and Salinas. Observers believed that Salinas was unhappy with the positions that Colosio was espousing in campaign rallies.<sup>91</sup> The conflict, if there was one, seemed to come to a climax on 6 March in a speech by Colosio in which he levied relatively abstract criticisms of the PRI regime and government officers. Some interpreted the speech as a direct

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<sup>89</sup> Colosio had served in both chambers of Congress and had been President of the party during the de la Madrid administration. He served in the Cabinet as head of *Secretaría de Desarrollo Social* (Social Development Ministry).

<sup>90</sup> This purpose was achieved. The Zapatista uprising was almost entirely devoid of violence, as was the government's response.

<sup>91</sup> The differences were attributed to Colosio's insistence on redressing the grievances of the poor, which in light of the Chiapas uprising would seem to be contextually appropriate, but which some interpreted as a criticism of the policies of Salinas (and de la Madrid).

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criticism of Salinas' policies,<sup>92</sup> although viewed in the light of Chiapas uprising and the government's earlier decision to avoid repression, it could just as easily have been interpreted as an endorsement of Salinas' peaceful management of the Chiapas crisis.

- Two weeks later, Colosio was assassinated while attending a political event in Tijuana. Rumours, never proven, flew back and forth for the rest of the year over whether there his assassin had acted alone; whether he was the same person that was eventually presented to the authorities to stand trial, or whether Salinas or one his close collaborators had instigated the crime.<sup>93</sup>
- A political crisis ensued regarding the presidential succession process. This crisis was created by the fact that members of the Cabinet were barred from standing for election because elections were less than six months from the date of Colosio's assassination. Salinas' choices boiled down to Camacho (who was perceived to be acting disloyally) and Ernesto Zedillo (who had resigned from the cabinet to manage Colosio's campaign). Salinas chose Zedillo, because he had served in two different posts in his Cabinet and had loyally supported all the reforms that the Salinas administration had made.
- Several months later, José Francisco Ruiz Massieu, Salinas' brother-in-law and the Secretary General of PRI, was assassinated. Shortly after being arrested, the men who murdered Ruiz Massieu confessed that they had killed Ruiz Massieu on instructions of Raúl Salinas de Gortari (the president's younger brother); an accusation that was also never proven.

Scandal was heaped on scandal and the political upheaval caused a loss of confidence in the political stability of the country to build up, leading to massive capital flight. Throughout the year, billions of dollars flew out of the country, despite several measures adopted to counter the pressure on the peso.<sup>94</sup>

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<sup>92</sup> The speech criticised the lack of sensitivity of political leaders and members of government to the needs of the poor and disenfranchised in Mexico. "*Veo un México con hambre y con sed de justicia. Un México de gente agraviada por las distorsiones que imponen a la ley quienes deberían de servirla. De mujeres y hombres afligidos por abuso de las autoridades o por la arrogancia de las oficinas gubernamentales*", Colosio, L.D., speech in commemoration of the 65th anniversary of PRI. Once again, viewed in the light of the Chiapas uprising, the contents were contextually appropriate and politically necessary.

<sup>93</sup> The narration of Colosio's assassination in the Spanish language version of Wikipedia, reflects the view that there was a conspiracy to murder Colosio.

<sup>94</sup> Krueger, A. and Tornel, A. 1999, *The Role of Bank Restructuring in Recovering from Crises: Mexico 1995-1998*, NBER.

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- The band for the crawling peg mechanism was widened. However, after Colosio's assassination, the peso was always at the top of the band, signalling that pressure was still building up.
  - The interest rate was also adjusted upwards.
  - The international short term debt of Mexico was renegotiated and *Tesobonos* (short-term debt instruments indexed to the US dollar) were issued in order to keep dollars from fleeing the country.

All of these measures were taken, to no avail.

### **Zedillo took office in the middle of a currency crisis**

Zedillo faced a full-blown currency crisis during the first few days of his administration. It was common knowledge that the crawling peg mechanism was under pressure, signalling that the peso was overvalued. For a few days, Zedillo tried to weather the storm, resetting the parity at four pesos to the dollar. But this measure failed to convince investors. Within a few weeks, the new president was forced to abandon the recently established exchange rate level, allowing the peso to float; it immediately sank to 7.20 pesos to the dollar.<sup>95</sup>

The distress caused by the storm in currency markets was enormous. Fortunately, the Clinton administration recognised that it was in the interest of the United States to stabilise the Mexican economy. Hence, in mid-1995, the US government organised financing from the Federal Reserve and several multilateral institutions worth roughly US\$50 billion. The financing package incorporated relatively onerous conditions, including the stipulation that Mexico raise domestic interest rates drastically.<sup>96</sup> Almost as soon as the financing was arranged the crisis abated and the currency market stabilised, but the damage had already been done.

