

The political economy of Mexico's dollarization debate

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Mexico, D. F., October 2006

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United Nations Publication
ISSN printed version: 1680-8800
ISSN online version 1684-0364

ISBN: 92-1-121617-6
LC/L.2623-P
LC/MEX/L.753
Sales N°: E.06.II.G.147
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Printed in United Nations, Mexico, D. F.

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Abstract

Between 1998 and 2002 Mexico was host to an intense debate over dollarization. This paper examines the conjunctural factors which led to the emergence of this debate, reviews the main participants in the debate and their arguments, and discusses why the debate ended. We further argue that the Mexican debate can best be understood not as one between rival ideological positions but between different, say, mainstream neoliberal positions. There is no mainstream consensus on the preferred form of the institutional governance of money. The Mexican debate on dollarization reflects this rather than simply the imperatives of global market pressures.

The political economy of Mexico's dollarization debate

“The unexpectedly wide debate provoked by the proposals in favour of a North American monetary union or the adoption of a currency board reflects, more than the actual soundness of their arguments, ideological dogma or the simple desperation of businessmen, bankers and even workers to find rapid remedies to cure the instability of the financial system and prices in the Mexican economy.” Ibarra and Moreno-Brid (2001: 16-17)

1. Overview of Mexican development

The attraction of silver meant that Mexico was incorporated into European imperial orbits during the sixteenth century. The brutality which accompanied Spanish colonialism also brought with it economic transformation and Moreno-Brid and Ros (2004:1) write that “by the end of the 18th century Mexico was probably one of the most prosperous regions [areas] in the world. It was surely one of the wealthiest Spanish colonies in America, with an economy whose productivity was possibly higher than that of Spain herself. Output per capita (in 1800) was around half that of the US, and Mexico’s economy was less agricultural, with an advanced mining industry and a significant manufacturing sector.”

From Mexican Independence in 1810, when Spanish rule was overthrown, to the Mexican Revolution in 1911, however, Mexico's relative position declined significantly. During this century, Mexico was frequently buffeted by internal and external political pressures and by numerous changes in economic policy and orientation.

Independence was accompanied by an economic slump as silver production fell. There were attempts to stimulate other parts of industry with, for example, a government run bank financing the development of cotton-spinning industries in the early 1830s. (Bazant, 1991: 13). The bank's funding came from protectionist tariffs. (ibid). These efforts at industrialization were, however, insufficient to stimulate an economy ravaged by continued internal and external instability. Texas declared independence in 1836 and joined the U.S. in 1845. Further Treaties after wars with the U.S. meant that by 1867, Mexico's northern border was moved southwards to the extent that Mexico had lost half of its territory (although less than two per cent of its population). (Bazant, 1991: 22).

Civil war, continued interventions by European imperial powers, periodic capital flight and ambiguous relations with the U.S. continued to plague 19th century Mexico. Among the causes of conflict with the U.S. was the Mexican government's decision in the 1870s to establish a ten mile duty free zone along the border with the U.S. in order to encourage settlement. (Katz, 1991: 68). But relations were ambiguous. In the 1870s, highly favourable concessions were also given to U.S. (and European) companies to provide incentives for FDI into the oil and railway sectors (Katz, 1991: 69-70). This included subsidies to railway construction which amounted to a half of their total costs (Moreno-Brid and Ros 2004: 9). This contributed to producing an economic boom in the last decade and a half of the century as annual GNP growth rates averaged 8 per cent and the exports as a percentage of GDP tripled. (Katz, 1991: 74 and Moreno-Brid and Ros 2004: 9).

The inequalities, regional and class, which the economic boom generated together with the end of that boom in the early 1900s provided the economic backdrop to the Mexican Revolution of 1910-11. The Revolution sought to establish a more egalitarian development path although the extent to which it was successful in this has been questioned by economic historians. Womack (1991: 200) argues that the struggles of the Revolution led to the consolidation in power of a regional faction (from the north-west) of the bourgeoisie. What followed, he concludes was "a long series of reforms from above, to evade, divide, diminish and restrain threats to Mexican sovereignty and capitalism from abroad and from below."

