UPDATE

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DON'T BLAME NAFTA FOR THE MEXICAN CRISIS

(Updating *Backgrounder* No. 1016, "The Bailout of Mexico: A Costly Mistake?" January 25, 1995.)

The economic crisis in Mexico has been blamed by some on the North American Free Trade Agreement (NAFTA). "We went into partnership with an unworthy partner," says television host Patrick Buchanan. "It's time to repeal NAFTA, cut our losses, and get out."[1] But Buchanan and other critics of NAFTA are wrong. The crisis was caused not by NAFTA, but by mismanagement of the Mexican economy, which was due largely to political opportunism. In fact, NAFTA represents the very kind of economic reform that Mexico must continue to prevent politicians there from wreaking such havoc again. NAFTA is key to the process of structural transition from a corporatist state to a democratic, free-market economy. NAFTA should accelerate the expansion of North American trade, increasing pressures on Mexico to consolidate the free-market reforms initiated in the mid-1980s. As the economy of Mexico becomes freer and more prosperous, democratic reforms will advance.

Policymakers need to be aware of the real story behind the Mexican economic crisis. Otherwise they will draw the wrong policy conclusions. Above all, they must reject the many myths about the Mexican crisis that trade protectionists are using to discredit NAFTA.

MYTH #1: NAFTA caused the peso's devaluation.

This charge has been made by numerous critics of free trade.[2] But it is untrue. It was the economic policies of former President Carlos Salinas de Gortari, in the last two years of his administration, that caused the Mexican economic crisis. Because Mexico has no independent authority to maintain price and currency stability—such as a currency board or strong central bank independent of political interference by the executive—politicians have frequently permitted the value of the peso to become subject to political whim. This happened in Mexico in 1982 and again in 1987, presidential election years in which misguided economic policies resulted in major devaluations of the peso.[3] In short, the devaluation was caused by the Salinas administration's use of the exchange rate to keep inflation down long after it had become clear that the peso had become overvalued.[4]

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1 Patrick Buchanan, "Stakes in Mexico and in the GOP: Political Cliffhanger," *The Washington Times*, January 25, 1995.

2 Including consumer advocate Ralph Nader and social conservative Patrick Buchanan, in testimony before the House bipartisan Fair Trade Caucus on January 25, 1995.

3 "Latin America After the Mexican Crash," January Strategy Document, Baring Securities, Inc., New York, January 1995.

4 *Ibid.*

There were other contributing factors as well. The rebellion in the southern state of Chiapas on January 1, 1994, and the assassination in Tijuana of Institutional Revolutionary Party (PRI) presidential candidate Luis Donaldo Colosio on March 23, 1994, aggravated political tensions and uncertainties in a presidential election year. Salinas did not change his policies because he wanted to end his presidency without a devaluation of the peso. The reasons: to improve PRI candidate Ernesto Zedillo's chances of winning and to enhance his global reputation as a savvy economic manager. Salinas was lobbying to become the next head of the World Trade Organization. In effect, he gambled that Mexico's situation would start to improve quickly after the elections were over. Some investors bought into his bet, but many more withdrew their capital in favor of more stable markets elsewhere. President Salinas bet the bank on his strategy: the Banco de Mexico's international reserves fell from about $25 billion at the end of 1993 to less than $5 billion in January 1995.

NAFTA played no role in the genesis of the Mexican crisis. The peso collapsed as a result of ill-advised policy decisions by the Mexican government. NAFTA, in fact, is a key part of the solution. The Mexican crisis arose because the state, dominated by the long-ruling PRI party, still exerts too much control over the Mexican economy. The solution is not to blame NAFTA or seek to destroy expanded free trade, but rather to pressure the Mexican government to apply the structural corrections that would prevent another crisis in a few years.

MYTH #2: NAFTA has helped Mexico more than the U.S.