### **Peso's depreciation triggered a financial crisis**

Roughly 30 per cent of the loan portfolio of the banks was in dollars<sup>97</sup>, despite the fact that in many cases the borrowers did not have dollar revenues. This mismatch

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<sup>95</sup> The decision to float the peso had been resisted by Salinas and Aspe throughout the previous months, thus Zedillo's decision to float the peso irritated Salinas' team. This decision was later to be referred to by individuals close to Salinas as "*el error de Diciembre*" — the December error.

<sup>96</sup> Krueger, Tornel (1999).

<sup>97</sup> Krueger, Tornel (1999).



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meant that both debtors and creditors were inherently exposed to currency fluctuations. During the first quarter of 1995, the drop in the value of the peso caused the currency crisis to become a financial crisis. The crisis worsened when domestic interest rates rose to more than 80 per cent by mid-year.

Hundreds of companies were unable to meet their obligations. In most cases, banks restructured loans, but in hundreds of other cases this was not possible. As a consequence, the locus of the crisis shifted from companies' balance sheets to the banks. Most banks had to be recapitalised, but many of their shareholders were unable or unwilling to provide fresh resources. Eventually, there was no choice but to have the government step into the breach.

It cobbled together a program that involved the purchase of distressed assets from the banks, *pari passu* with injections of fresh capital by shareholders. In this manner, four large banks<sup>98</sup> accounting for more than half of the banking system were rescued, but many others had to be intervened, merged, or liquidated.

The bank rescue was an ad hoc process. Different banks were dealt with differently; frequently, the discounts applied to similar assets were inexplicably different. Many observers later speculated that the size of the discount depended on relationships between debtors and creditors. Hence, the banks' rescue came to be viewed as an extreme example of cronyism and corruption.<sup>99</sup> The reputation of the rescue program itself and of the individuals that led the process was tarnished in heated polemics.<sup>100</sup>

Estimates of the fiscal cost of the bank crisis vary widely: papers citing IPAB (Mexico's deposit insurance corporation) and other official sources<sup>101</sup> place the cost of the crisis in the low to middle teens; others run as high as 25 per cent of

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<sup>98</sup> The Banks were Banamex, Bancomer, HSBC and Banorte: Alvarez Texocotitla, M. 2002, *La Crisis de las Instituciones Bancarias y el Desarrollo Económico de México*, Denarius.

<sup>99</sup> DeLuna Martínez, J. 2000, *Management and Resolution of Banking Crises: Lessons from the Republic of Korea and Mexico*, World Bank Report WDP413.

<sup>100</sup> For instance, Guillermo Ortiz, who was Secretary of Finance during the crisis, was barred from sitting on the Board of *Instituto para la Protección al Ahorro Bancario* (IPAB, the newly created deposit insurance corporation). This was the political punishment meted out to him for having been in the driver's seat at the time of the crisis.

<sup>101</sup> Official sources cited by economists such as Amieva Huerta, J. and Urriza González, B. *Crisis Bancarias: Causas, Costos, Duración, Efectos y Opciones de Política* and Chávez Presa, J. 2008, *The Public Finances of Mexico's 1995 Banking Crisis*, presentation at International Association of Deposit Insurers, October estimate the crisis cost roughly 12 per cent of GDP.

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GDP.<sup>102</sup> But the costs of the banking crisis were not contained in the financial system. The crisis spread from the banks to the real economy as companies adjusted their business plans and as falling disposable incomes caused individuals to cut consumption spending. The government's long-term finances were also affected due to the debt incurred socialising banks' losses.

### **Zedillo used shock therapy to control the crisis**

Zedillo had the technical skills and knowledge to manage the government's response personally. Consequently, he became deeply engaged in the day-to-day management of the measures to contain the crisis, working closely with the government officials who executed his instructions. Together with his team, Zedillo courageously decided to face the crisis head-on, focusing the government's energy and resources on stabilising the economy by implementing relatively harsh remedies that were intended to abbreviate the duration of the crisis<sup>103</sup> by starving it of resources; hence:

- The government started the year by implementing a budget with a primary surplus. However, twice over the course of the fiscal year further spending cuts were made, raising the primary surplus to 4.4 per cent of GDP.
- The government also used its majority position in Congress to raise the value added tax (IVA) rate from 10 to 15 per cent.
- Monetary policy was also affected: primary financing was reduced in order to starve inflation of the resources needed to maintain price growth.
- Part of the US\$52 billion loan package negotiated with the US government and multilateral institutions was used to purchase maturing *Tesobonos*, while other financial obligations were restructured and thrown into the future.

