The Heritage Foundation Backgrounder

No. 1070 | The Heritage Foundation • 214 Massachusetts Avenue, N.E. • Washington, D.C. 20002-4999 • (202) 546-4400 • http://www.heritage.org

March 6, 1996

FULFILLING THE PROMISE OF NAFTA: A NEW STRATEGY FOR U.S.-MEXICAN RELATIONS

INTRODUCTION

The Clinton Administration has lost sight of America's vital interests in the Western Hemisphere. With both eyes focused firmly on domestic U.S. politics, the Administration has dropped trade expansion from its Latin American policy agenda while adopting a more aggressive stance not only against illegal immigration from Mexico, but against drug trafficking in the Americas.[1] However, the Administration is not alone in its retreat from free trade. In Congress, some longtime free traders from both parties are also backpedaling from trade expansion and from the North American Free Trade Agreement (NAFTA). Populist proponents of protectionism have tapped into voter anxieties about the health of the U.S. economy and job security by misrepresenting NAFTA as the cause of the Mexican peso crisis, declining manufacturing wages in the U.S., rising illegal immigration from Mexico, and increased drug trafficking.

At one level, the Clinton Administration appears to understand the importance of foreign trade to the U.S. economy. The President's foreign policy team continues to extol the importance of free trade to America's economic interests. For example, Richard Brown, the White House coordinator for the Summit of the Americas, claims that the Administration has not retreated from the goal of completing negotiations for a Free Trade Area of the

1 During his State of the Union address to Congress on January 25, 1996, President Clinton announced the appointment of Army General Barry McCaffrey to head the White House Office of National Drug Control Policy. Although McCaffrey's appointment did not cause any reaction in the U.S., throughout Latin America it was widely seen as a sign that the Clinton Administration plans to militarize the hemispheric war on drugs. Another first was the Administration's decision to deploy local law enforcement officers alongside federal agents already patrolling the U.S. border with Mexico, and to increase the use of armed forces personnel as support for the U.S. Border Patrol.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Americas (FTAA) by 2005. Brown also insists that the President has not given up on obtaining fast-track negotiating authority to include Chile in NAFTA.[2] In practice, however, free trade is no longer a high priority for the Clinton Administration. During the past year, President Clinton has:

- ✘ **Reneged on his pledge to include Chile in NAFTA by 1996.** The delay in Chile's admission to NAFTA has damaged America's credibility and leadership in the Western Hemisphere.
- ✘ **Violated key provisions of NAFTA.** For example, the Administration postponed indefinitely the implementation of provisions to permit the circulation of Mexican trucks in U.S. border states.

Dropping the ball on trade with Latin America is merely part of a larger problem with the President's Latin American policy. The Clinton Administration has never possessed a coherent vision of America's economic and security interests in Latin America and the Caribbean. In 1993, bowing to pressure from American unions and environmental activist groups, the President delayed NAFTA's approval for a year while labor and environmental side agreements were imposed on Mexico and Canada. The Administration's invasion of Haiti in 1994 and secret immigration agreement with Cuba in 1995 likewise were undertaken in response to domestic political pressures.

The damage is done. The task for American policymakers now is to correct the current drift in U.S. policy toward Mexico and Latin America as quickly as possible. U.S. relations with Mexico must be repaired, NAFTA must be strengthened, and America must regain its dominant role in the process of hemispheric trade liberalization. To achieve these policy goals, the U.S. government should:

1. **Comply with NAFTA.** The U.S. should fulfill all of its NAFTA obligations on schedule. By cheating on NAFTA, the Clinton Administration has established a negative precedent that Mexico, Canada, and other countries could follow in the future.
2. **Complete the NAFTA with Mexico.** The peso crisis demonstrated the high degree of interdependence between the U.S. and Mexican economies. It also showed that NAFTA is an incomplete pact. Some of NAFTA's most important provisions have yet to be negotiated by the U.S. and Mexico. These include such issues as currency unification, forgiveness of the Mexican government's foreign debt, immigration, and labor and law enforcement problems.
3. **Expand NAFTA.** Since the end of the Cold War, free trade and support for democracy have been the pillars of U.S. foreign policy toward Latin America. The Clinton Administration's retreat from NAFTA's expansion has left the U.S. without a coherent foreign policy for Latin America and sidelined from the ongoing process of trade liberalization in South America. NAFTA must grow to remain vibrant and alive. Expanding NAFTA to include Chile and other countries would maintain the momentum for

2 "Clinton Administration Committed To FTAA 2005, Summit Coordinator Says," *International Trade Reporter*, Vol. 12, No. 50 (December 20, 1995), pp. 2105-2106.

expanding free trade in the Americas and beyond, including at a later time Asian countries that qualify.

❹ **Encourage Mexico to adopt a currency board.** The creation of a currency board in Mexico would stabilize the peso, reduce inflation and interest rates, and restore confidence in Mexico and NAFTA.

