

NAFTA AND THE PESO COLLAPSE Not Just a Coincidence

by Robert A. Blecker

There is little dispute that, since the North American Free Trade Agreement (NAFTA) went into effect in 1994, Mexico has endured one of the worst economic crises in its history. At the same time, a rising U.S. trade deficit with Mexico has meant a net loss of jobs in the United States, not a net gain, as predicted by NAFTA promoters' (see **Figure 1** and Scott 1996).

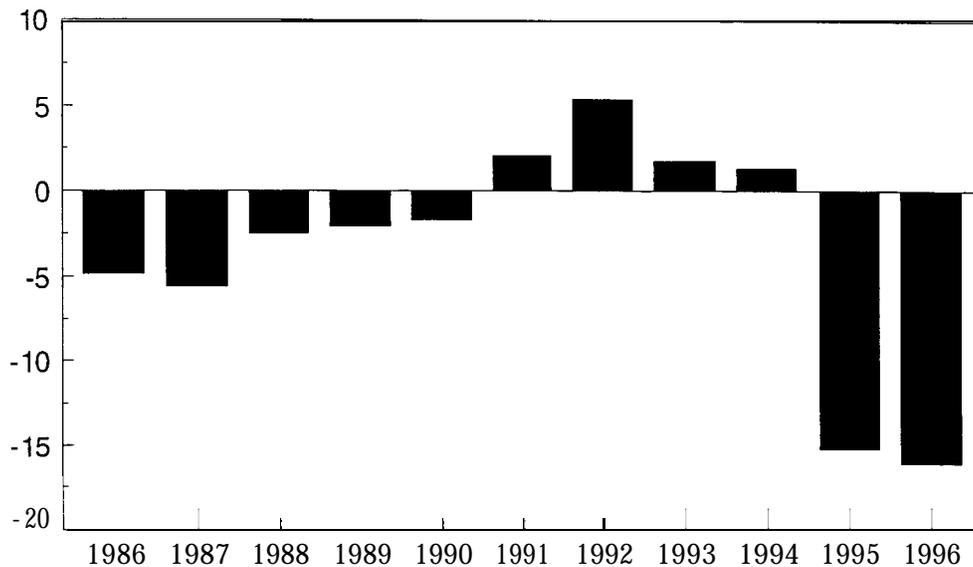
Many NAFTA promoters insist that the peso devaluation and the ensuing depression of the Mexican economy resulted solely from failed Mexican macroeconomic and exchange-rate policies. Furthermore, they argue that the current U.S. trade deficit with Mexico is merely a consequence of the devalued peso and Mexico's internal economic problems, not NAFTA.²

It is certainly true that Mexico's macroeconomic and exchange-rate policies were flawed and the peso devaluation was badly managed. Nevertheless, the peso had to be devalued in order to implement the Mexican strategy for export-led growth that NAFTA was intended to promote — a strategy that was pushed on Mexico by the U.S. government and the U.S. corporate interests that stood to profit from this trade agreement. In other words, *Mexico had to devalue the peso in order to attract the direct foreign investment and export-oriented manufacturing that the NAFTA agreement was designed to promote.*³

Mexico's trade and growth strategy

Mexico's main motivation for NAFTA was to encourage direct foreign investment in export-oriented manufacturing industries. Such investment was believed to be the key to renewing Mexican economic growth after the "lost decade" of the 1980s.⁴ In this respect, NAFTA was part of a larger package of economic "reforms" that were intended to liberalize the Mexican marketplace and create a more investor-friendly environment in Mexico. Indeed, NAFTA supporters often claimed that NAFTA was more impor-

FIGURE 1
U.S.-Mexican Merchandise Trade Balance, 1986-96
(In Billions of U.S. Dollars)



Source: U.S. Department of Commerce, Census Bureau.

tant for “locking-in” Mexico’s domestic reforms than for the new, relatively modest reductions in trade barriers it contained.