Post-Revolution Mexico therefore can be seen as a state, long penetrated by international capital, attempting to construct a nationalist, soft authoritarian form of capitalism. It was inevitably a path full of contradictions, not the least of which were in the economic relations with foreign capital and with the powerful neighbor to the North. Mexico continued to be a producer of raw materials primarily for the U.S. market. Mexico became the world's second largest oil producer in the early 1920s although by the end the decade oil production had fallen and Mexico had been overtaken as a producer by Venezuela (Meyer, 1991: 226). In 1930, as in 1900, the trade to GDP ratio was 20 per cent although the U.S. accounted for an increasing share of this trade over the period; by 1930 the U.S. accounted for 70 per cent of Mexico's imports and 80 per cent of the exports. (Meyer, 1991: 221). The Revolution had not immediately changed the pattern of export-led development. (Knight, 1991: 241).

Mexico did, however, change track in the late 1930s and in the post-1945 years. Underpinning this change was the formation of the Partido Nacional Revolucionario (PNR) in 1929 eventually renamed the Partido Revolucionario Institucional (PRI) in 1946, a party which brought political stability to Mexico through its hegemonic control. (See Moreno-Brid and Ros, 2004: 12). The state began to play a larger role, signaled by the nationalization of the oil companies in 1938. Compensation was eventually agreed with the U.S. for the expropriation of U.S. oil companies' assets in 1941, an agreement which included the provision of credit by the U.S. for support of the

peso. (Knight, 1991: 286). Agrarian reform and import substitution policies supported by protectionism became other central parts of government policy.

Knight argues (1991: 324-25) that “by some standards Mexico’s import substitution policies met with resounding success. Between 1940 and 1960 the GDP grew ... [at] an average annual [rate] of 6,4 per cent. ... By the late 1970s manufacturing represented nearly one-quarter of the GDP and ... the industrial sector as a whole accounted for 38,5 per cent of national output. It was this performance that came to be known as the ‘Mexican miracle’, an exemplary combination of economic progress and political stability in an area of the developing world.” According to Moreno-Brid and Ros (2004: 14) nothing less than “a complete overhaul the economy and society took place from 1940 to 1980”.

The ‘miracle’ was, however, soon to end. The import-substitution strategy had been expensive to foster and overseas borrowing had risen substantially as a result. In 1976 capital flight and balance of payments pressures led to a nearly 100 per cent depreciation of the peso. (Moreno-Brid and Ros 2004: 17). This appeared as but a temporary setback when Mexico’s own oil reserves were announced. Thus, the higher oil prices caused by OPEC action in 1979 encouraged further borrowing but, when the world economy went into recession in the early 1980s, Mexico’s crash came. In 1982, Mexico found itself with an inflation rate of 100 per cent, a huge government deficit (equal to 18 per cent of GDP), a plummeting currency, and inability to pay its international debts. (See Smith, 1991: 380-383). This was met with a “very orthodox, stabilization-first strategy” (Moreno-Brid and Ros 2004: 19) but within four years, Mexico was hit by the oil price shock of 1986 which “dramatically cut off a major part of the country’s main source of foreign exchange and fiscal revenues.” (ibid: 19)

The response adopted to the instability and crises of the 1980s involved another policy shift, this time to a more radical neoliberalism and a return to an export-led strategy, culminating in Mexico’s entry into NAFTA in 1994. The effects of this are briefly reviewed in section 3 below.