❺ **Offer to negotiate forgiveness of Mexico's public sector foreign debt.** This offer should be extended in return for an irrevocable pledge by Mexico to end all future international borrowing by government entities, not to take any more money from the IMF and World Bank, and to rely only on private investment to drive Mexico's economic development.

❻ **Offer to negotiate a law enforcement agreement with Mexico to deal with the growing problem of international organized crime and drug trafficking.** The rise of these drug cartels threatens the national security of both Mexico and the United States.

THE TRUTH ABOUT NAFTA

Since the peso's collapse on December 20, 1994, Mexico has been suffering its worst economic and political crisis in more than a century. The peso's meltdown sank the myth of Mexico as the standard-bearer of economic reform in the Third World. The "200,000 net new jobs" promised by the Clinton Administration have not materialized, and the U.S. is running a trade deficit with Mexico estimated at $15.83 billion for all of 1995.[3] Instead of a prosperous partner, Mexico has become a financial ward of the U.S. government. As a result, many Americans now believe that NAFTA caused the Mexican peso crisis.

Nothing could be further from the truth. NAFTA did not cause the Mexican peso crisis. The peso collapsed because the government of President Carlos Salinas de Gortari sacrificed sound fiscal discipline on the altar of political expediency. A series of political shocks in 1994 caused a sustained run on the peso by nervous Mexican and foreign investors.[4] But instead of raising domestic interest rates and cutting public spending, the Salinas administration sharply increased public spending and used the country's international reserves to support an overvalued peso. As a result, the peso collapsed. Moreover, it was the devaluation of the peso that crashed the Mexican economy and cheapened the value of Mexican exports. These cheaper Mexican exports account for the U.S. trade deficit with Mexico.

If not for NAFTA, the economic consequences of the peso's meltdown would have been far more serious. Thanks to NAFTA, those who favored returning to a closed, statist economy were kept at bay while President Zedillo was able to keep the country on course to capitalist democracy. NAFTA is still the best guarantee that Mexico will become a true capitalist democracy and prosperous trading partner.

---

3 Data from NAFTA Division, U.S. Department of Commerce.

4 Mexico was rocked during 1994 by the uprising in Chiapas, by the assassinations of PRI presidential candidate Luis Donaldo Colosio and party secretary general Jose Francisco Ruiz Massieu, and by the highly publicized kidnapping of several of Mexico's richest magnates.

NAFTA and U.S. Competitiveness. NAFTA is the best way to stimulate America's growth and competitiveness. Mexico is America's fastest-growing export market and third largest trading partner, as well as a key factor in the international competitiveness of many U.S. industries that have established manufacturing and assembly plants in Mexico since the 1960s. These plants enable U.S. manufacturers to compete against low-wage manufactures from China and other Asian countries.

U.S. exports to Mexico since 1987 have grown at a rate 2.5 times greater than U.S. export growth to the rest of the world.[5] From 1987 to 1993, 48 of the 50 states expanded their merchandise sales to Latin America and the Caribbean, with Mexico absorbing the largest absolute share each year; 17 states expanded their exports to Mexico and Latin America by more than 200 percent during this period, and 15 recorded export growth of more than 100 percent. The biggest state exporters to Mexico and Latin America are Texas, Florida, California, Michigan, New York, Illinois, New Jersey, Pennsylvania, Ohio, and Indiana.[6]

The U.S. exports $98 billion worth of goods to Latin America each year, with Mexico absorbing more than half of the total. These exports represent 19 percent of all U.S. merchandise exports and support nearly 1.96 million U.S. jobs. During the first year of NAFTA's implementation in 1994, U.S. exports to Mexico and Canada climbed rapidly. Merchandise exports to Canada, America's largest trading partner, grew by more than 13 percent to $114 billion, while exports to Mexico increased over 22 percent to $51 billion. U.S. exports to Mexico fell by 8.8 percent during 1995 as a result of the peso crisis but at the end of the year still remained well above the total for 1993, the last year before NAFTA went into effect.

Production-sharing operations along the U.S.-Mexican border, known as *maquiladoras*, are an important competitive strategy for many American firms competing in the U.S. domestic market with goods made by low-cost Asian producers. For example, products assembled in Mexico's *maquiladora* industries from U.S.-made components accounted for 48 percent of U.S. imports from Mexico in 1994.[7]

NAFTA and America's National Security. NAFTA is very important to U.S. national security. Illegal immigration and drug trafficking are perceived increasingly as threats to this security. By a very large majority, Americans want their government to control and reduce illegal immigration and stop the flow of illegal drugs entering the U.S.[8] Moreover, the Mexican peso crisis fanned the American public's concern that the U.S. is being overwhelmed by a flood of illegal immigrants and illegal drugs.

5 Merriam Mashatt, "Coast-to-Coast Increases in U.S. Exports and Jobs: Regional Trade With Mexico," *Business America*, U.S. Department of Commerce, October 1993.

