Economic Crisis and the Mexican State: Toward a New Institutional Interpretation

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Incentives are the underlying determinants of economic performance.

—Douglass North (1990)

... what makes [the Prince] hated above all else is being rapacious and an usurper of the property and women of his subjects...

—Nicholo Machiavelli (1532)

One of our biggest mistakes was arrogance and dogmatism in pursuing economic policy


Se obedece pero no se cumple

—Popular Spanish American saying during the colonial period

This article proposes an institutional interpretation of Mexico's long economic crisis of the end of the twentieth century. It argues that the inability of the Mexican government to commit credibly to protecting property rights is largely responsible for the stagnation of private investment levels between 1982 and 1995. This inability is similar to that of the English Crown in the seventeenth century, which resorted to property rights assaults to confront recurrent fiscal crises. The English solution to this problem came in the form of the Glorious Revolution and its associated reforms that stabilized the property rights regime by constraining the Crown's discretion. England's economic growth increased substantially afterwards. Mexicans have attempted a similar reform, through the adoption of domestic and international mechanisms that, as discussed in this article, stabilize the property rights regime. The reform is still unfinished, and it still faces considerable challenges, but if they are surmounted, a return to sustained economic growth is very likely.

Este artículo propone una interpretación institucional de la extensa crisis económica de México a finales del siglo XX. Aquí se establece que la ineptitud...
del gobierno mexicano para comprometerse verazmente a proteger los derechos de propiedad es la responsable del estancamiento de los niveles de las inversiones privadas entre 1982 y 1995. Esta ineptitud es similar a la de la Corona inglesa en el siglo XVII, la cual recurrió a atropellos a los derechos de propiedad para confrontar las reiteradas crisis fiscals. La solución inglesa a dicho problema fue la Revolución Gloriosa y sus reformas que estabilizaron el régimen de los derechos de propiedad limitando el poder de la Corona. Posteriormente, Inglaterra tuvo un crecimiento económico sustancial. Los mexicanos han intentado hacer una reforma similar a través de la adopción de mecanismos domésticos e internacionales que, como se arguye en este artículo, estabilizan el régimen de los derechos de propiedad. La reforma aún no ha terminado, y todavía se enfrenta a desafíos considerables, pero si éstos se superan, es probable el retorno a un crecimiento económico sostenido.

In the last three decades Mexico has experienced three severe balance-of-payments crises and two near-severe ones in 1976, 1982, 1985, 1987, 1994. Except for three brief instances from 1972 to 1975, 1979 to 1981, and (arguably) 1991 to 1993, Mexicans have lived as a consequence of these crises under the tough discipline of successive economic adjustment programs. All of these programs have required standard demand—contraction and expenditure—switching policies, and have been supplemented with wage restraints. Most were undertaken or implemented with the support of the IMF, while that following the 1987 crisis relied on the less orthodox discipline of managed price adjustments.

There is a broad consensus that the first two crises, those of 1976 and 1982, were created by a combination of excessively expansive macroeconomic policies and adverse terms-of-trade shocks. The last three derived from contradictory macroeconomic signals, adverse terms-of-trade shocks, and speculation. In all of these cases, exchange rate overvaluation immediately preceded the crisis.

The crises since 1976 largely originated in unsustainable development policies. Governments attempted to address major economic problems by implementing structural reforms that transformed the state’s role in the economy. Structural change in the 1970s meant increasing the state’s participation in productive activities, while ignoring fiscal constraints and monetary prudence. At the same time, the government attempted to promote exports, import substitution, state-led investment, and a broad set of contradictory economic policies. This economic

approach led to an unprecedented enlargement of the state apparatus and a significant increase in foreign indebtedness.

In the 1980s and early 1990s structural change implied a different policy combination: privatization, deregulation, and liberalization. The state shrunk and the Mexican economy opened its borders to the world. This was in principle an adequate response given the lessons learned from the spending spree of the 1970s, and perhaps the only alternative for achieving the current account surpluses necessary to repay the foreign debt. Yet this response proved insufficient, as evidenced by the 1994 economic crisis, Mexico's most severe contraction since the Great Depression. The absence of significant terms-of-trade shocks and of extreme fiscal deficits was insufficient to protect the Mexican economy from a downturn. Most blame the exchange rate regime and the Chiapas rebellion for this crisis, but it now seems that the causes are deeper.

