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Notes and explanation of symbols

The following symbols are used in tables in the *Review*:

Three dots (...) indicate that data are not available or are not separately reported.

A dash (—) indicates that the amount is nil or negligible.

A blank space in a table means that the item in question is not applicable.

A minus sign (-) indicates a deficit or decrease, unless otherwise specified.

A point (.) is used to indicate decimals.

A slash (/) indicates a crop year or fiscal year, e.g., 1970/1971.

Use of a hyphen (-) between years, e.g., 1971-1973, indicates reference to the complete number of calendar years involved, including the beginning and end years.

Reference to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated.

Unless otherwise stated, references to annual rates of growth or variation signify compound annual rates.

Individual figures and percentages in tables do not necessarily add up to corresponding totals, because of rounding.

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Review

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Mexico's stabilization policy

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Navarrete*

This paper discusses Mexico's stabilization efforts over the last two years, as related to the wider framework of the country's economic behaviour and the major elements in the external sector of the economy.

It is divided in three sections. First, a general look is taken of the country's economic evolution in the late 1970s and most of the 1980s, leading up to the inception of the current stabilization drive in December 1987. This overview of past events is rather sketchy, since it has no other purpose than to provide information which might be useful in appraising the design and implementation of the stabilization policy. The second section comprises a rather detailed but, I hope, not over-lengthy analysis of the main elements in the stabilization policy and its evolution from December 1987 to December 1989. Attention is given both to the process of policy formulation and to the actual implementation of the agreed measures and their consequences on prices (including labour and capital prices) and output. Some of its major social implications are discussed, albeit briefly. Finally, the third section deals with the future, trying to present the main perspectives that are now perceived for the Mexican economy as a whole and, in particular, for the stabilization policy objectives.

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I

The Mexican economic experience: 1976-1987

1. *An overview of long-term trends*

Nearly all studies of Mexico's post-war economic evolution used to emphasize the seemingly miraculous combination of rapid, sustained growth and price stability, with no exchange restrictions. For 20 years up to the mid-1950s, the economy grew at an average annual rate of 5.8%, the real value of production trebled while the per capita product doubled, and prices increased at a yearly average of around 3% (Solís, 1970). During the 12-year period between 1959 and 1970, the annual rate of growth of the GDP averaged 6.8% while the inflation, measured by the GDP deflator, stood at 3.6% per annum. From 1971 to 1975, however, the rate of economic growth decreased to 5.6%, while inflation accelerated to 12.3% annually (Nafin, 1977). The rate of exchange remained unchanged for a long period, standing at Mex\$12.5 to the US dollar from 1954 to 1976.

Over that long period, rapid population increases meant that fast economic growth translated into moderate but sustained gains in per capita output and income levels. Growth was uneven, however, both among sectors and among regions. Both in the dynamic and the traditional sectors, it was concentrated in a relatively small number of large industrial and services conglomerates and around a few development poles. Substantial areas remained largely outside the development process. Modern, efficient agriculture was concentrated in the irrigated lands, mainly in the Northwest, while low-productivity subsistence farming remained dominant in the backward rural areas. Regional development gaps appeared and rapidly got worse. Income and wealth distribution remained very uneven and worsened in the long run. All in all, this sustained but uneven growth produced, in the view of some scholars, the emergence of two, or even many, Mexicos.

The total population increased by 100% between 1940 and 1965 and doubled again in the

following 20 years. A very rapid process of urbanization also took place. In the mid-1970s, nearly two-thirds of Mexico's population lived in cities, as opposed to about one-third in the early 1940s (Nafin, 1977). High population growth was the result of rapidly diminishing mortality rates (particularly infant mortality), as a consequence of greatly improved sanitary conditions. Public expenditure brought about enormous increases in educational and health services, and standards of living improved for all: slowly for the majority and very fast for the privileged.

In the external sector, the import-substituting industrialization process succeeded in augmenting domestic supply of final-use goods, but resulted in increased needs of imported inputs, spare parts, equipment and technology. At the same time, the export supply remained weak, since manufactured production was mainly directed towards meeting demand in a protected domestic market. Thus, imports increased fast while exports lagged behind. Exports, which used to cover more than four-fifths of imports in the early 1950s, were equivalent to less than half in the mid-1970s. Net income from services transactions, mainly tourism, also weakened and the current account deficit widened constantly. Exchange rate overvaluation became a major factor in the worsening of the external payments position.

For all practical purposes, the long period of sustained stability and growth, usually referred to as "stabilizing development", which started soon after the Second World War, came to a close in September 1976, with the first devaluation of the Mexican currency in 22 years.¹

2. 1976-1982 from bust to boom —and back

The end of exchange rate immobility in 1976 came about amidst a strong deceleration of economic growth and a spurt of inflation. In 1975-1976, growth was no more than half the

average rate of earlier in the decade, and since 1973 the inflation rate had reached two digits. This also marked the start of a period of acute instability. The economy went from bust to boom conditions, registering from 1977 to 1980 the highest rates of growth in recent history, only to fall back into recession in 1981-1982, with decreases of -0.5 and -5.3% in the real GDP. Inflation followed a steep upward trend, going into three digits in 1983, and devaluation cut the value of the Mexican currency by more than six: from 12.5 to 96.48 pesos to the dollar at the close of 1982 (Nafin, 1988).

The main factors behind the economic boom of the late 1970s were the big oil discoveries, which allowed a very rapid increase in crude oil exports. The resulting ample foreign exchange receipts, complemented with a large inflow of capital, financed high levels of public spending and, consequently, an important expansion of aggregate demand. In this way, for a few years at the close of the 1970s, Mexico attained very high levels of investment, production, employment and social welfare.