6 "U.S. Exports to Latin America and the Caribbean: 1987-93 State Export Profile," *Business America*, December 1994.

7 "NAFTA Update: Steady U.S. Bilateral Trade Growth with Mexico Faces Mixed Prospects in 1995," *Industry Trade and Technology Review*, U.S. International Trade Commission, March 1995.

8 John E. Rielly, "American Public Opinion and U.S. Foreign Policy 1995," Chicago Council on Foreign Relations, February 1995, p. 15. The survey found that 85 percent of Americans want the government to stop the flow of illegal drugs into the U.S. and 72 percent want their elected leaders to control and reduce illegal immigration.

Nearly 3 million Mexicans enter the U.S. illegally each year.[9] More than 80 percent of the cocaine brought into America is transported through Mexico by Mexican drug cartels. Mexican police investigators have disclosed that drug traffickers penetrated the highest levels of the Salinas Administration. Drug-related corruption is widespread within the PRI, Mexico's ruling party, especially at the state level. The police, courts, and military also have been corrupted by Mexican drug traffickers whose operations generate profits in excess of $30 billion a year.

NAFTA is America's most valuable foreign policy tool in managing these security threats on its southern flank. In addition to accelerating Mexico's transformation into a capitalist democracy, NAFTA is a foundation on which to develop effective cross-border agreements to deal with the twin threats of illegal immigration and drug trafficking in both countries. With NAFTA promoting closer economic ties between the U.S. and Mexico, governments in both countries will face increased pressure from their respective constituencies to work out effective solutions for cross-border problems that hinder trade, economic growth, and competitiveness.

NAFTA and Democracy in Mexico. NAFTA is an important anchor for reform in Mexico. The closed, one-party system that spurred Mexico's economic development and guaranteed the country's political stability for over six decades is coming apart at the seams. A pluralist democracy is emerging, but the old statist regime will not surrender quickly or quietly. On January 12, 1996, 255 of the 298 representatives of the ruling Institutional Revolutionary Party (PRI) publicly called on the government to "abandon neo-liberalism and grant priority to action against poverty and unemployment."[10] Similar demands are being made by other groups, including the left-wing PRD, small and medium business, the rebels in Chiapas, consumer debtor organizations, and farmers.

Despite these pressures, President Zedillo has stood firm on Mexico's commitment to market-oriented policies, free trade, and compliance with NAFTA. Zedillo's main political priorities are to encourage the growth of a pluralist and open democracy, establish the rule of law, reform Mexico's judicial system, and eradicate widespread police corruption at the national and local level. Without NAFTA, Zedillo's chances of advancing these political reforms would be very poor.

NAFTA and a Free Trade Area of the Americas. NAFTA is the foundation upon which the U.S. can negotiate free-trade agreements with other Latin American countries. Latin America is one of the fastest-growing regions in the world, and the U.S. has been one of the principal beneficiaries of that growth. For over six years, Latin American governments have pursued aggressive policies to liberalize trade. As a result, America's exports to other countries in the Western Hemisphere (including Canada) have increased over 50 percent since 1990, growing from $137 billion to nearly $207 billion in 1994 and creating 1.4 million new jobs for American workers. Overall, two-way trade between the U.S. and the

9 Although some 3 million Mexicans enter the U.S. illegally each year, about 2.7 million also return to Mexico. Net illegal immigration from Mexico has averaged about 300,000 persons annually in recent years. Illegal immigration must be controlled, but the U.S. is not being overwhelmed by a flood of illegal immigrants.

10 "Mexico: PRI call to ditch neo-liberalism," *Latin American Weekly Report*, Latin American Newsletters, London, January 25, 1996, p. 35.

Western Hemisphere jumped over 44 percent between 1990 and 1994, from $292.8 billion to $423 billion. U.S. exports to Latin America accounted for one-fifth of total U.S. exports during 1994.

However, for free trade between the U.S. and Latin America to continue growing, NAFTA must be expanded quickly to other countries in the Western Hemisphere, starting with Chile and Argentina. It also should be expanded to include countries such as Australia, New Zealand, and Singapore that want to liberalize trade faster than currently envisioned by the Asia Pacific Economic Cooperation forum.

NAFTA is the linchpin of U.S. relations with Latin America and the Caribbean.[11] It assumes that the best way to achieve both sustained economic development and stable democracy is to expand international trade. The emerging capitalist democracies of Latin America and the Caribbean have embraced free trade and NAFTA without reservations, providing the U.S. an unparalleled foreign policy tool for the expansion of free trade, the consolidation of democracy, and the reaffirmation of American leadership in the Western Hemisphere. NAFTA is also the benchmark trade agreement for the creation by 2005 of a Free Trade Area of the Americas (FTAA). As long as NAFTA's expansion remains stalled, the U.S. has no effective Latin America policy.