It is easy to witness reminders of the impact of these recurrent crises in every Mexican town. Poverty, crime, pollution, deterioration of basic infrastructure, and other ills of a stagnating economy are common sights. Average living standards have declined (today's real wages are more or less the same as those of the 1960s), income distribution is more polarized than at any time since the 1940s, and absolute poverty has increased dramatically. Mexico is now a country with one fourth of its population living at or below the poverty line, the living standards of the middle class have declined, and the richest 10 percent earn approximately 40 percent of the country's income. Basic infrastructure construction has stalled and much of the existing stock is deteriorating.

Neither the development policies of the 1970s nor those of the 1980s provided solutions to Mexico's problem of inadequate economic growth. One may credibly argue that they contributed to the recurrent crises. What went wrong?

It has become fashionable to blame the forces of economic globalization, but it is doubtful that globalization on its own was the problem. It certainly provided relevant impulses at some points for the beginning of an adjustment period, such as that of the 1980s, when relative price changes associated with shifts in world market conditions lead to the reallocation of productive factors, a process that usually entails domestic costs. However, a plausible explanation of what went wrong may be traced to the Mexican government's response to these foreign commercial and financial shocks. This response, largely determined by recurrent fiscal crises, relied on measures that extracted wealth from Mexican nationals in the form of inflation and assaults on property rights. Insecurity over the property rights regime increased economic uncer-

2. Figures from the Consejo Nacional de Población, Mexico.
tainty, motivating lower rates of investment, capital outflows, insufficient job creation, and declining living standards.

**Characterizing the Mexican Crisis**

The following three statements synthesize, in my view, the nature of the economic problems Mexico has confronted since the late 1960s: (1) The Mexican crises reflect a deep structural problem. (2) This problem has a productivity and a governance component (3) The **solution** to the problem involves solving the **commitment problem** of Mexico's ruling institutions.

Aspects of the first two propositions have been examined in the economic and political literature on contemporary Mexico. The set of economic factors most commonly linked to Mexico's difficulties in achieving sustainable growth with internal and external equilibrium include low levels of tax revenues, the heavy fiscal burden of import substitution policies, the high income-elasticity of imports by the Mexican economy, the dualistic character of Mexico's manufacturing sector, the high vulnerability of the current account to fluctuations in the prices of primary products, low levels of domestic savings and investment (public and private), low educational levels, and explosive rates of population increase. They have also been linked to the government's propensity to borrow beyond its repayment capacity. These factors promoted the stagnant productivity and wages throughout most of the 1970-2000 period.

On the political side, the structural problem most frequently mentioned is extreme concentration of power, or to put it differently, extreme executive discretion. For reasons that need not detain us here, the United Mexican States have lived under the strong tutelage of the presidency since the end of the 1910-1920 Revolution. **Strong** means, at a minimum, that the presidency had veto power, or enjoyed agenda-setting powers, in the selection of candidates for any electoral post at any level or branch of government. These powers, combined with the electoral dominance of the PRI after 1929, allowed the president to appoint or remove almost any public officer at will, providing him with virtual control over the three government branches. Therefore Mexico's executive had unusual **discretion**, for a democracy, over budgetary decisions. This discretion also extended to monetary policy, since the Banco de Mexico's (the central bank's) independence is very recent (1994). As a consequence, the preferences of the executive had a strong impact over the course of Mexican economic policymaking and implementa-

3. For discussions of these factors see, for example, the work of Villarreal (1988), Martinez del Campo (1985), Gómez Oliver (1980) King, (1970), and Reynolds (1970).
tion. Political rather than economic factors frequently determined the policies of monetary institutions, repeatedly destabilizing the peso after 1976. They also contributed to the lack of budgetary discipline.

The third statement is a concise expression of a (possible) solution to the structural problems mentioned earlier. It implies refining the state's role in the economy and establishing a new set of institutions in which separation of powers, monitoring, and enforcing mechanisms to protect property rights become a part of everyday practice. The government must guarantee the property rights of both Mexicans and foreign nationals to promote stable, long-term economic growth. By decreasing uncertainty, the new structure will foster investment and job creation. Needles to say, this is a difficult, multifaceted task. As is explained below, the failure of succeeding administrations to implement such reforms provides part of the explanation for Mexico's post-1975 crises.