However, the boom was not sustainable because of increasing dependence on oil revenues, both for financing public expenditure and balancing external payments, and decreasing domestic resource generation. The expansionary policy relied too much on external demand and external borrowing. Domestic inflation ran well ahead of periodic exchange rate corrections, producing long spells of serious overvaluation of the Mexican currency, and the economy became vulnerable to external shocks.

These came, by mid-1981, in the form of falling international oil prices, unprecedented high levels of international interest rates, and a severe recession in the industrial countries which further curtailed non-oil exports and tourism income. The current account balance position became untenable: the deficit almost doubled every year between 1977 and 1981, reaching a total of US\$16.1 billion in the latter year.

The initial reaction to the external shocks was to delay adjustment and engage in unprecedented levels of foreign borrowing. In 1981, for instance, public external debt increased by US\$19.9 billion, and in the following year public debt service reached US\$10.6 billion or

¹ Among many others, the overviews of Mexico's long-term development offered by Vernon (1963), Solís (1970) and Hansen (1971) are particularly noteworthy. The pioneering study on income distribution is that by Martínez (1960) and a more updated analysis of inequality is to be found in the essays collected by Cordera-Tello (1984). A brief summary of the development imbalances in this decade is to be found in Navarrete (1971).

nearly 40% of current account revenue (Banxico, 1987). By August 1982, the situation became untenable, forcing the suspension of debt service payments—a step which marked the beginning of the current phase of the debt crisis.

3. 1983-1987: *incomplete adjustment and external shocks*

The onset of the crisis in August 1982 elicited a strong policy response by the Mexican government, particularly by the new administration which took office in December that year and "introduced a comprehensive three-year programme which contemplated a structural reform of public finances, a moderate wage policy, a tight monetary policy, flexible exchange rate and interest rate policies and the liberalization of trade and exchange rate controls" (Banxico, 1987).

The objectives were, in the short term, to reduce inflation and cut down the public and external deficits and, in the medium term, to promote savings and investment, restore price stability, enhance economic efficiency and reduce the dependence on foreign financing. Additionally, a more manageable external debt situation was sought, through a series of renegotiations.

This basic two-pronged policy approach—combining short-term adjustment measures and longer-term structural reform policies—remained in force until late 1987. At several points in time, mainly at mid-1985 and in early 1986, the policy was strengthened to respond to unfavourable external factors such as the collapse of international oil prices, the sharp increases in international interest rates and the drying-up of international financial flows.

Over the five-year period, short-term adjustment policy brought about a turnaround in some major variables in the Mexican economy:

- First, it produced impressive current account surpluses. These were a result, initially, of a major restriction on the import expenditure, which severely affected the growth prospects of the economy. Later, they reflected an equally impressive expansion of export receipts, coming mainly from non-oil exports, *maquiladoras* and tourism.
- Secondly, it resulted in spectacular

improvements in the public finances. The primary economic deficit disappeared and a sizeable economic surplus, which reached between 2% and 5% of the GDP, was generated.

- Thirdly, despite initial partial successes, the adjustment was not able to reduce inflation in a significant way.

To implement the adjustment policy throughout the period, two major tools were consistently used: on the one hand, very aggressive exchange rate and interest rate policies remained in force, keeping the former undervalued and the latter substantially positive, in order to fulfil the balance-of-payments goals; on the other, a policy of virtual indexation of the prices of public sector goods and services was followed, in order to fulfil the public finance goals.

These policies were implemented in a situation in which both the nominal levels of exchange and interest rates and the inflation floor continued moving up most of the time. For this reason, at any given moment a greater undervaluation of the currency was needed to achieve the same degree of incentive to export; a higher real interest rate was needed to keep the same degree of incentive to save and to repatriate capital; and a fuller indexation of prices of public sector goods and services was needed to avoid erosion of the public revenues. Additionally, the adjustment was sustained over a period far longer than originally envisaged.

The policy mix for short-term adjustment, the context in which it was implemented and the fact that it was applied over a long period—together with a worsened external environment—² produced some undesirable results:

- First, the growth potential of the economy was severely curtailed. The reduction of import expenditure and public investment

²The main negative external factors, present throughout the period, can be summarized as follows: a) Access to foreign markets for Mexican exports, mainly non-oil exports, was obstructed by protectionist and other trade-restrictive measures adopted by many developed countries and by the imposition of "graduation" and reciprocity criteria for the GSP and in wider areas—including the linking of trade with investment and intellectual property issues; b) The constant worsening of the terms of trade, arising mainly out of the wide fluctuations in commodity prices, including

affected growth prospects. Several years of negative or nil growth —interwoven with years of hesitant recovery— abruptly altered the expectations of the economic agents. A "culture of stagnation" emerged, replacing the "culture of growth" associated with the epoch of sustained development in previous decades. As a final result, real economic growth in the whole 1983-1988 period was virtually nil, averaging only 0.1% for the five-year period (Banxico, 1989 a).