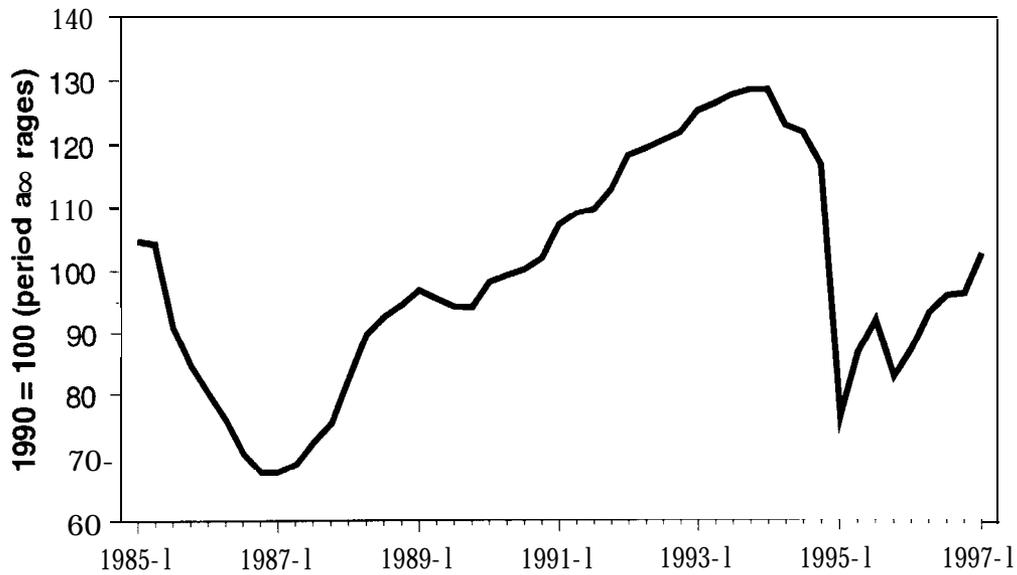
This strategy could not work as intended if Mexico maintained the macroeconomic and exchange-rate policies of the early 1990s. These policies had encouraged a massive inflow of portfolio capital (so-called “hot money”) and boosted the value of the peso (see **Figure 2**), the latter of which was inconsistent with Mexico’s export goals in NAFTA. Indeed, the high peso flew in the face of a long Latin American history showing that trade-liberalizing countries cannot hope to have rapid export-led growth if their currencies are overvalued (see Agosin and Ffrench-Davis 1993).

Why the peso had to fall

The overvalued peso in the early 1990s caused three related problems for Mexico. First, it made Mexican exports less competitive in the U.S. market compared with U.S. domestic products or imports from other newly industrializing countries. Second, the high peso combined with liberalized trade led to an unprecedented surge in Mexican imports of consumer goods in 1993-94. Weak exports and surging imports together resulted in an enormous trade deficit that reached \$29 billion — 8% of Mexico’s gross domestic product (GDP) — by 1994.

Third, the rising peso made Mexican labor costs rise in *dollar terms* in 1991-94 (see **Table 1**),⁵ thus

FIGURE 2
Real Value of the Mexican Peso, Quarterly, 1985 to 1997



Source: International Monetary Fund, International Financial Statistics, various issues, and author's calculations.

TABLE 1
Hourly Compensation Costs for Production Workers in Manufacturing
in the U.S. and Mexico, in U.S. Dollars, 1990-96

	United States	Mexico	Mexico as Percentage of U.S.
1990	\$14.91	\$1.58	10.6%
1991	15.58	1.84	11.8
1992	16.09	2.17	13.5
1993	16.51	2.40	14.5
1994	16.86	2.47	14.8
1995	17.20	1.51	8.8
1996 (estimated)	17.77	1.51	8.5

Source: U.S. Department of Labor, Bureau of Labor Statistics, "International Comparisons of Hourly Compensation Costs for Production Workers in Manufacturing, 1995," Report 909, September 1996, and author's calculations.

making Mexico a less attractive investment location for multinational corporations seeking sites for low-wage, labor-intensive assembly operations. The devaluation of the peso — which lowered Mexico's labor costs by about 40% in dollar terms from 1994 to 1995 — was thus **necessary** for the success of Mexico's economic strategy for attracting direct foreign investment.

The importance of devaluing the peso can be seen by comparing the impact of devaluation to the small tariff reductions in NAFTA. The U.S. International Trade Commission (1991, 2-2) calculated that the average tariffs in effect at the start of the NAFTA negotiations were about 3.4% for U.S. imports and 10% for Mexican imports. In contrast, the peso appreciated by over 75% in real terms from 1987 to 1994 and then fell by about 50% from 1994 to 1995. Thus, none of the tariff reductions in NAFTA could have made much of a difference if the peso stayed as high as it was in 1993-94. In order for NAFTA to promote Mexican exports as intended, a significant devaluation of the peso was unavoidable.

Politics and mismanagement: important, but not the whole story

Political factors did affect the timing and severity of the peso crisis and the subsequent economic disaster in Mexico. If Mexico had begun to devalue earlier, a more gradual adjustment might have ensued, and the Mexican economy might have been able to avoid collapse. Stabilizing the peso would have been preferable to having it shoot up and then crash.

But the Mexican government of former president Carlos Salinas had several reasons not to devalue the peso earlier. First, keeping the peso high held down inflation at home because the high peso made Mexican imports artificially cheap. Second, postponing the devaluation until after the 1994 presidential election helped the electoral chances of Salinas' hand-picked successor, Ernesto Zedillo. Salinas also boosted government spending and worsened the country's budget deficit in 1994 in an effort to help buy votes for the ruling Institutional Revolutionary Party (PRI) — a move that also worsened the country's subsequent financial crisis.

Third, the high peso helped to win votes in the U.S. Congress for passage of NAFTA in November 1993. The overvalued peso gave the United States a temporary trade surplus with Mexico in 1991-93 (see Figure 1, above), creating the illusion that NAFTA would be a net job creator instead of a net job loser for the United States.