The concept of protecting property rights has often been misused by contemporary ideologues, journalists, politicians. Most of the following discussion is devoted to an illustration of the nature of Mexico's institutional commitment problem, the way Mexicans have addressed it, and the prospects for the consolidation of a new structure of governance.

Property Rights Protection, Institutional Design, and Economic Growth

Property rights protection is indispensable for the functioning of the competitive mechanism of exchange and production. In its absence, incentives to generate wealth are distorted, since those individuals able to generate wealth cannot appropriate the fruits of their labor. The costs of using markets are higher and economic agents spend more real resources than is optimal to protect their property. Exchange ceases to be efficient. Savings and investments fall below their potential, while the few able to assault the property rights of others accumulate more wealth. The outcome of such a scenario tends to be economic stagnation.

The importance of property rights protection for economic growth has been emphasized in almost every analysis of economic development. A prominent example provided by Douglas North and Barry Weingast (1989) shows how a series of institutional reforms stemming from the Glorious Revolution of 1688 were able to stabilize credibly the fiscal regime of the English Crown and promote growth. Recurrent fiscal

crises, whatever their origin, had resulted in the king's practice of assaulting the property rights of his subjects to finance the Crown's deficits. Such assaults came in the form of confiscation and reneging on debt payments. Reforms to separate legislative from executive powers, in particular to provide the Parliament with the sole authority to contract debt and to increase the Crown's budget, blocked the king from behaving in this manner. In the ensuing years England experienced substantially higher rates of economic growth. Similar stories are found in other countries where governments introduced institutions insulating monetary and fiscal authorities from particularistic political interests.5

The stability of the investment regime interacts with the efficiency of property rights protection to determine sustained long-term growth. An imperfect institutional system with stable economic policies still can grow, until the distortions become too costly and adjustment is necessary. A system with the correct incentive structure also grows, but at a faster pace, and it may encounter its limits much farther away than those of less efficient systems. For example, the credible but distortionary incentive structure of the Mexican state generated growth in the twentieth century, but not as prolonged or robust as that of the less distortionary incentive structure of the United States. In both cases, the important point was that the incentive structure was enforced consistently and that the majority of the economic agents expected it to endure. This makes investment less risky and economic growth more likely.

The problem is that it is easier to recognize the importance of property rights protection than it is to find and implement the mechanisms that will protect property rights credibly, efficiently, and consistently. Establishing institutions for property rights protection is a protracted and conflictive process. On a purely technical level, as North (1990) notes, it takes time to figure out solutions and to receive and evaluate feedback concerning the proposals. On a political level, it takes time to figure out who has the power to enforce the new property rights structure. This important decision impacts the quality of policymaking and future economic performance; those who hold power will determine whether the economy's incentive structure privileges rent-seeking or production.

The reforms to England's institutions analyzed by North and Weingast took decades to be implemented. Some solutions were found through trial and error. Most followed clashes between rival elites. They required the use of real resources to enact, monitor, and enforce them. Only after a new configuration of power between the elite and the

5. See the interesting evidence collected by Cukerman (1992) and Alesina, Cohen and Roubini (1992) on the relationship between low inflation rates, central bank independence, and budgetary institutions shielded from political pressures.
Crown, and after successive *marginal* improvements in financial and fiscal legislation, did the institutional structure become credible enough to stabilize the expectations of the Crown's subjects.

Much like seventeenth-century Great Britain and other countries afterward, Mexico is undergoing currently a long process to redefine its mechanisms for protecting property. Confronted with the productivity and governance crises mentioned above, and with the challenges of globalization, Mexicans have had to search for the right combination of political and economic structures to generate a new, credible institutional regime. As in the case of the Glorious Revolution, their trial-and-error process has continued for almost thirty years, and it is still incomplete.

**Property Rights Protection and Mexico's Policymaking since WWII**

For much of Mexico's successful period of economic growth after the Second World War, the structure of incentives in the Mexican economy was more or less stable. Corruption, abuses of public authority, and heated ideological debates existed, but the property rights of most Mexican citizens, and the conditions of their enforcement, were fairly reliable and understood by many. The consequence of this state of affairs was that, despite the presumed inefficiency of the economic strategy then pursued (ISI), the investment environment had a longer horizon, and it was reasonable to think that the beneficiaries of this strategy would be those investing at home.