- Second, a heavy social price was paid: real wages greatly diminished, high inflation meant even more unequal income distribution and social public expenditure was curtailed. In short, per capita income levels dropped and standards of living fell.
- Third, financial investment was privileged over productive investment. Towards the close of the period, the very short-term financial assets turned out to be the most attractive and a strong bias against long-term capital formation emerged.
- Fourth, the amount of financial expenditure tied up by the servicing of domestic and external debt reached inordinate and towering levels —over a fifth of the GDP for 1988. The primary economic surplus was totally absorbed by, and resulted insufficient to cover, this financial burden.
- Finally, a new sort of inflation arose, as the adjustment policies, acting in a perverse way, fuelled it and kept it at high levels. This was worsened by the destabilizing effect of sharp fluctuations in foreign exchange receipts and public revenues, as a consequence of external factors like the collapse of the oil price in 1986. Other factors also came into play: the rigidities and bottlenecks in distribution worsened and speculative behaviour was stimulated.

the price of oil, sharply curtailed foreign exchange receipts and public revenues; c) Repeated increases in the level of international interest rates —until late in 1987, when the crisis in the stock exchanges forced them in the opposite direction— made the debt service burden heavier and maintained at very high levels the transfer of resources for this purpose; d) Long delays in the provision of new financing agreed with the banks (particularly at times in which other sources of foreign exchange income were also affected, as was the case in 1985-1986) aggravated the financial difficulties and led to costlier domestic borrowing (Navarrete, 1988).

Along with the short-term adjustment, a longer-term process of structural reform was consistently pursued. It was implemented principally through the rationalization of protection and a gradual but relatively fast opening of the market; a more open attitude towards direct foreign investment; the reduction of the size of the public sector, through liquidation, merger or sale of non-essential public entities, and a sustained effort to modernize the country's industrial base and to enhance its productivity.

By their very nature, these structural reform policies were bound to produce results over the long term. It was expected that they would help to increase competitiveness in the economy and improve its overall efficiency. Towards 1987, it appeared that the trade policies were already producing positive results and that the impressive expansion of non-oil exports compared with previous years was, at least partially, a result of the improvement in competitiveness due to a more open market.

As 1987 drew to a close, it became evident that, despite the adjustment measures and the structural reform policy followed consistently over the previous five years, inflation remained the most pressing problem. Mexico's Central Bank summarized the situation as follows:

"In spite of the strengthened public finances, the depreciation of the exchange rate, the deterioration of the terms of trade with respect to the levels prevailing at the beginning of the eighties, the modest growth of financial savings and the lack of net external credit, made the control of inflation increasingly difficult, since the combination of all these forces enhanced inflationary expectations. This, coupled with a growing indexation of key prices in the economy, placed Mexico on the brink of hyperinflation and substantially limited the possibilities of success of the gradualistic stabilization approach. Under these circumstances, a new strategy to attack the roots of inflation and to break inflationary inertia became necessary. At this juncture, a concerted program based on coordinated and decreasing price adjustments was considered viable" (Banxico, 1989 a).

II

A "socially concerted" approach to stabilization policy

1. *First stage: the Economic Solidarity Pact, 1987-1988*³

Towards the end of 1987, controlling and reducing inflation became the top economic priority as well as the major social demand. The response came through a new programme concerted among labour and peasants' unions, employers' organizations and government representatives: the Economic Solidarity Pact. This was to be implemented in two phases: first, from mid-December to February, and second, starting in March, in successive monthly periods.

The implementation of the stabilization programme was preceded by a set of measures designed to increase its viability, to correct distortions in the existing price structure, and to allow time for the anti-inflation drive to gain momentum. This package included:

a) A 22% depreciation of the controlled exchange rate of the Mexican peso, to 2 198.5 to the US dollar, restoring a comfortable margin of undervaluation.

b) An increase in the prices of goods and services produced by the public sector, which had lagged behind inflation, to recover the lost ground, to realign major relative prices and to obtain a very significant and "front-loaded" increase in public sector income. Major price increases were: petrol, 85%; electricity 89%; fertilizers, 82%, and air fares, 26%.

c) An increase in domestic interest rates, by about 45 points, to reach a level close to 160% yearly, in order to "dry out" liquidity in the market and to continue attracting back flight capital.

d) A 38% increase in wages to partially restore the purchasing power lost as a result of inflation.

After implementing these measures, the authorities felt that the main preconditions for the success of a stabilization programme had

been fulfilled. These preconditions include very moderate public finance operational deficits, which could be financed by non-inflationary means; availability of external resources or very high international reserves, to support the implementation of the programme; close linkages between domestic and external prices; a competitive real exchange rate; absence of major distortions in relative prices; a sound current account position, and a widespread social desire to participate in the anti-inflationary campaign (Banxico, 1989 a).

The new programme combined elements of an orthodox or conventional demand-curbing approach with some heterodox elements. Among the former were measures to increase public sector revenues and to reduce public expenditures so as to strengthen public finances, and to curtail credit, in order to absorb excess liquidity and reduce aggregate demand. The latter elements included the commitment by all sectors of society to contain and bring down inflation, through a new socially concerted income policy approach. Additionally, through the accelerated opening-up of the economy, international competition would limit domestic price increases.

The measures specifically aimed to curb demand were related mainly to public expenditure and credit policy. A major reduction of public expenditure was envisaged for the first months of the year, with the aim of achieving a primary economic surplus of about 10% of GDP. Credit ceilings on banks were established for January and February 1988, equivalent to 90 and 85%, respectively, of the level of credit granted in December 1987. This amounted to a reduction in total credit of about 25% in real terms.

The socially concerted anti-inflationary programme for January and February 1988 included the following elements:

a) Minimum wages, prices of public-sector-produced goods and services, and prices of about 80 basic consumer-good items, included in the so-called "basic commodities basket", were to remain frozen.

³This section is based on Navarrete 1988 and updated with information from Banxico (1989) and Banxico (1989 b).

b) No authorization would be given to increase the prices of a wider range of products subject to the administered prices régime.

c) Restraint would be exercised in fixing other non-controlled private sector prices.

d) Interest and exchange rates would keep their flexibility.