2. Brief history of exchange rate regimes and monetary institutions

During the 1870s, which many regard as a previous wave of globalization, Mexico did not adopt a currency board as some colonies did or follow the move to join the Gold Standard as many of the core imperial states did. Instead, Mexico remained on the silver standard a decision which resulted in a 26 per cent real depreciation of the peso during the 1890s and contributed to the export boom of the period. (Moreno-Brid and Ros 2004: 9)

With the Mexican Revolution came a new period of state-building which included the creation of the central bank in 1935. The Bank operated as a part of the hegemonic state apparatus put in place by the PRI during the import-substituting strategy of economic development which lasted until the debt crisis of the early 1980s. The Bank was granted formal independence 1994.

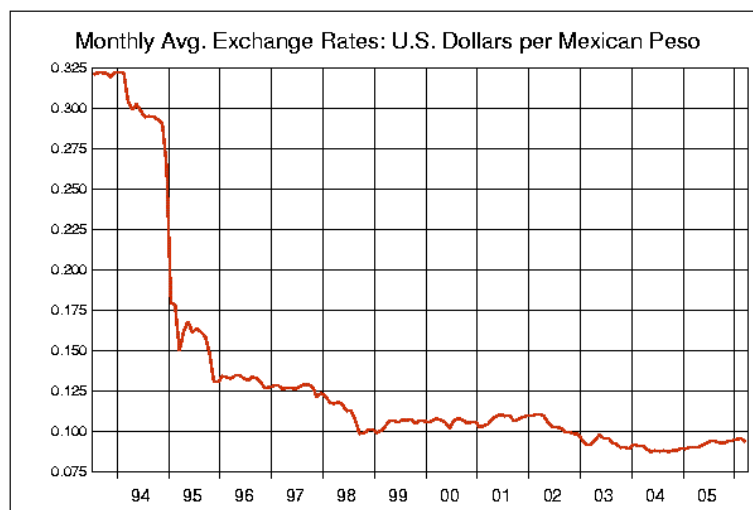
During the first five decades of its existence the Bank of Mexico was charged with maintaining a fixed exchange rate, a role that it played with a large measure of success. However, this was first challenged in 1967 and for the last three decades Mexico has switched exchange rate regimes several times. The exchange rate crisis in 1976 resulted in the devaluation of the peso; from its fixed level of 0,0125 pesos to the US dollar, the peso fell to 0,0226 to the US dollar between August 1976 and April 1977. The devaluation of the peso, dramatic though it was at the time, merely marked the beginning of a continuous decline in the nominal exchange rate punctuated with a series of dramatic collapses.

The next dramatic collapse came in 1982 when Mexico, as discussed above, was forced to renege on its international debt repayments. The currency crisis saw the nominal exchange rate collapse from 0,0264 pesos to the US dollar in January 1982 to 0,1181 pesos to the US dollar in July 1983. Exchange controls were briefly reintroduced and a fixed rate was restored. However, in 1986 the exchange rate was under attack again and the peso fell from 0,5989 to 1,017 to the US dollar.¹

In response to these currency collapses, Mexico adopted a number of different regimes in an effort to provide an anchor for the control of inflation. Edwards (1997: 8) describes the next period as follows: “between 1988 and 1994 Mexico modified its exchange rate system several times, moving first from a completely fixed rate to a system based on a preannounced rate of devaluation – with the actual devaluation set below the ongoing rate of inflation – and then to an exchange rate band with a sliding ceiling....Until October 1993 ... the actual peso/dollar rate was extremely stable, remaining in the lower half of the band.”

In 1990 Mexico signed on to the Brady debt reduction plan and entry into NAFTA was being negotiated. There appeared to be the prospect of some stability but this proved to be elusive as again the currency crashed. Mexico found itself embroiled in yet another currency crisis, the so-called Tequila crisis in 1994, in which the crawling band had ultimately to be abandoned, the peso devalued by 50 per cent as shown below in Figure 1. The real costs to the economy were also high as GDP fell by 6 per cent and the financial system was left in ruins.