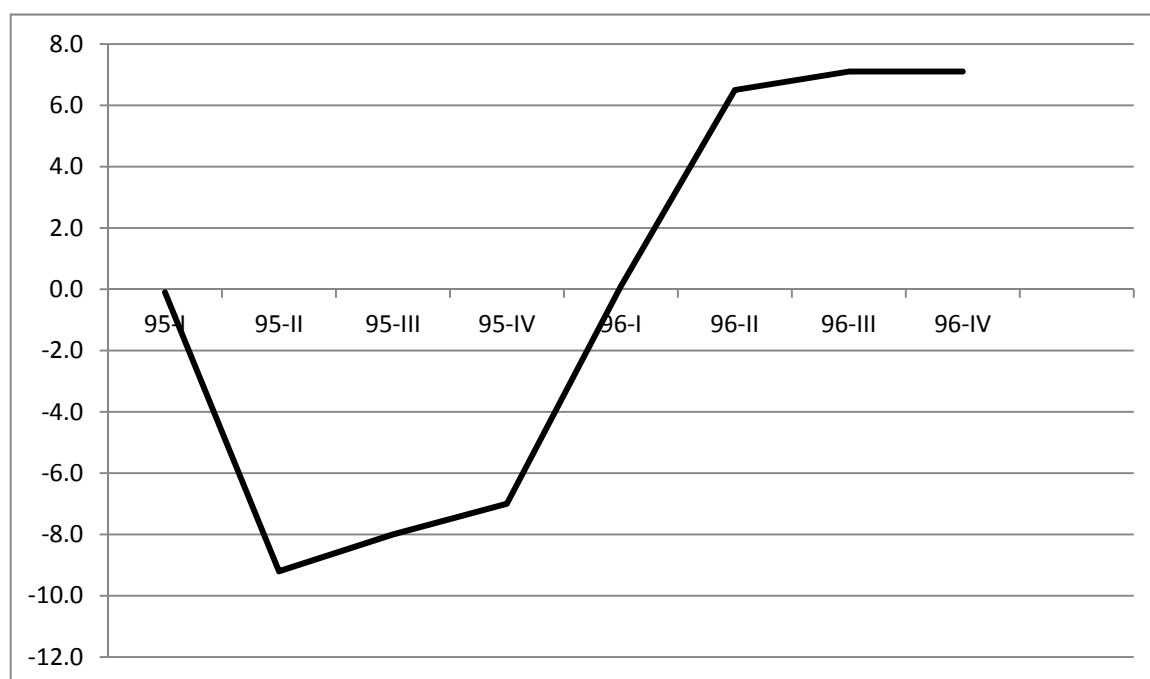
The government's strategy to deal with crisis was exactly the opposite of López Portillo in 1982. Rather than crafting a political response to distract the polity and purportedly soften the effects of the crisis, Zedillo designed a strategy that contained the crisis and abbreviated its effects. Per design, starting in early 1995, economic activity dropped sharply and kept dropping for four quarters in a row; but early in 1996 it began rising again, as shown in figure 6.

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<sup>102</sup> A presentation by a World Bank officer, cited in *La Jornada*, (21-09-2005) estimated the cost of the crisis at 25 per cent of GDP. The presentation suggested that the management of the crisis was an extreme case of cronyism in which debtors costs were socialised. The presentation document is cited in the World Bank's site, but is not available.

<sup>103</sup> Krueger, Tornel (1999).

Figure 6 GDP growth annualised: 1995-96



Data source: INEGI

Zedillo's management of the crisis was masterful<sup>104</sup>, and is frequently cited as a model for effective crisis resolution<sup>105</sup>, nonetheless, the costs of the crisis were great and its consequences were unevenly distributed throughout the economy.

- The output of tradable sectors recovered rapidly. The market opportunities available in the two neighbouring economies caused exports to grow by more than 30 per cent per annum between 1995 and 1997, and they continued growing in double digits for the rest of the *sexenio*.
- Imports also grew rapidly during this period, but the combined effects of an undervalued peso and the aftereffects of the crisis kept the current account from becoming a financial burden.

Many companies and individuals gained from the growing trade flows, but many more paid a high cost from the crisis. For many companies the costs were even

<sup>104</sup> I am not alone in making this judgment. For instance, Summers quotes Zedillo saying 'markets overreach, so policy needs to overreact as well' in Summers, L.H. 2000, *International Financial Crises: Causes, Preventions and Cures*, Richard T. Ely Lecture, *AEA Papers and Proceedings*, May 2000.

<sup>105</sup> See for instance, Sachs, J., Tornell A. and Velasco, A. 1996, *The Mexican Peso Crisis: Sudden Death or Death Foretold*, Economic Research Reports, RR # 96-20, C.V. Starr Center for Applied Economics, New York University, New York., and Krueger, Tornell, (1999), Summers (2000).

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higher as a consequence of the further opening of the economy caused by NAFTA. Zedillo's masterful management of the crisis was never to be recognised by voters or members of the business community.