The socially concerted anti-inflationary programme was formally agreed among the labour and entrepreneurial sectors and the government. The labour sector was represented by the major unions, both those of urban workers,⁴ and those of rural workers and small landholders.⁵ The management sector was represented by organizations of agricultural, industrial, commerce and services entrepreneurs.⁶ Finally, the Ministers of the Economic Cabinet participated on behalf of the government.⁷ The basic intention was to involve the most representative bodies of workers and employers in the process of concertation, to ensure wide acceptance and firm commitments to follow the agreed measures.

The initial set of corrective measures, implemented in mid-December 1987, brought about high inflation rates both in that month and in January 1988, with the consumer price index increasing by 14.8 and 15.5%. Interest rates reached very high nominal levels. For instance, the average annual rate of interest for the 28-day Treasury bills rose more than 30 percentage points, from 121.8% in December to 154.1% in January. The depreciation of the peso deepened in both months, with the exchange

rate reaching Mex\$2 281 to the US dollar at the end of February.

Then, as the results of the concerted stabilization programme started to be felt, inflation began to drop significantly during February (to 8.3%), allowing both interest and exchange rates to remain, on average, at levels similar to those of the previous month.

The second phase of the stabilization policy was launched in March, through the implementation of the concerted incomes policy agreed by the parties to the Economic Solidarity Pact.

Towards the end of February, labour, management and government representatives met to decide about the measures to be implemented in the following month. It was agreed:

- a) to extend the freeze of the prices of public sector goods and services and the prices of the "basic commodities basket" goods for a month;
- b) to maintain the administered prices;
- c) to increase minimum wages by 3%;
- d) to prevent this increase from being transferred to non-controlled prices;
- e) to keep the controlled exchange rate unchanged and to reduce interest rate levels *pari passu* with the lower inflationary expectations.

The results obtained in March were encouraging: the inflation rate, measured by the consumer price index, came down to 5.1% and, as a result, year-on-year inflation fell for the first time since very early in 1987. There was also a substantial unprecedented reduction in interest rate levels: the average yearly rate for 28-day Treasury bills fell from 151.4% at the end of February to 67.9% in the first week of April, reflecting sharply reduced inflationary expectations. As planned, the controlled exchange rate remained frozen, at the level of Mex\$2 282.00 to the US dollar, without noticeable pressures on the foreign exchange market.

The parties to the Pact met again towards the end of March and, this time, they decided to set measures and objectives for the following two months. The lengthening of the period was designed to preserve and widen the effect of the change of direction of the inflationary inertia, noticeable in the behaviour of prices in March,

⁴The Labour Congress, the Mexican Workers' Confederation, the Revolutionary Confederation of Workers and Peasants, and the Mexican Regional Labour Confederation.

⁵The National Peasant Confederation and the National Confederation of small Agricultural, Livestock and Forestry Landholders. Later, the National Confederation of Livestock Breeders also took part.

⁶The Entrepreneurial Co-ordinating Council, the Confederation of National Chambers of Commerce, Services and Tourism, the Confederation of Chambers of Industry, the Employers' Confederation of the Mexican Republic, the National Chamber of Processing Industries, the Mexican Businessmen's Council, the Mexican Association of Insurance Institutions, the National Agricultural and Livestock Council, the Mexican Association of Stockbroking Companies and the Mexico City National Chamber of Commerce.

⁷The Ministers of Labour and Social Welfare, Programming and Budget, Commerce and Industrial Development, Finance and Public Credit, Agriculture and Water Resources, and the Interior. The President of Mexico chaired the main concertation meetings.

and to provide a slightly longer horizon for short-term decisions.⁸

It was agreed that during April and May: a) official and controlled prices would not be increased; b) administered prices would remain unchanged; c) the utmost restraint would be applied in fixing the other private sector prices, which should not be increased, because labour and input costs had been largely stabilized and financial costs were decreasing fast; d) wages would be kept at the prevailing levels, and e) the controlled exchange rate would not be further depreciated and interest rate levels would continue to be adjusted to reflect the lower inflationary expectations.

The results of the implementation of the programme in April and May continued to be encouraging: inflation registered a further drop, larger than expected, moving down to 3.1% in April and to 1.9% in May. Continued stability of the exchange rate did not erode foreign exchange reserves in a significant way, and both interest rate levels and inflationary expectations continued to decline. The average yearly rate for 28-day Treasury bills in May was 50.7%: more than 100 points less than in February and more than 40 points less than two months earlier.

Encouraged by these results, the labour, management and government representatives agreed at the end of May to extend the programme, this time for a further three-month period (June-August). The main decisions were: a) to continue the freeze of the minimum and other wages, prices of public sector goods and services and prices of products included in the "basic commodities basket"; b) to continue denying authorization for increasing the administered prices; c) to apply certain price reductions, given the sharp fall in production costs accumulated over the previous three months; d) to maintain the controlled exchange rate unchanged at the level at which it had been frozen since the beginning of March (Mex\$2 281 to the US dollar), and e) to continue

reducing nominal interest rates, in line with the sharply reduced inflationary expectations.

The consumer price index increased by 2% in June, 1.7% in July and 0.9% in August. At the end of this three-month period, in August, the average yearly rate for 28-day Treasury bills stood at 41.3%: nearly 10 percentage points less than in May. The international reserves kept a healthy level, despite the freeze of the exchange rate.