Under this incentive structure Mexico's economy grew almost without interruption between 1933 and 1980. Average income per capita increased fivefold, from around $200 to $1000 in constant 1970 dollars. The economy also achieved the by no means insignificant feat of generating one million jobs per year and providing health, housing, and education for a population growing at a rate of approximately 3 percent per year.

It took many years to design, implement, and enforce this structure of incentives. The period between the beginning of the Mexican Revolution in 1910 and the late 1940s encompassed an intense process of institution-building deriving from clashes between competing elites. It required the formation of new coalitions, and the imposition of new economic rules developed with the technical advise of national and international experts, and led to the imposition of new economic rules. The emerging consensus established conditions for the creation of Mexico's central bank, development bank, social security system, national oil industry, land reform programs, and the corporatist political structure. Together, they provided the political stability and the economic certainty required for a long period of uninterrupted income growth.
The executive controlled these new institutions. Since this concentration of power was a consensual decision reached by the different factions of the coalition that won the Revolution, it generally did not threaten property rights—except for the land reform process. The factions agreed implicitly or explicitly to a system of government strongly dependent upon party discipline and presidential leadership but reliant upon consent from the leaders of the labor, peasant, and middle class sectors of the ruling party. Unity candidates (the president’s choice) in most elections prevailed, but the frequent rotation of posts and policies made the system fluid enough to avoid concentration of power in just one generation of policymakers or around one single ideological doctrine. Policymakers and policy could change but did so in a controlled manner, and the same political party both endorsed and provided the political resources to support the changes.

Grey areas remained, of course, in the design of this property rights structure. For example, in trying to compensate peasants for land seizures carried out by the elites of the Porfiriato, or in trying to secure Mexican sovereignty over its territory, the framers of Mexico's Constitution chose to write Article 27 with restrictive provisions for land tenure and special privileges for state intervention. But with a relatively well-managed exchange rate policy (until the mid 1960s) and strong incentives for industrialization, both agricultural and manufacturing output expanded enough to provide Mexicans with rising, albeit unequal, living standards.

Under this incentive structure the Mexican state also counted, thanks to the economy’s relatively low integration with world capital and goods markets, with the option of shifting the burdens of economic adjustment (in case of an imbalance in the foreign accounts) or of redistribution from Mexican nationals to foreigners without confronting severe punishment by investors. Imposition of higher trade barriers, nationalization of industries owned by foreigners (oil, electricity, railroads) were measures that, beyond their consistency with ISI, helped to redistribute income away from foreigners and in favor of Mexican nationals in difficult economic or political periods. Capital and exchange controls reduced the costs of disciplining market reactions such as massive short-term capital outflows in response to these actions. A closed economy priced foreign producers out of the Mexican market and even helped to attract foreign direct investment. Problems arose in the 1970s as a consequence of the new challenges and opportunities that the combination of a more integrated global economy and the structural economic and governance problems mentioned above posed. Higher integration in goods and capital markets made it unwise to rely on policies that decreased competitiveness and increased market risk. Domestic and for-
eign investors could quickly move their capital abroad in response to inconsistent Mexican macro or microeconomic policies. Foreign importers easily found alternative suppliers when Mexican exports became too expensive. This new international scenario posed a dilemma for the Mexican government: whether to continue isolating the Mexican economy and imposing the costs of adjustment on foreigners or to accept the discipline of international markets and stop transferring the burdens of adjustment abroad.

Opting for increased participation of the state in the economy, Mexican authorities under Presidents Luis Echeverría Alvarez and José López Portillo favored real wage increases beyond productivity gains, imposed new restrictions on foreign direct investment, neglected intellectual property protection, and fostered inflation. The outcome was predictable: a fall in private investment, and reduced international competitiveness, which the state chose to combat by expanding public investment and consumption financed with foreign borrowing. Coupled with an overvalued exchange rate, these policies set the conditions for capital flight and macroeconomic instability that caused the balance of payments crises of 1976 and 1982.