Wage earners were among the biggest losers of the economic crisis, especially in the manufacturing sector, where the political leverage of unions was weakest. Between 1994 and 1997, real wages in the sector fell more than 25 per cent. But the damage was not limited to income losses: workers' welfare was also affected by the rise of IVA and by job losses, especially in industries that had been affected by the opening of the economy and the banking crisis.

As a consequence, thousands of families were unable to stay current on house payments and many more felt the cost of the crisis through the cost of credit card balances and mortgage debts. These welfare losses angered hundreds of thousands of voters who were anxious to make the hated PRI leaders pay for the costs of the crisis. The PRI would pay its share of the political costs of the crisis in the mid-term elections.

### **Judicial reform introduced early in 1995**

Zedillo's earliest attempt to reform Mexico's political economy was lost in the tumultuous months of the crisis. In his inaugural address of 1994, Zedillo asked congress to amend the Constitution to improve the judicial system. The reforms that he proposed were ambitious:<sup>106</sup>

- The *Consejo de la Judicatura* (Judicial Council) was created with a mandate to establish processes that would lead to the gradual professionalisation of the judicial system, creating career tracks for judges and magistrates and establishing processes that were expected to lead to the development of a reliable and meritocratic judicial system, one free of corruption and of political interference in judicial decisions.
- An independent *Comisión Federal de Derechos Humanos* (Federal Human Rights Commission) was also created. It was given the mandate to act in defence of the human rights of individuals and was established as an autonomous entity with its own budget and governance.
- The Supreme Court was also reformed. Its independent status was strengthened by endowing it with a significantly larger operating budget and by making staggered appointments to the court of individuals who would serve ten years.

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<sup>106</sup> Fix-Fierro, H. 2003, *La Reforma Judicial en México: ¿de Dónde Viene? ¿Hacia Dónde Va?, Beyond Common Knowledge: Empirical Approaches to the Rule of Law*, Stanford University.

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The number of justices was redefined, and in what was to prove a very controversial measure, all members of the Supreme Court were made to step down and an entirely new roster was nominated by the president and ratified by the senate. Finally, the provision was made to have the president of the court (second in line for succession in case of the death of the president) be elected by the full panel of Supreme Court justices.

The intention of the judicial reform introduced by Zedillo was to greatly strengthen the branch and to firmly establish it as a political coequal of the executive branch and congress. Expectations regarding the impact of the judicial reform were modest. The changes were not expected to make a radical difference overnight, especially in light of the fact that there was a clear need to improve the quality of the individuals serving in the judicial branch and because even more profound changes would be necessary at the state level. But in introducing this reform Zedillo was clearly acting in anticipation of changes needed to modernise the political economy of Mexico.

### **Political discontent made independent IFE indispensable**

Whether Zedillo was equally enthusiastic about the notion of modernising the way electoral system of Mexico operates is a question that is open to debate. What is obvious, however, is that in the context of the political crises of 1994 (the Zapatista movement, the assassinations of two prominent political figures and so on) and the economic crisis of 1994–95, there was no realistic option available but to improve the reliability and independence of the entity in charge of overseeing federal elections.

Hence, in 1996, reforms were introduced that led to the establishment of an autonomous entity, headed and composed by private citizens — not government officials — to oversee federal elections in Mexico. The *Instituto Federal Electoral* (IFE) also became the model for equivalent institutions established at the state level. The IFE was charged with several critical functions:<sup>107</sup>

- Ensuring the quality of voter rolls in local districts.
- Training polling officials and overseeing the fairness of elections in the more than 100 000 voting booths sprinkled throughout the country.
- Ensuring that the political playing field was level for all political parties competing in elections.

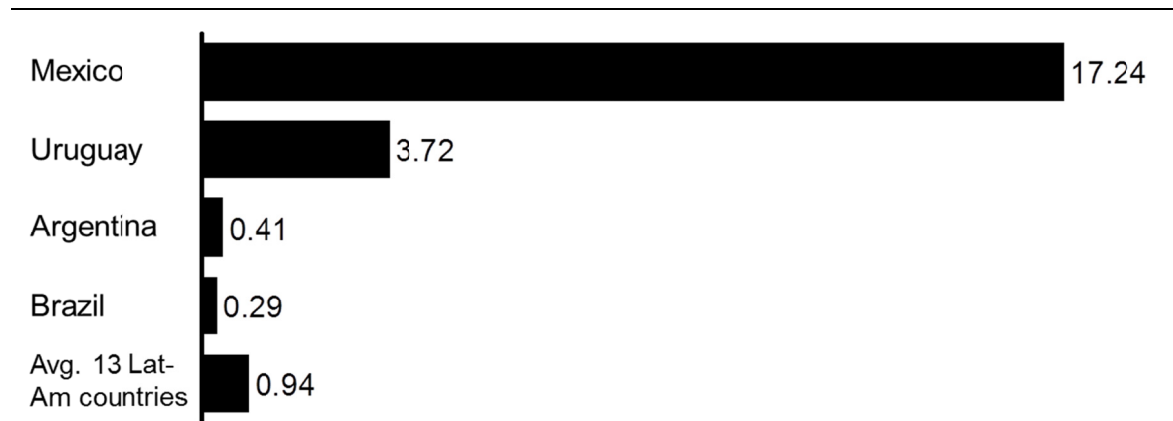
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<sup>107</sup> Ace Project 2011, *Mexico: Democratization through Electoral Reform*, The Electoral Knowledge Network.