This charge is made by NAFTA critics like Ross Perot who want to use the Mexican crisis to discredit NAFTA. But this charge also is untrue. There are few conclusive statistics yet, but all three nations—the United States, Mexico, and Canada—are starting to feel the benefits of free trade.[5] U.S. exports and imports grew twice as fast with Mexico in 1994 as with the rest of the world. According to the U.S. Commerce Department, in the past year Mexico surpassed Japan as the second-largest consumer of U.S. products, trailing only Canada.[6] American exports to Mexico grew by 22 percent in the first nine months of 1994, compared with the same period in 1993, while U.S. imports from Mexico rose by 23 percent. America's trade surplus with Mexico for this nine-month period was $1.8 billion.[7] At the same time, the Commerce Department reported the creation of 100,000 new jobs for the first nine months of 1994 as a result of increased U.S. exports to Mexico following NAFTA's implementation.

Of course, in 1995, the peso's devaluation reversed some of these gains. But U.S. companies still are exporting more goods and services to Mexico and Canada, and are not exporting jobs as many predicted would happen.[8] A survey by the accounting firm Coopers & Lybrand reported that 21 percent of America's growth companies became more active in Canada and Mexico after Congress approved NAFTA.[9] Nearly all were exporting goods and services from U.S.-based facilities. Only five percent had set up manufacturing facilities in the two other countries, and only four per cent were importing more goods from either nation. In Mexico's case, the survey found that only three percent of the U.S. firms surveyed had set up production in Mexico, and only one percent were importing more from Mexico.[10]

5 "Trade Pact Anniversary — for Better or Worse," *The Christian Science Monitor*, January 3, 1995.

6 "One year later, a look at NAFTA," written for United Press International by Dr. George Trivoli, a professor at Jacksonville State University in Alabama, January 3, 1995.

7 "Happy ever NAFTA?" *The Economist*, December 10, 1994.

8 "NAFTA Increases Exports to Canada, Mexico," *The Legal Intelligencer*, October 12, 1994.

9 "Trendsetter Barometer," Coopers & Lybrand L.L.P., Business Wire, New York, September 27, 1994.

10 "NAFTA Increases Exports," *op. cit.* George Auxier, National Director of Entrepreneurial Advisory Services for Coopers & Lybrand, says that "so far, fears of jobs being lost to Mexico and Canada are unfounded, at least among the nation's fastest growing firms ....As yet no tidal wave of American jobs has swept across the border, as some had speculated. On the contrary, it appears that America's growth companies are currently viewing opportunities in the two countries purely as

Myth #3: The peso's devaluation will damage NAFTA over the long-term.

Actually, it is exactly the opposite: over the long-term, the economic reforms sparked by NAFTA will prevent politically motivated economic mismanagement. In addition to its membership in NAFTA, Mexico also belongs to the General Agreement on Tariffs and Trade (GATT) and Organization of Economic Cooperation and Development (OECD). All of these institutions will force continued economic reforms that will further insulate the Mexican economy from political shocks such as in 1994.

Since 1987, the Mexicans have been steadily modernizing and diversifying their economy. This has not been in vain, despite the peso's steep devaluation. To be sure, U.S. exporters have lost competitiveness and market share for now, and Mexican exporters have gained. But such factors as Mexico's higher inflation, its inferior infrastructure, and the higher cost of imported capital and manufacturing goods should erode Mexico's short-term export advantages quickly.

NAFTA did not cause the peso's devaluation. Mexico's currency crisis resulted from ill-advised economic policy decisions in a presidential election year. The initial results from NAFTA are, in fact, promising. Trade between the U.S. and Mexico grew rapidly in NAFTA's first year, and there was no "giant sucking sound"[11] of U.S. jobs headed south to Mexico.

NAFTA critics would be wise to pause and ask themselves why Mexico has had numerous currency crises in the past before NAFTA was in place. The cause of the most recent collapse of the peso is the same as in previous instances: the heavy hand of the state-controlled economy. Free trade did not cause the Mexican crisis. Mexican politics did.

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territorial expansion."

11 A much-quoted phrase coined by billionaire populist and NAFTA foe H. Ross Perot.