The Mexican executive had little recourse under these circumstances but to shift the burden of adjustment from foreigners to Mexican nationals. The shift was not only of the expenditure-switching and demand-reduction type. It also involved shifting the locus of expropriations from foreigners to Mexican citizens to redistribute income either between Mexicans or in favor of the state. The two most blatant examples were the surprising expropriation of land in the state of Sonora in 1976 and the equally unexpected bank nationalization of 1982. The latter was accompanied by freezes on dollar-denominated bank accounts, partial expropriation of these deposits by returning them at an undervalued exchange rate, and the potential that all the assets owned by banks in other productive sectors through Mexico's holding companies would also be transferred to the state. Mexico never before was so close to becoming a state-run economy.

This massive transfer of assets and purchasing power from the private to the public sector was a reality most Mexicans living after World War II had not confronted. The last time Mexicans experienced uncompensated, arbitrary asset transfers was when the Porfiriato supported land seizures by elite landowners, associated with the appearance of the Tierra y Libertad movement of Zapata. This time the locus of the expropriations were neither the poor nor foreign investors, but the Mexican middle class and the business elite. Such an unprecedented assault on property rights triggered the events that led to the institutional reforms discussed below.
Mexico's Search for a New Institutional Structure

In retrospect, it is evident that a campaign to limit the discretionary powers of the Mexican presidency started with the viable external institutional control mechanisms. Had the crises of 1976 and 1982 resulted in policy adjustments different from expropriations, or derived policies with little relation to the government's excessive spending behavior, Mexico's institutions might have remained more or less intact. But since the crises highlighted the executive's unwillingness (with the acquiescence of a congress controlled by the same party) to abstain from endangering the property rights of its citizenry, institutional reform became a priority. Broad segments of the population viewed imposing constraints on government decision-making and redefining the state's role as a way of providing a new credible incentive structure to increase productivity and living standards.

The campaign faced many obstacles, from the predictable opposition by the ruling coalition to the gigantic task of solving, at least by parts, the collective action dilemmas involved in the creation of efficient governance. The means used by Mexican society to push forward a state reform included defections from the PRI, the creation of new political parties, voting in favor of the opposition parties, the use of the press to express discontent, the creation of NGOs, the staging of protest marches, migration to the United States, lobbying by business lobbies, and investment outside Mexico. These actions reduced the relative power of the ruling coalition, as evidenced by the PRI's lower share in the national vote, and forced it to accept institutional reform or face disintegration.

Notable examples of external mechanisms adopted by Mexicans since 1982 to control or monitor state behavior include the adherence to international trade agreements, in particular the GATT (1986) and NAFTA (1993). But the adoption of external enforcement mechanisms was much broader and diverse: Mexicans brought in international observers to sanction elections (1985, 1988, 1992, 1994, 1997), reformed the electoral code and laws to allow the citizenry to monitor the electoral process (1990, 1993), introduced a higher degree of proportional representation in congress (1993), privatized most state-owned corporations (1985–1998), reduced the battery of regulatory capabilities of government agencies (1990–1994), granted independence to the central bank (1994), established an independent institution to oversee banking practices (1999), opened the door to the privatization of ejido lands (1993), created conditions for the independence of the judicial branch (1998), and expanded freedom of speech to new degrees.

As most of these examples suggest, the mechanisms chosen to discipline the Mexican executive relied on combinations of contracting,
third-party enforcement, separation of powers, and competition. Adherence to trade agreements such as the GATT or NAFTA anchored trade policy through the contracting and third-party enforcement mechanism. The high levels of reputational capital committed by the Mexican government in respecting these agreements made it basically self-enforcing and even opened the door to third-party monitoring and sanctioning (by the United States, Canada, WTO members) of the Mexican government's behavior. Civilian supervision of elections through the Instituto Federal Electoral, or IFE, and its ratification by foreign observers also worked as third-party enforcement of transparent elections. Increasing political competition and the potential of electoral defeat helped discipline incumbent governments. Separation of powers, a by-product of electoral transparency and proportional representation, permitted congress to monitor and sanction the executive's budgetary behavior. Central bank independence solved in principle the tendency to resort to inflation to finance budget deficits and reduced political influence in the setting of exchange rate policy. Privatization—barring the proliferation of monopolies—reduced wasteful spending and allowed the use of the competitive mechanism to discipline economic agents. Freedom of the press increased the flow of information available to the public, expanding its potential to punish government behavior at the polls.