- Defining the borders of electoral districts.
- Allocating proportional representation seats in congress to the winning parties, in accordance with the established formulas.

However, the key change introduced that year was ensuring the independence of the federal commission that oversaw the 1997 elections. This change more than any other, established the credibility of the new institution and its accompanying processes. Since then, IFE has maintained its crucial role in elections, albeit at an unusually high cost per vote cast, as shown in the graph below.

Figure 7 **Electoral infrastructure and processes are very costly**  
Cost per effective vote



Data source: Aplicacion de la Reforma Electoral de 2007/2008, International Foundation for Electoral Systems 2009.

### **Pension plan reform: Last major change promoted by Zedillo**

Shortly before the midterm elections of 1997, Zedillo proposed reforming Mexico's pension system to create obligatory individual pension accounts managed by private corporations that were made to compete for the privilege of investing individuals' funds. The reform ended the Mexican Social Security Institute's (IMSS) role as sole custodian of these funds; Zedillo wanted to give workers a choice between IMSS and private professional pension plan managers.

The reform was expected to provide several collateral benefits:

- Future pensioners were made participants in decisions that would affect their future wellbeing. By establishing individual accounts it became easier for workers to track the value of their savings and to understand whether they were accumulating at a satisfactory rate.

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- These funds were also put beyond the reach of government. Hence, they would no longer be exposed to capricious political decisions that could lower their value, as had happened previously under IMSS supervision.
  - The resources were to be channelled to Mexico's capital market and invested in a number of authorised instruments that have longer durations and higher yields than federal treasury certificates (CETES) or normal bank deposits. This provided pension managers with opportunities to invest in instruments that would build savings up more rapidly.
  - Voluntary savings could be comingled with the obligatory pension contributions of individuals thus simplifying the task of administering the savings of pensioners and growing the total pool of savings managed by pension managers.
  - Last but not least, the creation of the individual retirement accounts was expected to cause the mass of resources channelled to the capital market to grow rapidly, thus deepening Mexico's financial markets.

It is possible that if this reform had not been considered and approved before the new Congress was sworn in, it might never have been passed. By having Congress consider the reform in July 1997, Zedillo was able to ensure its passage before PRI lost control of the lower house of congress.

### **PRI paid the costs of the twin crises**

The natural reaction of the electorate to the political and economic crises was to blame them on the corrupt practices of PRI, Salinas, his 'neo-liberal' cronies (including Zedillo, commercial bankers and everyone involved in the bank rescue). Hence, despite the fact that the economy was once again growing, voters punished the PRI in the midterm elections.

Voters chose PAN over PRI or PRD. In so doing they voted for the 'safer' of the political options available to them. With the loss of the lower chamber, Zedillo lost the ability to pursue politically sensitive reforms, especially if these reforms entailed amending the Constitution. Nonetheless, during his administration: Zedillo introduced and passed more Constitutional reforms than any other previous PRI president, 77 altogether.<sup>108</sup> However, after the midterm elections of 1997, the passage of politically sensitive reforms became excruciatingly difficult. For instance, in 1999, when Zedillo attempted a constitutional reform to allow private participation in electric generation and distribution, the proposed amendment was

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<sup>108</sup> Sáenz, L. 2006, *La Presidencia Moderna: Análisis de una Institución que es Urgente Comprender* Taurus.

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frozen in commissions by PRI dissidents and was not presented to Congress<sup>109</sup> until the subsequent president had been sworn in.

The outcome of this reform is the best example available of the growing distance between traditional PRI constituencies and President Zedillo. Towards the end of the administration, hard-liners in PRI were willing to demonstrate their displeasure with Zedillo at every turn, in so doing revealing that the traditional structure of the PRI's political economy was no longer functional.