MEXICO HAS NOT TURNED THE CORNER

The Clinton Administration claims that the worst of the Mexican crisis has passed. Mexico's external accounts are once again in balance, exports soared in 1995, the peso has risen, inflation is slowing, and interest rates have eased from their peak levels of 80 percent to 100 percent in early 1995. Moreover, Mexico has raised over $6 billion from international capital markets since the peso collapsed, and the Zedillo government is meeting the deadlines for repaying the money it owes to the U.S. Treasury's Exchange Stabilization Fund (ESF).[12]

11 The Reagan Administration understood that support for democracy and the hemispheric expansion of free trade was the foundation of future U.S. relations with Latin America. During the two Reagan Administrations, the Caribbean Basin Initiative was launched, and the groundwork was laid for a new relationship between the U.S. and Mexico based on the expansion of bilateral trade and investment, closer economic interdependence, and progressive economic liberalization in Mexico. In 1988, the U.S. and Canada signed a Free Trade Agreement that later would serve as the foundation for NAFTA. The Bush Administration's Enterprise for the Americas Initiative, launched in 1989, outlined a blueprint for creating a Free Trade Area of the Americas (FTAA); the first step in achieving the goal of a hemispheric FTAA was the negotiation of the NAFTA with Mexico. When the Clinton Administration was inaugurated in 1993, the NAFTA talks between the U.S., Mexico, and Canada already had been completed. Clinton delayed NAFTA's implementation until 1994 while unnecessary labor and environmental side agreements were negotiated with Mexico and Canada. Moreover, at the Summit of the Americas, Clinton reaffirmed long-standing U.S. policy that NAFTA should be the standard for creating a hemispheric FTAA.

12 On January 29, 1996, the Mexican government repaid the U.S. Treasury $1.3 billion in short-term swaps issued under the U.S.-Mexico Framework Agreement announced by the Clinton Administration on February 21, 1995. In all, $13.5 billion in U.S. funds was disbursed to Mexico from the ESF, of which $10.5 billion in medium-term swaps remains outstanding. The ESF, created by the Gold Reserve Act of 1934, has been used since the 1973 demise of the Bretton Woods fixed exchange rate regime to intervene in foreign exchange markets and finance short-term loans to developed and developing countries. As of early 1995, the ESF held about $25 billion. The ESF is not financed with regular appropriations from Congress, so it "borrows" from the Federal Reserve when it needs additional funds. These loans are "warehoused" at the Federal Reserve, where the Treasury stores its foreign currencies in exchange for dollars that must be repaid later.

However, the Clinton Administration's claim that Mexico has "turned the corner"[13] is premature. The Mexican economy contracted between 6 percent and 8 percent during 1995.[14] Finance Minister Guillermo Ortiz admits that 1995 was the worst year for Mexico since the revolution,[15] although he also projects that the Mexican economy will grow 3 percent in 1996. Yet most private analysts forecast slower growth, more devaluation, and higher inflation because Mexico's banking system is still very weak.

The Mexican government already has spent $6.5 billion to bail out the banking system and may have to spend another $10.9 billion during 1996 to keep the system afloat.[16] In all, the cost of bailing out Mexico's banking system could add up to $20 billion, or more than 12 percent of Mexico's GNP for 1995. Salomon Brothers, the New York-based investment bank, estimates that 30 percent of the Mexican banking system's debts are non-performing.[17] Moreover, the system's problems may be worse than they appear to be, because Mexican banks book only the interest on past-due loans and not the entire loan, including the principal, as U.S. banks are required to list in their accounting.[18]

Another problem for the Mexican economy is the political weakness of President Zedillo. Two national polls conducted in November 1995[19] found that three-quarters of Mexico's voters approve of Zedillo's honesty and commitment to democracy but they give him poor marks on political leadership and ability to manage the economy. Two-thirds of the respondents in both polls disapproved of how Zedillo was governing the country, and over 80 percent said that he should change his cabinet. More than half of those surveyed felt the first two ministries to be changed should be the Finance Ministry and the Trade and Industrial Development Ministry. Compared to a similar poll conducted three months earlier,[20] the November poll indicated less confidence in Zedillo and increasing discontent with how he is managing Mexico's difficulties.

---

13 Nancy Dunne and Leslie Crawford, "Mexico's troubles will end soon, say Clinton, Zedillo," *The Financial Times*, October 11, 1995, p. 5.

14 Preliminary data from the Mexican Finance Ministry estimate a 6 percent drop in GDP. Independent private forecasts estimate the real drop in GDP at more than 7 percent.

15 Industrial output fell 10 percent, domestic consumption dropped 14 percent, retail sales were off by 21 percent in the first 10 months of 1995, and wholesale sales declined 16.6 percent in the same period. Purchases of consumer durables plunged 47 percent in the first nine months of 1995, and inflation for the year was 51.97 percent, although the price of the "basic basket" of food, medicine, and clothing jumped by 60.57 percent. Over 1 million workers in the formal Mexican economy were laid off. Mexico's Finance Ministry reported that public investment fell by 32.5 percent in the first nine months of 1995, while private investment dropped by 29.4 percent. Overall, gross fixed investment fell by 30 percent during that period, with the domestic component declining by 28.9 percent and the external component by 33.6 percent.