Most of these new institutional structures and processes emphasize the importance of rules. They provide more predictability, transparency, and democracy in government decision-making. This is not to say that every political actor agreed on every institutional change—in fact, the left and the right disagreed strongly over the economic program Mexico should follow. Yet their disagreement focused primarily on the actual or expected distributive effects of the economic strategy, that is, over its outcome. They did not dispute the need for the adoption of new rules of governance. The new rules establish a pattern of decision-making that will constrain future presidents. Even though strong disputes remain over economic programs, both sides agreed on incentives in relevant areas. For example, constraints on the government's ability to raise trade barriers may have been disliked by the left, but thanks to these constraints no one expects wild policy swings in trade policy. Workers and capitalists can therefore move investment to a more profitable sector knowing that the rules of the economic game will not change dramatically. In the political sphere, voters have less reason to wonder if their vote has been stolen; in fact, claims of electoral fraud are now less credible. They question instead the size and source of campaign funds.

Despite these important accomplishments, the new system is not yet complete. As the next section explains, these positive changes have not been matched by effective measures to support them.
**Where Do We Stand?**

Perhaps the main irony of Mexico's state reforms is that in pursuing greater predictability, transparency, and an expanded role for markets in the creation of wealth, they have at the same time removed some essential preconditions for success. Mexico's state has shrunk, but it is not necessarily stronger or more efficient. It seems less able to combat private monopolies, to enforce contracts, to fight drug trafficking, to provide a sense of social security, and to persuade the Mexican public that a new incentive structure has been consolidated. Credibility remains the Achilles heel of the Mexican state.

Five key factors are related to this problem: (1) insufficient tax revenues, (2) simplistic laissez-faire mentality, (3) inconsistency between macro- and microeconomic policies, (4) unclear separation of principals from agents in state institutions, and (5) time. The protection of property rights is costly, and that protection will not improve as long as government finances are weak. In the absence of a reform to the tax code—a reform badly needed for 178 years—the Mexican state will continue to confront problems in financing basic activities and be tempted to resort to foreign borrowing, monetary expansion, the use of state-owned enterprises (read PEMEX), or even expropriations. Without tax reform consistency in law enforcement will remain a wish, since both the proportion of law enforcement officials to population and wages in the judicial system will remain low.

Compounding these law-enforcement problems are the consequences of a simplistic laissez-faire mentality. Deregulation and privatization have been pursued under the assumption that markets will develop automatically the self-enforcing mechanisms they need to allocate resources efficiently. But high costs of transacting in markets, deriving from both market realities and inconsistency in law enforcement, preclude such a rosy scenario. Typically, a credible third-party enforcer of the law (the state) must also play a role in protecting competition, but the Mexican government's hands-off policy has not been very helpful in this regard. The notion that "the best industrial policy is not to have one," as Jaime Serra Puche, President Carlos Salinas's secretary of trade and industrial development, stated, has resulted in the survival of large monopolies or quasi-monopolies (telephones, copper, television) and the banking failure of 1994-1998. More and better supervision of market practices is required, sufficient to protect rather than stifle competition.

Inconsistency between macro-and microeconomic policies has slowed the structural change of the Mexican economy. For example, an overvalued currency and high interest rates between 1988 and 1994 ham-
pered the relocation of resources from the non-tradable to the tradable sector of the economy. While these policies helped to control inflationary pressures and to mitigate capital outflows, they also made intersectorial factor transfers relatively unattractive. Expecting that an appreciating exchange rate would reverse relative price signals, and confronting high financial costs, factor owners did not relocate large shares of investment to the tradable sector. Such expectations also led to high discount rates, which transform into higher risk premiums and less productive investment. As a consequence, fourteen years after the official beginning of structural change along the lines of the Washington consensus, the Mexican economy remains dualistic.

The fourth problem is that state behavior in crucial areas is not as disciplined as it could be because of the lack of either a clear separation of powers or of the fusion of principals with agents. A few examples illustrate the situation. First, even after the acknowledgment of the need to monitor the executive's expenditures to avoid corruption and pillage, the first reform in this regard, enacted in 1983, consisted of creating a new ministry under the control of the executive itself. Due to the pressure deriving from political competition, it took more than a decade to create an independent office in Congress that can perform this review. It is too soon to judge the impact of the new structure.