One would think that the harrowing issues that Zedillo faced during the first half of his administration would have made the last three years seem pleasant by comparison, but it is doubtful that it felt that way to the president or his closest collaborators. During the crisis years relations with members of the opposition parties became so strained that there was no reason to expect them to collaborate in legislation, even to promote further reforms. But Zedillo's largest political problems during this period were the ongoing conflicts that he had with members of his own party. For instance,

- Zedillo was accused by Roberto Madrazo, the PRI governor of Tabasco, of having supported Andrés Manuel López Obrador's (PRD) suit to reverse the 1994 election results in Tabasco. Whether this was the case is still an open issue. What is known, is that the governor successfully withstood *Los Pinos'* pressure<sup>110</sup> and ended up serving his full term as governor. This would have never happened during prior PRI presidencies. The conflict between Madrazo and Zedillo established a precedent and created political tensions that would influence the presidential campaign in 2000, and thrust López Obrador in to the national lime-light shortly thereafter.
- Zedillo also had ongoing conflicts with PRI hard-liners.<sup>111</sup> He locked horns with them over policy issues, but the conflict with them was especially harsh during the period leading to the selection of the PRI's presidential candidate. Zedillo publicly stated his intention to maintain distance from the process to select his successor and the choice of candidates to fill other positions. Zedillo's decision created a power vacuum and caused confusion within PRI.<sup>112</sup> It also obliged the

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<sup>109</sup> This reform died two painful deaths, first during the Zedillo administration and later when President Fox asked Congress to consider its passage.

<sup>110</sup> *Los Pinos* is the official residence of the President.

<sup>111</sup> One such hard-liner was Manuel Bartlett, who was openly in opposition to any additional reforms, especially in the energy sector.

<sup>112</sup> Helmke, G. and Levitsky, S. *Informal Institutions and Democracy: Lessons from Latin America*. During the run-up to the 2000 election, several party members publicly stated their intention to seek the Presidential office. This marked a distinct change in the selection process



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PRI's leaders to improvise internal processes to manage candidate selection. The outcome of this process left everyone feeling dissatisfied: those who opposed Francisco Labastida Ochoa claimed that Zedillo secretly supported his candidacy, while Labastida supporters felt that the president had abandoned them.

These conflicts happened out in the open, where everyone could see them, and weakened Zedillo's leadership role during the second half of his administration.

## **6. Mexico's new institutions are change resistant**

Retrospectively it is clear that what best explains Mexico's current slow economic growth is the political immobility that resulted from the abrupt, albeit peaceful, transition to democracy. This political status is the unintended consequence of maintaining many of the PRI's political institutions in a plural political system.

In the first section of this paper we traced the authority of the PRI presidents to three power sources: the role as de facto head of the (only) party; the role as head of all branches and levels of government; and finally, the role as head of state. The grip of the president over these three sources of authority weakened over time and collapsed when PRI lost control of the lower chamber in the 1997 elections. From that moment on, the PRI president could no longer wield unchallenged authority over the other branches and levels of government. But because provisions had not been made to modernise all of the institutions required to make Mexico's democracy function effectively, the resulting regime was a weak presidency bound by limits imposed by groups and elected officials that wield effective veto power that favours the maintenance of the status quo.

Democracies characterised by this type of structural arrangements change slowly, almost as if by design<sup>113</sup>, and are unable to respond with agility to the challenges posed by forces in the global economy.<sup>114</sup>

Fukuyama explains the unanticipated nature of this outcome in the following manner:

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and was one more example that the traditional political economy of Mexico had changed irreversibly.

<sup>113</sup> Fukuyama, F. 2008, 'Do Defective Institutions Explain the Development Gap between the United States and Latin America' in *Falling Behind: Explaining the Development Gap between Latin America and the United States*, Oxford University Press.

<sup>114</sup> Robinson, J. A. 'The Latin American Equilibrium' in Fukuyama (2008).

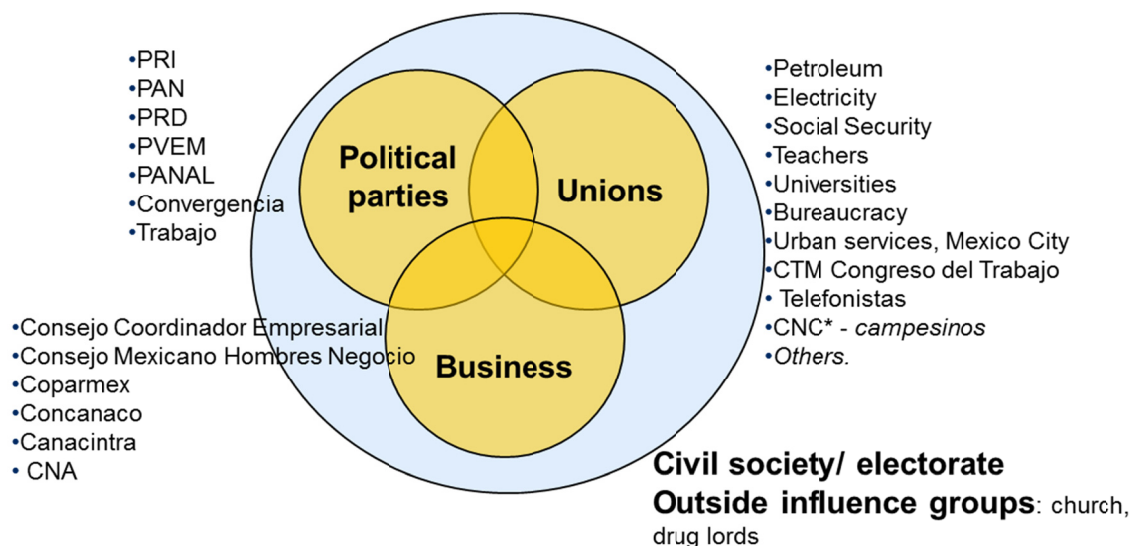
Institutional reform is sometimes treated as if it were a technical issue of developing the right incentive schemes or organisational structures in a public agency. But institutions are inherently political: they serve political purposes and affect political fortunes. Without political will, they cannot be created or reformed, and in a bad political climate they will collapse. In many ways, understanding what a good institution should look like is far easier than developing a strategy to bring about the reform to an existing institution. Would-be reformers who disdain the dirty work of getting votes, building coalitions, cutting deals and convincing sceptical publics seldom get very far.<sup>115</sup>