16 "Mexico: Banking bailout bill set to reach US $17bn," *Latin American Weekly Report*, January 11, 1996, p. 11.

17 "Mexican banking system: Prospect of renationalisation grows as bad debts mount," *Latin American Economy & Business*, December 1995, p. 11.

18 Craig Torres, "The Banking Disaster in Mexico Whipsaws an Ailing Economy," *The Wall Street Journal*, January 25, 1996, p. A1.

19 *El Norte* and *Reforma*, two leading independent newspapers in Monterrey and Mexico City owned by the same media group, polled 1,500 Mexicans in 14 states from November 20-25, 1995, and simultaneously conducted a second poll from November 20-29, 1995, of 138 business and political leaders, academics, intellectuals, and specialized consultants.

20 *Reforma/El Norte* poll published September 1, 1995.

A MEXICAN FREE-MARKET SOLUTION

The Clinton Administration's $50 billion bailout has not halted Mexico's downward spiral of devaluation, depression, and eventual default. Clinton ignored the principles of free trade when he went to the aid of the Mexican government. The main beneficiaries were Wall Street speculators and Mexican banks and companies owned by business leaders close to the Salinas regime and the ruling PRI. Moreover, the Administration's decision to bail out Mexico with $20 billion from the U.S. Treasury's Exchange Stabilization Fund effectively underwrote the cost of refinancing the Mexican government's entire short-term debt without a U.S. congressional appropriation. Clinton's failed attempt to rescue Mexico also created a moral hazard: It signaled foreign governments and private investors that mistakes caused by political incompetence and corruption will be underwritten by American taxpayers through the U.S. Treasury, the International Monetary Fund, and the World Bank.

Instead of correcting the structural causes of the Mexican peso crisis, President Zedillo is repeating the errors of the Salinas administration. The policies of Finance Minister Ortiz are indistinguishable from those pursued by Pedro Aspe, his predecessor during the Salinas government. Pressured by the U.S. Treasury and the IMF, the Zedillo administration is following policies which are destroying Mexico's economy. The Zedillo government is doing everything it can to maintain the Wall Street fiction that Mexico is an investment-grade economy. At bottom, Zedillo's economic policies are intended to keep Mexico safe for portfolio investment, not to promote the sustained export growth that constitutes the only escape route from Mexico's current economic crisis.

The central problem is that Mexico's financial technocrats refuse to consider a fixed exchange rate policy to achieve price stability. Since the peso's collapse, Mexico's central bank has implemented a floating exchange rate regime that allows the country's monetary authorities broad discretionary power to manipulate monetary and currency exchange policies. The problem with this policy is that Mexico's central bank lacks the credibility and international reserves to sustain itself without continued loans from the U.S. government and the IMF.

To achieve price stability under its current floating exchange rate, the Bank of Mexico will have to impose a relatively tight monetary policy and high interest rates. Inevitably, this will be accompanied by very slow economic growth. A sluggish Mexican economy would depress export earnings and foreign investment, making it more difficult for the government to service its foreign debt obligations. Slow economic growth also would fuel increased political turmoil, a revival of statist economic prescriptions, and more illegal migration to the U.S. This could weaken support for NAFTA in both countries and increase cross-border tensions over sensitive issues like drug trafficking and illegal immigration.

Only Mexico can devise lasting solutions for the Mexican crisis. NAFTA is vitally important to Mexico's future economic prosperity and democratic stability, but it is only part of the equation. Mexico has yet to go the full distance to capitalist democracy. Moreover, it has yet to devise an effective economic model capable of delivering the sort of sustained growth Chile has managed to achieve since 1985. Natural resources, human capital, and access to technology are not the problems. Mexico has all three in abundance. Missing, however, is the bold, imaginative leadership capable of conceiving and executing a strategy to complete Mexico's transition to capitalist democracy. Ideally, such a strategy would involve five goals:

❶ **Restore confidence in Mexico by stabilizing the currency.** This requires replacing the Bank of Mexico with a currency board.[21] To achieve sustained export growth and price stability, Mexico needs a sound monetary system, which a currency board would provide. The Bank of Mexico's floating exchange rate may be the favored option of Mexico's financial authorities, but it is fundamentally unsound because it allows arbitrary, discretionary control over Mexico's monetary and exchange problems. The principal goals of a currency board would be to fix the Mexican peso to the U.S. dollar and to eliminate the broad discretionary power (and lack of accountability) of Mexico's financial authorities to manipulate monetary and exchange policy.