A second example is that of law enforcement. Strong efforts have been made to end police corruption and to increase its effectiveness. However, no workable, generalized, punishment mechanism for poor police performance has been developed. The creation of the Consejo de la Judicatura represents a significant step in the right direction but is still insufficient. The Ministry of the Interior both sanctions and enforces the law, and the threat that unemployed policemen will become criminals makes the layoff option less attractive. More participation is required from congress and the judicial branch (and more economic growth) to solve this problem.

The third example is the central bank. While independent, it has yet to provide signals of its willingness or ability to challenge the executive's economic policy. Almost no one believes that the central bank sets its policy objectives independently from the executive. The central bank's independence will not be put to test until a new president is sworn in and the public observes that he is unable to remove at will the governor of the Bank of Mexico. Moreover, it is not clear yet whether an executive order can actually remove a governor of the central bank should policy differences develop between the presidency and the heads of the Bank of Mexico.

Finally, the reforms are too new to have proved their efficacy and to allow the new institutions to develop a favorable reputation. To func-
tion adequately the new institutions require the acquisition of new skills, new relationships, new decision-making mechanisms, new practices. None of these result automatically from the enactment of a law.

We are now able to judge which components of the institutional reforms of the 1980s and 1990s are working. Practices have changed in important areas, but old habits remain and inhibit the efficiency of the new institutional solutions. A sense that the new system has not replaced the old one prevails in many quarters. But time and consistency in the enforcement of incentives will eventually help confirm that Mexico is indeed operating under a new regime.

**What Should Be Done?**

Experience and economic theory teach that wealth creation requires institutional solutions that are market-friendly and credible. This is even more apparent in an era of highly integrated capital and goods markets: following the opposite path implies capital flight, speculative attacks, economic stagnation. Therefore the main questions Mexican policymakers should be asking themselves are "how does one improve a market?" and "how can one help people in markets perform their function better so that they can raise their living standards?" Credibility of property rights protection, as the preceding discussion argues, is the starting point. Yet building better information and physical infrastructure, producing higher levels of human capital, paying attention to social justice, and guaranteeing individual security are equally important. These help people be more productive and improve the quality of their life; and they extend the lifetime of the market mechanism.

Better information and physical infrastructure will reduce the costs of factor transfers, thereby increasing the potential for market efficiency. Information on prices and quantities must flow quickly and cheaply to more areas of the country so that entrepreneurs and consumers may make better market decisions. The same applies to shipments of goods. This will in turn contribute to the break up of segmented markets—even monopoles. For instance, to date Mexican small farmers learn national grain prices from the local purchasers who routinely approach their farms. It is not a bad system, but everyone can be better off and the allocation of resources would be improved if a national grain market is created where prices, quantities, and qualities are available, and where contracts can be struck to hasten efficient resource allocation. Mexican producers have known about these impediments for a while. The question is why it is taking so long to build this information infrastructure. It was only in February 1999, after five years of negotiations between large and small producers, that a national grain market opened with the objective of setting
a national maize price, eliminating excessive intermediation, and fostering production. More such markets are required, and more political stability is needed to make investments of this nature worthwhile.

Attention to spending in education, social justice, and security is also necessary. It is a prerequisite for institutional stability and, by extension, for market operation. Individuals with higher levels of human capital are more competitive and thus can adapt better to the whims of markets. A more or less equitable income distribution helps to foster social stability and to support democratic governance. Individual security reduces investments on personal protection, which releases resources for production, exchange, and wealth creation.

None of this is easy, of course. It implies large investments. But to the degree that the institutional framework adds predictability to the economic system, it is more likely Mexico will be able to compensate for its low savings by borrowing more at better interest rates. The key is that institutions extend the horizon of investments to allow for planning and productive risk-taking.

Conclusion

Mexico's economic crisis is not necessarily a consequence of globalization. It is an outcome of domestic political and economic structural problems. The way out of this situation is to redesign the structure of incentives in the Mexican political-economic system to generate higher levels of accountability and a secure regime of property rights protection. Market-friendly and social-friendly institutions are required, together with credible political backing to support them.

References