Mexico's current political structures are the unintended consequence of decisions and reforms that were made in the midst of crises conditions. They were useful in that they allowed Mexico to transit from a one-party regime to a plural democracy. But the birthing process was painful, chaotic and incomplete.

### Who wields effective veto power in Mexico?

Purón has graphically portrayed the new power structure of Mexico per the graph below:

Figure 8 Three main oligarchic power groups



Data source: Purón, 2011.

Purón's portrait captures the essence of the current power structures of Mexico. It is true that members of the 'oligarchical circles' pictured in Purón's graph are frequently in conflict with each other — as in the case of the labour organisations

<sup>115</sup> Fukuyama, F. 'Conclusion' in Fukuyama, (2008), p. 286.

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grouped in National Union of Workers (*Union Nacional de Trabajadores*) and those gathered around the Labor Congress (*Congreso del Trabajo*). Nonetheless, the members of each of the three groupings tend to have shared interests and objectives and react in similar ways to specific stimuli.

### **Rules vary, but the outcome is predictable**

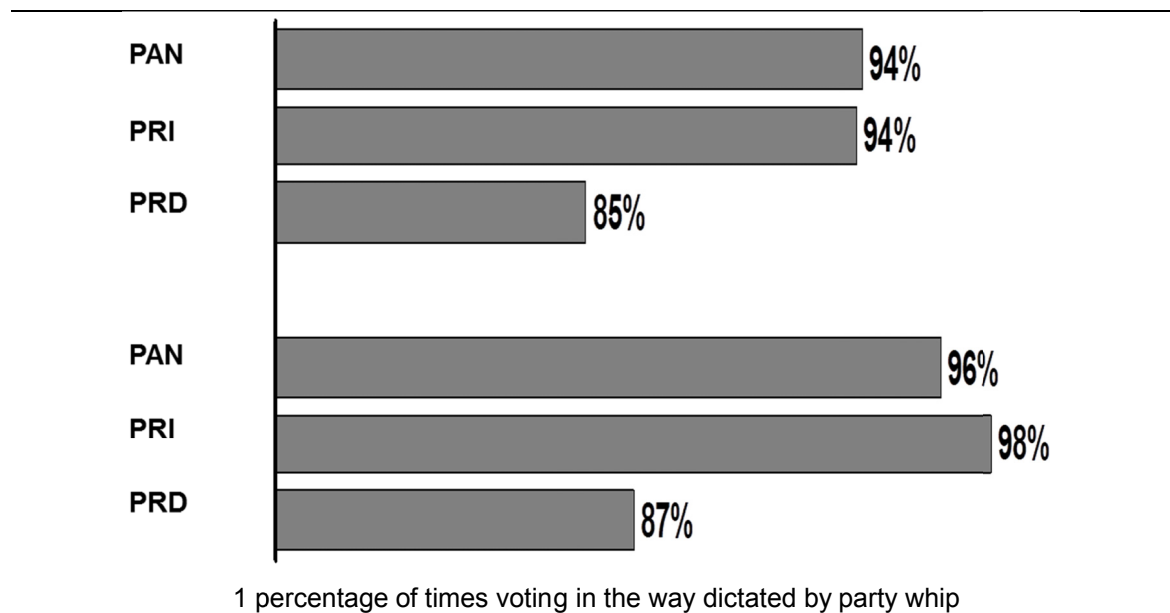
Political parties have adopted different institutional structures, but in each case, the result has been to maximise the control that party functionaries wield over elected officials:

- With the possible exception of PAN<sup>116</sup>, until recently, all political parties have designated candidates using formulas that maximise the control of each party's *nomenclatura*. These mechanisms ensure that party leaders have a decisive role selecting candidates that will stand for elected positions. Party insiders also are in charge of drawing up the list of party members that will fill the seats awarded by the proportional representation formulas in elections. While IFE and the electoral tribunal (TRIFE) have a mandate to ensure that internal selection processes are fair and strictly observed, in reality these institutions have little influence over the internal processes of parties.
- The influence of party leaders is further strengthened by the article in the Constitution that bars elected officials from serving consecutive terms. The intention of this article was to avoid having individuals amass so much power that they could not be removed from office in subsequent elections. But the practical result has been to make elected officials employees of parties' *nomenclatura*. At best, elections in Mexico are useful mechanisms to reward or punish an entire party, they have virtually no influence over the behaviour of individual elected officials, who are not accountable to voters because they cannot be re-elected.
- Consequently, the current political economy of Mexico rewards party discipline, which is strictly observed, as is shown in figure 9, also taken from Purón.

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<sup>116</sup> As this paper is being written, there is debate between followers of Ernesto Cordero who is perceived by many to be President Calderon's favourite and Josefina Vázquez Mota's followers, over the process to select the PAN's Presidential candidate. Vázquez Mota's followers believe that the membership roles of PAN have been inflated in order to favour the candidate anointed by Calderón.

Figure 9 **Party discipline in congress is very high**  
Index of party discipline – LXI Congress



Data source: J. Weldon, 2010, cited in Purón, 2011.

- Today, Mexico’s political system is highly plural: There are three major parties and several small parties that represent many hues of the political spectrum, as well as specific population segments, such as the school teachers in the case of *Partido Nueva Alianza* (PANAL). In this context, there is no longer a need for a mixed congress composed of the winners of district elections (in first-past-the-post elections) and others designated per the proportional representation formulas. But as things now stand, incumbent party leaders have no incentives to make changes to this arrangement, especially as doing so will limit the number of party functionaries that they can hand-pick to serve in federal and state congresses. This means that today there are two classes of party members: those who are so high in the party hierarchy that they don’t have to compete to maintain their places in the congress, the senate or other roles; and those that obligated to do so.

### **President no longer head of all branches and levels of government**

Nowhere are the changes to the structures of the political economy more important and apparent than in the relationship between the president and members of other branches and levels of government.

In the new political economy of Mexico, the president is no longer the uncontested kingmaker. Governors, members of the judiciary and of congress are designated and maintained in their roles by processes that are independent of the president’s

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wishes. The president can influence these processes but he lacks the authority to impose outcomes. In sum, the president is no longer the de facto head of all the branches and levels of government.

This change came about before making provisions to ensure the accountability of government officials serving in congress and in other levels of government. This is especially delicate in the case of state governments, which now control more than 50 per cent of the resources spent by all levels of government, with very weak institutional mechanisms in place to ensure accountability.<sup>117</sup> As Pardini has shown<sup>118</sup>, the consequences of this are dire and promote an even deeper divorce between the polity and the members of the formal political structures of the country.

In sum, the structures of Mexico's current political economy combine features that make them resistant to change. This is both good and bad: It is good, because there is relatively little likelihood that any future president can wield power as capriciously as previous PRI presidents did. In this sense, Mexico is relatively safe from the downside risks of the sort that created the numerous crises that Mexico experienced during the years of the PRI regime.

Paradoxically, the current political arrangement also creates conditions that enable interest groups to block reforms of the sort needed to accelerate the pace of change and growth of the Mexican economy. We are safe from politically induced mismanagement of the national economy, but we are simultaneously trapped in a perpetually slow growth equilibrium.

There are reasons to be optimistic, however:

- Zedillo planted seeds of reform in the judicial system that will eventually resolve the paralysis that currently characterises policy reforms in Congress.
- Other institutions, especially Banco de México, IFE, *Comisión Federal de Telecomunicaciones* (the telecommunications regulator) and the Federal Competition Commission, are slowly making headway, creating precedents that are gradually resolving open issues that impede the efficient functioning of critically important markets.

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<sup>117</sup> During the tenure of Humberto Moreira (PRI), the government of Tamaulipas forged documents and falsified sworn declarations in order to borrow more than three billion dollars from commercial banks. Moreira is currently the head of PRI, a position which provides him with enormous influence selecting future PRI candidates.

<sup>118</sup> On this issue, see for instance, Pardini, J. 2010, *Igualdad y Desarrollo en México*, presentation document, IMCO, and *La Caja Negra del Gasto Público: Índice de Competitividad Estatal 2010*.

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- With economic stability, conditions have been created that are enabling the accumulation of productive assets and strengthening the net worth of millions of Mexican families.
  - Mexican citizens have finally tasted the sweet nectar of choice, in political markets and in the markets for goods and services. This is causing them to become more demanding and discerning in the new political economy of Mexico.

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