Figure 1
US DOLLAR/PESO EXCHANGE RATE JULY 1993-MARCH 2006



Source: Pacific Exchange Rate Service, University of British Columbia

Since this crisis, Mexico has not attempted to go back to a fixed exchange regime but has moved to an increasingly free float. With inflation falling to single digits, the nominal exchange rate entered a period of stability from 1999 onwards as shown in Figure 6.1. The financial system has been repaired (and privatized) while the reputation of the Bank of Mexico as an overseer of the monetary affairs of the country has been to a significant degree reclaimed. As an indicator of this, Mexico issued 20 year bonds in 2003; in 1995 the maximum maturity was one year dollar-denominated *Tesobonos*. In 1995 two-thirds of Mexican debt was held by foreigners; by 2006 this

¹ Data from the Bank of Mexico.

had fallen to 40 per cent with Mexican national holding 60 per cent of net public sector debt. (See Fisher 2006).

The major periods in Mexico's exchange rate regimes are summarized below in Table 1.

Table 1
EXCHANGE RATE REGIMES IN MEXICO: 1931-2006

1931- 1934	Fixed versus the US dollar, periodically adjusted.
1935- March 30, 1938	Fixed.
March 31 1938 to Feb 2, 1939	Free floating as the Bank of Mexico announced (march 31, 1938) the suspension of the free convertibility of the peso with gold or foreign exchange.
Feb 3, 1939-1976	Fixed versus US Dollar, adjusted periodically.
1976 – 1982	Floating versus US Dollar.
Sept. 1982 – 1983	Full exchange rate controls Two rates: i) a, so called, controlled one for selected banking/debt operations, ii) a free one for the rest of transactions.
1983 – 1987	Fixed with devaluations.
1987-1994	Pre-announced crawling peg, aimed at controlling inflation.
1995- Present	Floating.

Source: Arturo Guillén (2004), México: Régimen cambiario e integración en el marco del tratado de libre comercio de América del Norte., and Rene Villareal (1981), El desequilibrio externo en la industrialización de México (1929-1975), Fondo de Cultura Económica, México.

3. Summary of recent trends and policies²

The policy shift to trade liberalization and the downsizing of the public sector in the 1980s, following the debt crisis of 1982 drew upon structures put in place decades earlier. Maquiladoras, for example, owed their origin to policies developed in the 1960s (Harris, 1993: 162). Its growth was inversely related to the level of the peso but by the late 1980s this sector accounted for 25 per cent of Mexico's manufactured exports. (Harris, 1993: 162). Most of this came from U.S. companies attracted to Mexico by the duty-free incentives and low labour costs. Although there were, therefore, some strong roots on which to base the new strategy it is clear that a policy change did take place. As Harris (1993: 158) has written, most of the maquiladora growth prior to the mid-1980s "took place almost by default and without substantial government stimulation. Successive administrations emphasized issues of economic independence, rather than interdependence, and industrialization to supply the domestic market rather than external demand." This interpretation is supported by Moreno-Brid and Ros (2004: 23) who argue that "current trends in the trade *pattern* and industrial *structure* are largely an extrapolation of the past."

In terms of trade volumes and the policy environment, however, there have been large changes. From the mid-1980s onwards the PRI government abandoned its protectionist policies and had turned to neoliberalism as the solution to Mexico's economic ills. Mexico joined GATT in 1986 and, adopting the array of policies recommended by the Washington Consensus, introduced a program of rapid trade liberalisation, privatisation and deregulation. By 1990 Mexico had become one the world's most open developing countries. Entry into NAFTA on January 1, 1994 cemented the neoliberal policy reforms, an explicit objective followed by the Salinas government (1988-1994)

² This section draws upon Moreno-Brid, Santamaría and Valdivia (2005) and Moreno-Brid, Nápoles and Valdivia (2005). Data are from these sources unless otherwise indicated.

which argued that NAFTA would impose international legal and extra-legal constraints that would deter any attempt by subsequent governments in Mexico to return to trade protectionism.