The fifth round of concertation among labour, management and government representatives was held in mid-August and an agreement was reached to extend the programme for a further three-month period. Later, in mid-October, it was agreed to carry it over for an additional month until the end of the year, thus covering a four-month period. On this occasion, they not only ratified the by then already usual measures relating to immobility of the prices of public sector and "basic basket" goods and the wage and exchange rate freezes but also agreed on several additional measures:

a) Tax reductions aimed to benefit low-income consumers, such as the elimination of the 6% value-added tax on processed food and medicines and a 30% reduction of income-tax rates applicable to taxpayers earning no more than four times the legal minimum wage.

b) The lowering, by an average of 3% of the prices of goods not subject to control, particularly in the food and apparel sectors.

The behaviour of prices in this four-month period was uneven. In September and October, the consumer price index showed very moderate increases (0.6 and 0.8%), fully in line with the downward trend that had started with the inception of the stabilization programme at the beginning of the year. In November and December, however, the monthly increases were 1.3 and 2.1%. Similarly, the prices of the "basic commodities basket" items, which were formally frozen, actually went down in the first two months of the period (-1.1% in September and -0.5% in October), but increased by 1.3% in November and 1.7% in December. This behaviour, at odds with the objectives formally agreed upon, provoked intense debate: entrepreneurs were accused of not respecting the established commitments, and labour demands to end the wage freeze grew louder.

⁸ A political motivation was also involved: if the longer-period programming (say two months) should become the rule, there would be no need for a concertation round towards the end of June, just a week or so before the Presidential and Congressional elections.

Reflecting the evolution of prices, interest rates stopped falling as of September and increases were recorded. For instance, the average yearly rate for 28-day Treasury bills stood at 52.3% in December: 11 points higher than four months before. Additionally, significant erosion of the international reserves started to be felt: at the close of the year, their level was US\$6.6 billion: less than half the US\$15 billion reached at the end of 1987.

Looking at the situation at the end of 1988, it seems safe to argue that the stabilization programme succeeded in reversing the inflationary inertia. The factors that had pushed up inflation in previous years started to work in the other direction: by the end of the year, public sector prices had remained unchanged for a full 12-month period; the controlled exchange rate had been frozen for 10 months, without significant departures from the free-rate level; nominal interest rates had been dramatically reduced, although the real rates remained high and attractive; and public sector expenditure had been reduced and further adjusted in line with the diminished inflationary expectations. The target of less than 2% monthly inflation—originally envisaged for the end of the year—was achieved as early as May, and the monthly inflation rate averaged 1.1% in the third quarter and 1.4% in the last. Year-to-year inflation dropped from 159.2% in 1987 to 51.7% in 1988.

The general evolution of the economy in 1988 was largely determined by the successful implementation of the stabilization programme. Real economic growth was 1.1% (only 0.4 points less than in 1987), because the restrictive effects of the stabilization policy were partially offset by the increase of exports (especially non-oil products), the positive reaction of private investment (which augmented 10.1% in real terms) and the decrease in the prices of imported goods brought about by the trade liberalization measures.

2. The second stage: from stabilization to growth, 1989

The new Mexican administration which took office on December 1988 decided to continue the socially concerted approach to the stabilization

policy, taking advantage of the experience accumulated over the previous year.⁹

In mid-December, the representatives of labour, business and government decided on a new programme, the Pact for Stability and Economic Growth, and designed the policies to be followed over the first seven months of 1989. (Banxico, 1989 a and "Pact, 1989). The new programme was similar in design to the previous one, but it entailed important alterations. One, particularly noteworthy, was the lengthening of the period over which the agreed policy measures were to be implemented. The aim was to reduce the uncertainty generated by the shorter-term approach used in 1988 and to give the economic policy better overall direction.

The main objectives of the stabilization drive were also reviewed, stressing the need to consolidate price stability, to establish the basis for a gradual and firm economic recovery, to protect the purchasing power of salaries and employment levels, and to reduce the net transfer of resources abroad (basically linked to the external debt service).

To launch the new programme, several initial measures were adopted in relation to public sector prices, the exchange rate and wage levels.

a) Recognizing that the year-long freeze of public sector prices was eroding public revenue levels and that on the other hand a sharp, generalized adjustment would reignite inflation, it was agreed to adjust the prices of some goods and services, sold mainly to industrial and commercial enterprises, and maintain the freeze on those with the greatest incidence on consumer expenditure, such as gasoline, electricity and gas for domestic use.

b) As it was clear that the 10-month freeze of the rate of exchange was eroding the level of international reserves but that reaching inflation levels similar to those prevailing in

⁹As the new Pact for Stability and Economic Growth was being announced at the beginning of 1989, there was a strong feeling that, if the stabilization drive were to continue being successful, the only major restriction on restoring economic growth might well be the very heavy burden of debt service payments, which in 1988 reached US\$14.2 billion, equivalent to 43.6% of current account income and representing a net financial transfer abroad of 6.4% of the GDP.

Mexico's major trading partners would still take some time, it was agreed to depreciate by one peso daily the rate of exchange of the Mexican peso *vis-à-vis* the US dollar, between 1 January and 31 July 1989. Accordingly, the rate would move from Mex\$2 281 to Mex\$2 491 to the dollar. This preannounced devaluation of about 9% would dispel uncertainty about the exchange rate level, removing the fear of a major devaluation without pushing inflation up too much.

c) Since it was realized that the 10-month freeze of minimum wages had translated into a further reduction of real wage levels, it was agreed to increase the minimum wage level by 8% with the aim of avoiding further losses of purchasing power. This increase was deemed compatible with the stabilization objectives.