The establishment of a currency board would stabilize the peso virtually overnight and restore confidence in Mexico. It would do so by instituting a non-discretionary, rules-bound, and totally transparent currency exchange regime. A currency board would prohibit public spending above levels that threaten reserves, stimulate more foreign direct investment, and insulate the peso from political interference and bureaucratic tinkering, in addition to quickly reducing inflation and interest rates, thereby spurring an increase in real long-term productive investment in Mexico.

More than 70 countries have used currency boards. In all cases, these boards have produced stable currencies that keep inflation at substantially low levels. No currency board has ever devalued its local money against its reserve currency. Argentina has been using a variant of the currency board since 1991. In every country where a currency board has been established, governments have succeeded in killing the deadly virus of high inflation, lowering local interest rates to manageable levels, and encouraging direct foreign investment in the local economy. The creation of a currency board in Mexico would be the first step in a Mexican free-market solution for the Mexican crisis.[22]

❷ **Break Mexico's addiction to foreign debt.** This means restructuring Mexico's banking sector. Standard & Poor's estimates that the bailout of Mexico's private banks will cost the equivalent of 12 percent of the country's 1995 GNP.[23] Debt relief programs created by the Zedillo administration will not work under the current floating exchange rate because higher inflation from the ongoing devaluation of the peso caused by the banking crisis, along with the continuing need to cheapen Mexico's exports, will cause Mexico's domestic debts to increase more rapidly than the ability of debtors to repay them. Moreover, Mexico cannot increase its borrowings from the IMF because it already has exceeded, by a factor of nearly 20, its allowable credit ceiling under existing IMF rules. Complicating matters even more, in November 1995 the Clin-

21 A currency board issues a local currency fully backed by reserve assets denominated in a widely used and respected foreign currency, such as the U.S. dollar. Under a currency board, the peso could be converted into the reserve currency—in this case the dollar—at a pre-established fixed rate at any of the board's offices; the local currency supply could expand only in proportion to an increase in net exports or capital inflows; and the board's reserves could be invested in high-quality, interest-bearing notes and bonds denominated in the reserve currency.

22 For a concise discussion of the advantages of currency boards over pegged and floating exchange rate regimes, see Steve H. Hanke, "A Tale of Two Pesos: A Comparison of Currency Policies in Mexico and Argentina," *Heritage Lecture* No. 552, December 12, 1995.

23 Torres, "The Banking Disaster in Mexico Whipsaws an Ailing Economy."

ton Administration rejected a formal Mexican request for more financial assistance to bail out the banking system.[24] As a result, the Zedillo government may be tempted to print more pesos to rescue the banks, driving up inflation and keeping interest rates at high levels.

A currency board would create the stable price environment that Mexican banks need to recapitalize and restructure their domestic credit portfolios. Bad debts could be winnowed out of bank portfolios and written off. Collectable consumer and corporate debt could be restructured and securitized,[25] creating a secondary market where domestic debt paper could be traded at a discount. However, the government also should lift all remaining limits on ownership of banks and other commercial enterprises.[26]

❸ **Promote sustained economic growth.** A key to achieving this goal is liberalizing Mexico's national oil industry.[27] The Mexican government owns 100 percent of the country's oil and natural gas industry. On February 12, 1996, the Mexican government announced its new energy program for the next five years. The plan is a restatement of Mexico's traditionally anti-market, monopolistic approach to energy development.[28] Jesus Reyes Heroles, president of the state oil monopoly *Petroleos Mexicanos* (Pemex), predicts that Mexico will attract $6.3 billion in foreign investment in petrochemicals, power plants, and natural gas companies. However, declared Reyes Heroles, no private investment will be permitted in upstream exploration, production, and refining of oil.

For Mexico, a better alternative would be to follow the example of more efficient and successful state-owned oil companies. A good model is *Petroleos de Venezuela (PDVSA),* which is implementing a mixed-economy expansion program to develop the country's oil and gas reserves.[29] Without giving up ownership of Mexico's oil and gas reserves, Pemex could contract with small private operators to exploit older and smaller oil and gas reservoirs that are uneconomic for Pemex to operate commercially. In addition, Pemex could enter into long-term associations with large international oil companies to find and develop major oil and gas reservoirs which Pemex is not financially or technologically capable of exploiting by itself.

---

24 Christopher Whalen, "Wait Till Next Year, Amigo," *The Washington Post*, January 21, 1996, p. C3.

25 Securitization converts debts into tradable securities that allow banks and other creditors to convert these debts into cash at whatever value is assigned by the market.

26 Under NAFTA, foreign participation in Mexican banks was limited to 30 percent. After the peso's collapse, the Zedillo administration allowed an increase in foreign ownership of financial institutions, up to 100 percent in some cases, but continued to severely restrict foreign participation in the largest banks.

27 George Baker, "The Concept of Virtual Economy in Mexico's Energy Sector: The Legal Challenge," *NAFTA: Law and Business Review of the Americas*, Vol. 1, No. 3 (Summer 1995) pp. 78-93.