The main economic debates in Mexico over the past decade have centred around whether the experience of NAFTA has been positive or negative for Mexico. The positive argument rests on Mexico's performance since NAFTA having been marked by small budget deficits, low inflation, and a surge in non-oil exports and foreign FDI. Mexico's exports, and the volumes going to the U.S. have surged as indicated in below in Table 2.

Table 2
MEXICO'S EXPORTS 1985-2005: TOTAL AND U.S. SHARE

Year	Total exports (US\$ millions)	Exports to U.S. (US\$ millions)	U.S. share of exports (per cent)
1985	22 105	8 954	40,5
1986	16 120	7 574	47,0
1987	20 526	8 252	40,2
1988	20 765	12 102	58,3
1989	22 975	15 553	67,7
1990	26 838	18 418	68,6
1991	42 688	33 912	79,4
1992	46 196	37 420	81,0
1993	51 886	43 068	83,0
1994	60 882	51 855	85,2
1995	79 542	66 336	83,4
1996	96 000	80 541	83,9
1997	110 431	94 379	85,5
1998	117 539	103 002	87,6
1999	136 362	120 262	88,2
2000	166 121	147 400	88,7
2001	158 780	140 564	88,5
2002	161 046	141 898	88,1
2003	164 766	144 293	87,6
2004	187 999	164 522	87,5
2005	213 711	183 052	85,7

Source: 1985 to 1989: The Mexican Handbook: Economic and Demographic Maps and Statistics, 1994; 1990-2005: INEGI. <http://dgcnesyp.inegi.gob.mx/cgi-win/bdieintsi.exe/NIVJ10#ARBOL>.

While oil revenues have decreased from around a quarter of total exports in the early 1990s to half of that level, manufactured exports have taken an increasing share of exports. Manufactured exports now account for 85 per cent of total exports with over a half of these coming from the maquiladora sector. The bulk of Mexico's non-oil exports originates in no more than 300 businesses, most of them linked to MNCs. This has facilitated a rapid increase in intra-industry trade as firms have specialized production across the U.S. – Mexico border. Fiess (2004: 16) reports that “according to Bruehlhart and Thorpe (2001), between 1980 and 1998, the unadjusted Grubel-Lloyd index (3-digit SITC level) for manufacturing products between the US and Mexico grew from 0,36 to 0,61. Mexico's dramatic shift in intra-industry trade with the US is predominantly explained by increased vertical intra-industry trade in textiles and apparel, and auto industries.”

This export growth has resulted in Mexico being among the top ten countries in terms of increasing its share in the world (non-oil) market. Indeed, in the period 1994–2001 (the most recent year from which comparative data is available) Mexico was second only to China in increasing its share of world manufactured exports.

With respect to FDI, performance requirements for foreign investors were progressively removed and by 1993 91 per cent of branches of economic activity had been opened to majority participation by foreign investors. Measured as a percentage of Mexico's GDP, FDI registered an impressive growth since the early 1990s, increasing from levels close to 2 per cent to its peak of 4 per cent in 2001. Nevertheless, it never reached the relative proportions achieved by Chile. Moreover, it has stagnated in the aftermath of the Asian crisis.

While these trends are used by supporters of Mexico's recent policy, as encapsulated by NAFTA, other trends are highlighted by those who view Mexico's path as have a negative effect on Mexican development. Thus, economic growth has been disappointing with GDP growing at a rate significantly below its historical average and insufficient to generate the number of jobs required by the country's expanding labour force. Investment rates have been below the level required to produce the 5 per cent annual level of growth needed to provide full employment.