Other elements in the new programme, to be followed during the first seven months of 1989, were the following:

a) The representatives of business organizations agreed to recommend their members to absorb the wage increase, the adjustment in the exchange rate and the higher prices of public goods and services, without raising final prices to consumers.

b) However, in cases where the maintenance of steady prices despite increases in production costs would create shortages, price revision would be allowed. Moreover, the government announced a national programme of deregulation, aimed at removing barriers that generate unjustified upward pressures on the costs of private enterprises.

c) The government committed itself to follow a fiscal policy fully consistent with price stability and the gradual and sustained recovery of the economy.

d) The import tariff structure would be adjusted in order to reduce rate dispersion and eliminate distortions.

Additionally, the major tools of economic policy would be closely linked to the new stabilization programme. In this way, discipline in the management of the public finances would be strengthened. The overall aim for the year would be to achieve a drop of 5 percentage points in public sector borrowing requirements: from 12.3% of GDP in 1988 to 7% in 1989. Interest rate policy would be aimed at continuing to

provide investors with positive yields in real terms, in order to stimulate savings. However, it was foreseen that later in the year —after an adequate agreement on debt had been reached and as a result of the continued success of the stabilization policy— real interest rates would start to fall.

The new stabilization programme succeeded in keeping inflation under check in the first seven months of 1989, without provoking any serious shortages. The consumer price index registered an average monthly increase of 1.4% and the accumulated inflation in the seven-month period was 10%. The prices of the "basic household commodities basket" registered an average monthly increase of 0.8% and an accumulated increase of 5.4% over the seven-month period (Banxico, 1989 c and SRE, 1989).

Thus, the behaviour of both consumer prices and those of the basic basket over the period was fully consistent with the initial objective of keeping inflation below 20% for the year as a whole.

The inflation rate in January 1989 (2.4%) reflected the impact of the selective public sector price adjustment introduced at the beginning of the year.

The average rate in the following six months (1.3%), however, demonstrated that the impact of both the initial wage increase and the daily depreciation of the Mexican currency were absorbed without major inflationary implications.

After the increase observed in interest rates in the last few months of 1988, small fluctuations within a general downward trend were registered in the first seven months of 1989. The average yearly rate for 28-day Treasury bills stood at 47.0% in July 1989: the lowest level since October and more than 5 percentage points below the December level.

On 31 May 1989, the National Development Plan 1989-1994 was launched.¹⁰ The Plan's

¹⁰The Plan sets an economic growth target of 2.9 to 3.5% annually for 1989-1991 and of 5.3 to 6.0% yearly for 1992-1994. In 1983-1988, the annual rate of economic growth was 0.1% on average. Additionally, the Plan sets average annual growth rates for total investment of 6.3 to 7.3% in 1989-1991 and 8.8 to 9.7% in 1992-1994. In 1983-1988, investment averaged a negative annual growth rate of 4.4%. Accordingly, the rate of investment, which averaged 19.1% of the GDP in 1983-1988, should increase to

economic strategy has two main objectives: to reach an economic growth rate of about 6% yearly and to reduce inflation to levels similar to those prevailing in Mexico's major trading partners. To attain the latter objective, stabilization is seen not as a policy to be implemented only over a given period, but as a continuous endeavour. The socially concerted approach to stabilization, adopted both for the Economic Solidarity Pact in 1988 and for the Pact for Stability and Economic Growth in 1989-1990, is thus incorporated into the long-term development planning process.

In mid-June 1989 the labour, management and government representatives met to evaluate the implementation of the Pact for Stability and Economic Growth and decided to extend it for an eight-month period: from August 1989 until March 1990 (Pacto, 1989 a). Again, it was felt that a decision to keep in force the socially concerted approach to stabilization, adopted well in advance at the end of the concertation period and covering a longer new one, would help to consolidate the stabilization policy objectives, strengthen confidence in the future course of economic policy, discourage speculation and provide a firmer framework for investment decisions.

The new eight-month extension was based on a set of reciprocal commitments by the government, labour and business sectors, as well as on concrete policy measures. The main agreements were the following:

a) The public sector would keep its prices and rates unchanged.

b) The business sector committed itself to respect and not raise prices, as well as to provide sufficient and timely supplies.

c) Wages would be set through negotiations between the labour and management sectors. It was agreed to increase the minimum wage by 6%.

d) The daily one peso depreciation of the exchange rate would be continued until 31 March 1990, "without abandoning the aim of

stabilizing the exchange rate as soon as circumstances permit". For the end of the period, the rate would be Mex\$2 734 to the dollar: a devaluation of 9.8% over the eight months.

e) The strict discipline in public finances would be maintained in order to achieve the objectives established, particularly the primary surplus and the lowering of the PSBR.

On 23 July 1989, the President of Mexico announced to the Nation that agreement had been reached in principle with the banks regarding Mexico's external debt. This agreement followed those concluded earlier in the year with the International Monetary Fund, the World Bank and the Paris Club. Taken together, these agreements removed the major restriction for the resumption of economic growth, namely the inordinate amount of net transfers of resources abroad due to the external debt service. It was estimated that, once the agreements were in full operation, the net transfer of resources abroad would diminish from 6.4% of the country's GDP in 1988 to less than 3%.¹¹