Clearly, the peso devaluation could have been managed better, and politics — including the effort to get NAFTA passed and the PRI reelected — got in the way. But this does not mean that devaluation could have been avoided. The real effects of NAFTA must include the consequences of increased foreign direct investment and the devaluation of the peso, and not just the effects of the tariff reductions in NAFTA alone.

Why NAFTA still isn't working

There is some truth to the argument that the U.S. trade deficit with Mexico results from Mexico's domestic problems. Mexico's national income has been severely depressed by the contractionary fiscal and monetary policies adopted in the wake of the country's financial crisis of 1994-95 (see Williamson 1997). Its real GDP plummeted by 6% in 1995, and, while it recovered slightly in 1996, Mexico is still struggling to emerge from what is in fact an economic depression. Under these conditions, it is no surprise that Mexico's demand for U.S. exports has fallen dramatically.

Since the devaluation of the peso, the Mexican government has felt obligated to maintain tight fiscal and monetary policies in order to placate nervous investors and to suppress inflation. These policies have been pushed on the Mexican government by the U.S. government and the International Monetary Fund (IMF) as a condition for the assistance Mexico received in supporting the peso in 1995, and they are still supported by foreign holders of Mexico's debts.

With these policies in place, most Mexicans are not seeing the gains they were promised from NAFTA and the entire export-led growth strategy. Some Mexican workers have gotten export jobs, but only at real wages that are 20% lower than they were in 1994. Worse yet, these job gains have been more than offset by reduced employment in the rest of the Mexican economy. Meanwhile, Americans are not **seeing** the booming export market that they were promised in Mexico. Instead, the lower Mexican labor costs shown in Table 1 are creating a substantial movement of manufacturing jobs south of the border, just as NAFTA's critics predicted.

This is a lose-lose situation for workers on both sides of the border — Mexican workers whose real wages have been cut sharply, and U.S. workers whose jobs and bargaining power are in jeopardy. The only winners in this shell game are the multinational corporations who profit from lower wages in both countries and the financial speculators who are responsible for Mexico's recent macroeconomic and financial policies. From the standpoint of both U.S. and Mexican economic prosperity, the current situation is what in Spanish is called ***una callejón sin salida*** — a dead end.

Another crisis, or another way out?

The real value of the peso has been climbing steadily since late 1995, and it is now growing about 5-7% **per quarter** (see Figure 2). Essentially, this rise is occurring because inflation in Mexico is much higher than in the United States, and the peso is not depreciating enough in nominal terms to compensate. Moreover, the Mexican government has recently increased spending in order to stimulate the economy in advance of congressional elections to be held in July.⁶ If past experience is any guide, we can reasonably expect another devaluation, and another contraction in Mexico, in the near future.

There is an alternative, but it requires a fundamental redirection of Mexican economic policy and a sea-change in the economic advice that the United States, the IMF, and other outside agencies give to the Mexican government. Mexico needs to stimulate growth by raising, not lowering, the incomes of its workers. A substantial rise in Mexico's minimum wage and renewed public spending on infrastructure

would help to jumpstart its domestic economy. Mexico needs to rely less on exports as the main source of growth, and it needs to diversify its export markets away from an exclusive focus on the United States.

The United States in turn needs to stop insisting that the Mexican government cut spending in order to reduce budget deficits and fight inflation. A more progressive tax system, targeting the excess profits of foreign investors, would be a better way to solve Mexico's financial problems and would also reverse the worsening of inequality in Mexico since the early 1980s (Lustig 1992).

A prosperous, more equitable Mexico could be a valuable trading partner for the United States. There is plenty of room for mutually beneficial trade, with the United States exporting capital equipment and high-technology products to an expanding Mexican economy. It is possible for U.S.-Mexican trade to create jobs at good wages on both sides of the border. But this potential will not be realized unless current policies are reversed.

May 1997

Endnotes

1. See, for example, Hufbauer and Schott (1993).
2. For example, Hinojosa et al. (1996, 60) claim that "the most important negative impact on employment has been the decline in U.S. exports due to the Mexican peso crisis, not the liberalization of tariffs due to NAFTA."
3. For more details on the causes and consequences of the peso devaluation crisis, see Blecker (1996a).
4. See U.S. Congress, Congressional Budget Office (1993, xiii); Lustig (1992, 134), and Blecker (1996b).
5. Note that labor costs are much lower in many export-oriented maquiladora plants than those shown in the average data in Table 1. Mexican workers did not really benefit from their higher labor costs in dollars terms in 1991-94 since their real wages (in constant pesos) did not rise.
6. Dornbusch (1997) notes the link between current government spending and the political cycle in Mexico; he hints that another devaluation will be needed soon in Mexico. His preferred solution — an Argentina-like fixing of the peso to the dollar — seems unlikely to be adopted in Mexico, and it might backfire by leading to further real appreciation.

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