28 Dianne Solis, "Mexico Doesn't Plan to Privatize Pemex," *The Wall Street Journal*, February 20, 1996, p. A14.

29 Under Venezuelan law, the state is the sole owner of Venezuela's hydrocarbon resources—including crude oil, natural gas, and coal. However, PDVSA and the Venezuelan Congress have developed model contracts of association with private investors whereby PDVSA (Venezuela) retains title to its oil and gas reserves. Private investors put up most of the capital (and assume most of the risk) and both parties share in the profits.

As oil and gas export earnings increase, part of the incremental profits could be reinvested in the expansion and modernization of Mexico's oil industry, and part could be deposited directly to the accounts of Mexican workers in privately managed pension funds. Such a strategy would represent a true "nationalization" of the Mexican oil industry, since it would transfer real oil wealth directly to workers and their families, creating a fast-growth domestic savings industry to finance Mexico's economic development with internal savings rather than with crippling external debt.

❹ **Increase disposable income.** Mexico's income tax rate should be cut and income thresholds increased. The top tax rate of 35 percent takes hold at very low levels of income. To spur investment, Mexico should extend its current zero percent capital gains tax rate on large stock exchange companies to all investments.[30]

❺ **Create better legal and political institutions for economic growth.** This requires both judicial and political reform. The rule of law and transparent democratic institutions are essential for the well-being and prosperity of successful capitalist democracies. President Zedillo has pledged massive overhaul of the judicial and political systems in Mexico, but efforts on both fronts are not progressing quickly, largely because of increased political discontent and resistance to change fueled by the current economic depression.

REASSERTING AMERICAN LEADERSHIP IN LATIN AMERICA

The current drift in U.S. policy toward Mexico and Latin America is dangerous. The Clinton Administration is projecting an image of retreat. In Mexico, still struggling to overcome its economic difficulties and recover its political stability, there is widespread concern about the depth of Washington's commitment to NAFTA. Throughout Latin America, political leaders trying to promote unpopular free-market reforms are questioning the sincerity of the Clinton Administration's pledge that the U.S. would lead the process of creating a Free Trade Area of the Americas. The longer America's policy drift continues, the greater the risk that hard-won economic and democratic reforms will be stalled or even rolled back in some countries. Moreover, if Latin America's emerging capitalist democracies feel that U.S. leadership is weakening, they may reach out to Europe or Asia for the support that America is failing to provide. To regain the initiative in Latin America, the U.S. government should:

❶ **Comply with NAFTA.** The Clinton Administration should respect NAFTA's provisions and timetables for implementation. By cheating on NAFTA, the Administration has established a negative precedent that Mexico, Canada, and other countries could follow in the future. Permits for Mexican trucks to circulate in the U.S. border states should be issued without further delay if the vehicles comply with all technical, safety, and legal requirements as stipulated in NAFTA.

30 Raymond J. Keating, "A year after the Mexican crash," *The Washington Times*, December 20, 1995, p. A23.

❷ **Complete the NAFTA with Mexico.** The peso crisis demonstrated the high degree of interdependence between the U.S. and Mexican economies. It also showed that NAFTA is an incomplete pact. Some of NAFTA's most important provisions have yet to be negotiated by the U.S. and Mexico, including currency unification, forgiveness of the Mexican government's public-sector debt, illegal immigration, and labor and law enforcement problems.

❸ **Expand NAFTA to include Chile and other countries.** Since the end of the Cold War, free trade and support for democracy have been the pillars of U.S. foreign policy toward Latin America. The Clinton Administration's retreat from NAFTA's expansion has left the U.S. without a coherent foreign policy for Latin America and sidelined from the ongoing process of trade liberalization in South America. Thus, NAFTA should be expanded to include Chile, and later to include Asian countries that qualify.

Chile is a beacon of economic prosperity and democracy for all of Latin America. It has set the standard for success in the region by achieving average growth rates of 6 percent annually every year since 1985, along with inflation of less than 8 percent, unemployment of 5 percent, and savings and domestic investment of 27 percent of GDP. Postponing Chile's admission to NAFTA would slow hemispheric trade integration and weaken American leadership.[31]

Asian countries also should be considered for NAFTA membership. Some members of the Asia Pacific Economic Cooperation (APEC) forum, such as Australia, New Zealand, and Singapore, are willing to liberalize trade at a much faster pace than is currently envisioned by APEC and may wish to negotiate free trade agreements with the U.S. as quickly as possible. Instead of a series of separate bilateral pacts, incorporating Australia, New Zealand, and Singapore into NAFTA would make sense.