¹¹In mid-April 1989 Mexico signed an Extended Facility Agreement with the IMF covering a period of three years and providing resources for 2.8 billion SDRs (US\$3.64 billion). It was agreed that up to 30% of these resources could be used to finance debt reduction operations. Additionally, Mexico obtained 433.5 million SDRs (US\$590 million) compensatory, financing loan. Agreement was reached with the World Bank on 18 May 1989 on a credit package of US\$1.96 billion. The package has four components, with US\$500 million being used to support Mexico's financial sector and its anti-inflationary strategy; a portion of these resources could be used for debt reduction operations. A second US\$500 million credit will support modernization of the industrial and commercial sectors; a third tranche of the same amount, will finance restructuring of the State-owned sector, and, finally, US\$ 460 million will be channelled to the construction of two hydroelectric projects. The agreement with the Paris Club, signed on 30 May 1989, allows for the rescheduling of US\$2.1 billion in principal and US\$ 500 million in interest of official and officially-guaranteed credits, due between June 1989 and June 1992, over a period of 10 years with a six-year grace period. Export credit financing will continue to be available for Mexico. The agreement with the banks' Advisory Committee foresees that the existing debt will be exchanged for new 30-year-maturity Mexican government bonds. It provides three options for the banks: either to accept new bonds with a face value 35% less than the nominal value of the old debt and carrying a market rate of interest, or to accept bonds with the same face value as the old debt but carrying a fixed, below-market interest rate of 6.25%. (Both the principal and some of the interest of the new bonds will be guaranteed by resources obtained by Mexico from the multilateral financial bodies and from the Government of Japan.) The third option allows the banks to provide new money over four years, starting in

22.7/23.1% in 1989-1991, and 25.6/26.0% in 1992-1994. According to the Plan, the net transfer of resources abroad, which averaged 6.1% of the GDP in 1983-1988, should decrease to 1.7/2.1% in 1989-1991 and further decrease to 1.5/1.7% in 1992-1994 (Mexico, Presidencia de la República, 1989).

Both in August and in September inflation stood at a monthly rate of only 1%, bringing the accumulated rate for the first nine months of the year to only 12% despite the wage increase and the continued depreciation of the Mexican peso.

A major factor in keeping inflation at bay was the substantial drop in interest rates. The average yearly rate for 28-day Treasury bills (used throughout this text as representative of interest rate movements) dropped by more than 12 percentage points in August compared with the previous month, to stand at 34.9%: the lowest level since 1982. It fell still further, to 34.2%, in September. It is clear that this substantial drop in interest rates was a direct result of the debt deal, which removed the main factor of uncertainty about Mexico's economic prospects.

In the last quarter of 1989 some warning lights started to blink. According to preliminary estimates, inflation in October amounted to 1.3%, in November it reached 2.1%, and in the first half of December prices rose by 1.8%, raising fears that an "inflationary bubble" was in the making, despite the continued implementation of the stabilization programme. Since October, interest rates rose moderately. The average yearly rate for 28-day Treasury bills moved up slightly, to 37.6%, in the first half of that month, and continued edging upwards, reaching 41.3% in early December. The news on the external front was not encouraging, as the rate of increase of manufactured exports declined and the current account deficit increased. On the public finances front, the additional expenditure brought about by the interest rate increases started to exert pressure, particularly after the nearly two-year freeze of prices of major public sector goods and services. All these factors stimulated an intense public debate, occupying ample spaces in the Mexican press, about the prospects of the stabilization programme and, particularly, about the

transition from the stage of socially concerted stabilization policies to an open and free play of market forces towards the early Spring of 1990.

Early in December, the labour, management and government representatives met again to evaluate the implementation of the stabilization programme. They decided to extend the implementation of the Pact, on the terms agreed in June 1989 and in force since August, for an additional period of four months, until the end of July 1990. In this way, the actual period of concertation, originally envisaged for eight months, would cover a full year. Addressing the session, the Mexican President stressed that the objective of the stabilization policy was "not to immobilize or freeze all prices, but to guarantee general price stability and to insure against increases not agreed to by the parties" ("Pacto, 1989 b).

Accordingly, two major modifications were introduced:

a) An increase averaging 5% was made in the prices of gasoline and other public sector goods and services such as electricity rates, in order to avoid further erosion of public revenues and a deterioration of the financial position of the public enterprises involved.

b) A 10% increase in the minimum wage was agreed upon, to be implemented as from 1 December, in order to maintain the objective of generally preventing further decreases of the workers' purchasing power.

In closing this analysis of the formulation and implementation of the stabilization policy in Mexico over the last two years, reference should be made to the mechanism established to oversee the policy's actual performance and to ensure that any adjustments needed were made in a timely manner. Ever since the inception of the Economic Solidarity Pact in December 1987, a system of permanent evaluation has been in place, with the parties to the concertation process —workers, businessmen and government representatives— forming part of a Follow-up and Evaluation Commission.

This body met regularly at least twice a month and held many extraordinary meetings. It heard views on the way in which the agreed measures were being applied and, particularly, it

1989, for an amount equivalent to 25% of the nominal value of the Mexican debt with each bank. The Mexican Finance Ministry envisages that the first option will allow for a permanent reduction of 35% in the value of the debt (in repaying its debt Mexico will cover only 65% of the original nominal value), and the second option provides for a reduction of about 40% in the annual debt service transfers, and the third one will provide additional resources on a multi-year basis (Salinas de Gortari, 1989 a).

heard complaints about violations of the agreed commitments. The Commission was empowered to adopt corrective measures and, even more, acted as a forum to constantly review the behaviour of the economic agents involved in the implementation of the stabilization policy. Both the government's spending policy and the private decisions on fixing prices were

closely scrutinized during the Commission meetings.

To co-operate in this process, state-level commissions were established in the 31 entities (provinces) of the country. These state-level commissions also met regularly and presented their findings and recommendations to the national Commission.