❹ **Encourage Mexico to adopt a currency board.** The current Mexican experiment with a floating exchange rate will fail eventually.[32] The U.S. should encourage Mexico to adopt a currency board that would fix the peso's exchange rate to the U.S. dollar. The creation of a currency board would stabilize the peso, reduce inflation and interest rates, and restore confidence in Mexico and NAFTA. Under a currency board, if a run on the peso occurred, the worst that could happen would be the total dollarization of Mexico, since trading would take place in U.S. dollars while the currency board held the stock of Mexican pesos.[33]

❺ **Offer to negotiate forgiveness of Mexico's public sector foreign debt.** This offer should be extended in return for an irrevocable pledge by Mexico to end all future international borrowing by government entities, not to take any more money from the IMF and World Bank, and to rely only on private investment to drive Mexico's eco-

31 For a succinct review of the advantages of including Chile in NAFTA immediately, see Ricardo Matte Equiguren, "Chile Should Join NAFTA," Heritage Foundation *Committee Brief* No. 10, October 19, 1995.

32 For a comprehensive debate on exchange rate policy options for NAFTA's member countries, see James A. Dorn and Roberto Salinas-Leon, *Money and Markets in the Americas: New Challenges for Hemispheric Integration*, (Vancouver, Canada: The Fraser Institute, 1996). The book was published in association with the Cato Institute and Mexico's Centro de Investigaciones Sobre la Libre Empresa (CISLE).

33 *Ibid.*, p. 328.

nomic development. There is no moral hazard in forgiving Mexico's entire public sector foreign debt, since it will never be repaid in full anyway. Moreover, writing off the public-sector's foreign debt would free Mexico from the IMF's destructive clutches.[34] The IMF's record in Mexico, an IMF borrower since 1976, has been impoverishment, indebtedness, and dependency.[35]

⑥ **Offer to negotiate a law enforcement agreement with Mexico to deal with the growing problem of international organized crime and drug trafficking.** For many years, America's war on drugs in the Western Hemisphere has concentrated on the Andean drug trade, with special emphasis on Colombia, while largely ignoring the closer threat of Mexican drug traffickers. However, since the mid-1980s, 19 distinct drug cartels have emerged in Mexico.[36] President Salinas himself admitted that the annual flow of cocaine and other illicit drugs through Mexico totals some $100 billion annually. The rise of these drug cartels threatens the national security of both Mexico and the United States. The U.S. and Mexico should begin talks to enhance cooperation in apprehending and prosecuting illegal drug traffickers.

CONCLUSION

The Mexican peso crisis weakened support in America for NAFTA, damaged U.S.-Mexico relations, and halted further U.S.-led trade expansion in the Americas for at least the next two years. Moreover, the crisis in Mexico is not over yet: Clinton's $50 billion bailout of the Zedillo government kept Mexico from defaulting on its foreign debt obligations in 1995, but Mexico's downward economic spiral was not reversed. The economic policies of the Zedillo government will not achieve the structural reforms that Mexico needs to avoid another currency collapse. The market's recent surge of optimism in Mexico's recovery therefore may prove to be very short-lived.

If the Mexican crisis continues, strains in U.S.-Mexico relations are likely to grow. Conflicts over illegal immigration and drug trafficking easily could displace cooperation on trade and investment. More crisis in Mexico also will fuel opposition in both countries to NAFTA and free trade, possibly delaying NAFTA's implementation in North America and derailing its expansion to other countries in Latin America and the Caribbean.

The Economist argues that NAFTA is one of the principal factors responsible for "a second Mexican revolution,"[37] and asserts that Mexico's successful transformation into a stable capitalist democracy depends on its becoming "more like America."[38] More than that of

---

34 Since the debt crisis of 1982, the U.S. government and the IMF have refinanced, restructured, and rescheduled Mexico's public-sector foreign debt five times, including the so-called Brady Plan put forward in March 1989 by U.S. Treasury Secretary Brady and signed in early 1990. During this period, Mexico rescheduled large amounts of public-sector debt principal, including $19 billion in 1983, $30 billion in 1985, $45 billion in 1987, and $48 billion in 1990, for a total of $123 billion. Yet the Brady Plan, praised in some quarters as the solution to Mexico's debt problems, succeeded in extinguishing only $15 billion of Mexico's foreign debt, or about 16 percent of Mexico's total foreign debt as of 1989.

35 Doug Bandow and Ian Vasquez, *Perpetuating Poverty: The World Bank, the IMF, and the Developing World* (Washington, D.C.: Cato Institute, 1994).

36 Data from U.S. Federal Bureau of Investigation.

37 Country Survey, "Mexico: The Second Revolution," *The Economist*, October 28, 1995.

any other country in Latin America, Mexico's future is tied, for better or worse, to the future of the United States. However, the American goal of creating a Free Trade Area of the Americas (FTAA), based on NAFTA's expansion to all democratic countries in the Western Hemisphere, depends on the quick return of economic and political stability to Mexico. As long as the crisis continues in Mexico, it will be difficult for any U.S. Administration to rebuild bipartisan congressional support for NAFTA's expansion and regain public trust and support for free trade. The U.S. needs to work with Mexico, through NAFTA, to help end this economic crisis.

John Sweeney
Policy Analyst

38 *Ibid.*