III

Looking into the future: the prospects for stabilization and growth in Mexico

At the close of the 1980s, the behaviour of the Mexican economy is reflecting the results of the stabilization effort maintained over the last two years. The primary aim of the stabilization policy to —bring down inflation and keep it low— has been largely achieved. It seems that the economic agents have abandoned the "inflationary frame of mind" in which they were trapped for several years. For 22 months, from November 1986 to August 1988, the year-to-year inflation rate stood at levels of three digits and the country was on the brink of hyperinflation. The socially concerted approach chosen to implement the stabilization policy showed that, as the Mexican President put it in his first annual report:

"Mexicans have rejected the option of living with high inflation. [They] found a strategic answer to this problem in the Pact. It has not been an easy or flattering answer, but it is working because we have been able to complement concerted social agreement with fiscal discipline" (Salinas de Gortari, 1989 b).

Information available so far is still insufficient and does not allow for a full balance of the relative contribution of each one of the three sectors involved in the stabilization policy. However, the following indications seem appropriate:

a) From 1982 to 1987, real wages, measured by deflating the nominal minimum wage with the consumer price index, decreased 35.4%. In

the 19-month period from January 1988 to September 1989, the minimum wage was increased on five occasions (as mentioned above) and, despite falling inflation, real wages deteriorated by a further 18.7%. However, there is a trend towards diminishing real wage erosion: all the recent purchasing power loss occurred in 1988, while from January to September 1989, real wages improved, although only very slightly: 1.2%.

It seems indisputable that wage restraint has been a major factor in the stabilization process and that the contribution of the labour sector to it has been of paramount importance.

b) During the first half of 1989, according to estimates included in the President's annual report, the public financial deficit declined by 60% in real terms, as compared with the deficit a year before. The primary balance —which does not include debt service payments— showed a surplus 31% larger in real terms than a year before. Public spending continued to be strictly controlled. To alleviate the impact of the stabilization policy on lower income groups, public expenditure allocation was oriented towards social priorities.

The prices of public sector goods and services, which were adjusted in December 1987 to lay the basis for the stabilization policy, remained unchanged for a full year. Then in December 1988, a selective increase was introduced, which did not apply to those of greatest incidence in consumers' expenditure, after which all remained unchanged for another

year. Only in December 1989 was an increase which averaged 5% introduced.

Consequently, the government contribution to the stabilization policy, both through financial discipline and direct restraint in fixing prices, has been a major one.

c) The reduction of the nominal levels of interest rates and, lately, a small reduction in real rates has contributed decisively to the lowering of inflation. However, through most of the period of implementation of the stabilization policy, real rates have been positive and, in some months, highly positive. The real yearly yield of major short-term saving instruments was between 21.9 and 28.3% at the close of 1988 and between 12.7 and 20.7% in September 1988 (SRE, 1989).

It is clear that interest income-earners are among those making the least sacrifice towards the stabilization objectives —to put it very mildly.

In more general terms, it seems that the major strategic decisions behind the success of Mexico's stabilization policy were the following:

a) The decision to put an end to the negative process of cumulative causation in which some elements of the traditional adjustment policies —particularly the management of interest and exchange rates and public sector prices— were perversely fueling inflation, although apparently they were contributing to the adjustment objectives by stimulating savings and exports, discouraging capital flight and avoiding the worsening of the public deficit.

This aspect of the Mexican experience is of paramount importance, as traditional adjustment recipes continue to be prescribed, without due regard to the specific situation in which those policies are to be applied.

b) The decision to launch a process of social concertation as the basic instrument to design, implement and oversee the stabilization policies.

A larger objective of the stabilization effort was, of course, to lay the basis for the resumption of economic growth. Here the initial results are also encouraging. It has already been noted that in 1988 the Mexican economy actually grew by 1.1%. In the first half of 1989, according to figures contained in the President's first annual report, Mexico's economy grew 2.4% in real

terms compared with the same period of the previous year. Accordingly, it is expected that economic growth in 1989 as a whole will be between 2.5% and 3%: well above the initial estimates of about 1.5% (Presidencia, 1989 d). For the first time since 1985 economic growth will be higher than the population growth rate, leaving room for improvement (albeit very slight) of the per capita product.

In assessing this situation, the Presidential report strikes a note of caution:

"We are resuming growth at a faster rate than expected and even at a faster pace than is desirable. We cannot force the rate of recovery, because the lack of investment in infrastructure during the years of the crisis would now lead to bottlenecks and inflationary pressures" (Salinas de Gortari, 1989 d).

Precisely this question —growth and stability— is now at the centre of the economic policy debate in Mexico: how to ensure a safe landing for the stabilization policy which took off two years ago.

There seems to be a growing consensus to the effect that, even after the Pact for Stability and Economic Growth concludes, at the end of July 1990 or at a later date, some sort of socially concerted approach to formulation and implementation of economic policy will be needed. The greater predictability of the behaviour of the different economic agents that this approach provides will be particularly important in a period in which uncertainty about other factors, specially in the external sector of the economy, is bound to increase.

However, if the socially concerted approach is to remain credible and generally acceptable, a fairer distribution of the costs and benefits than that prevailing so far is clearly needed. If the stabilization effort has been borne mainly by the labour sector, then the workers and peasants should benefit directly from the resumption of economic growth that the stabilization itself made possible.

Falling back into problems that seemed to have been overcome has not been alien to the Mexican experience in the last decades. At this juncture, it is essential to avoid this danger, which is clearly present in an over-precipitate

recovery. On the other hand, the prolongation of the years of economic stagnation or, even worse, the relapse into acute instability, is socially and politically unacceptable.

In the 1990s, Mexico needs a growing economy, matched with price stability and

sufficient employment generation; a dynamic society, in which inequalities are lessened; and an increasing capacity to respond to the expectations of its people in terms of political participation, standards of living, social advancement and cultural enrichment.

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