While manufacturing sector jobs have increased, there has been a net job loss in the economy as the agricultural sector has shed over a million jobs. The result has been the increase in the informal economy and in emigration to the U.S. which has reached record levels. Indeed, Cypher and Delgado Wise (2006) describe Mexico's economy as one now best described as a "labour export-led" model. They argue that to the emigration must be added the export of labour through the maquiladora sector and through the "disguised maquiladora sector" where the latter refers to domestic firms which use maquiladora produced inputs in their exports. "In all three instances", they write (2006: 2), "Mexico is not really exporting goods because the only Mexican-made value/input in this complex transnational process is (with only minor exception) cheap labour." As a result, they conclude that Mexico's new strategy is nothing less than the subordination of the economy to the demands of the U.S. economy has not lead to high growth.

The net result has been that instead of closing the real per capita GDP gap with the U.S., it has widened. In the late 1980s, Mexico managed to begin to reduce this gap but this improvement was short-lived as the economic crisis of 1995 widened it once more. Since then there has been little change and the current GDP per capita difference between the U.S. and Mexico is comparable to its level in the 1950s.

4. The contemporary currency debate

While Mexican policies have, as illustrated, undergone considerable change over the past sixty years, traditionally, the topic of formal dollarization was never included as part of the discussions of Mexican economic policies. However, this dramatically changed in the late 1990s when dollarization became the subject of an intense debate. Local and foreign academics, policy advisers, editorialists, high placed government officers as well as prominent CEO's of Mexican industrial and financial firms intervened in heated discussions on this matter. Indeed, in 1998–1999 the speculation on dollarization acquired such intensity that the President – Mr. Ernesto Zedillo - formally stated that Mexico would continue now and in the future with its traditional exchange rate policy based on a monitored float of the peso against the US dollar.

Why was dollarization begun to be seen as a practical and perhaps commendable option for Mexico? A key element behind the sudden interest in it was the by then rather successful price stabilization performance of the Argentinean economy under its currency board. Moreover, the adoption of the Euro as a common currency for various countries in Europe on January 1, 1999 was

another factor that helped to fuel this debate. And finally, as various analysts and businessmen argued, after more than ten year of drastic macroeconomic reforms to size down the State, Mexico should proceed towards a monetary integration with the United States. Such monetary integration would limit even more the degree of intervention of the State in the Mexican economy by eliminating its capacity to alter the foreign exchange rate market. It was also an opportune moment as Mexico was coming to an end, in 2000, of a Presidential term and electoral cycles had led to previous currency crises; dollarization might offer the opportunity to prevent another episode.

In any case, in 1998–2000 the Mexican press was swamped with articles examining the pros and cons of dollarization. On the one hand, and in brief, its advocates argued that the adoption of the US dollar as the local currency would be a necessary and logical step for Mexico after NAFTA. They saw dollarization as a way to strengthen Mexico's preferential position in trade and investment with the United States. They argued that, given the vast proportion of domestic financial assets and liabilities already denominated in dollars, formal dollarization would merely give legal recognition to the *de facto* highly dollarized status of the Mexican economy. Finally, they saw in it a guarantee for long-run price stability given that it would ensure prudent conduction of monetary and fiscal policies. Though they admitted that in principle a floating exchange rate regime may be useful for developing countries, they pointed out that in practice it was inadequate for Mexico given the traditional lack of a credible commitment from its monetary authorities to maintain price stability. Supporters of this measure did differ on their considerations of the time horizon to move forward with dollarization. The more radical ones believed that the sooner the better. More moderate supporters considered that Mexico needed to carry out a number of economic reforms before implementing dollarization. They estimated that, in practice dollarization in Mexico would not be a reality before at least a decade.

On the other hand, its critics argued that dollarization would hinder Mexico's economic development. Its actual costs in terms of bringing about an increased vulnerability to external shocks would far outweigh its potential benefits on reducing the rate of inflation. The main costs that they identified included the elimination of the possibility of implementing an independent monetary and exchange rate policy, as well as the loss of fiscal revenues associated with seignorage. In addition, they said that given that the Bank of Mexico would not be able to act as a lender of last resort, under dollarization Mexico would be prone to more frequent and deeper banking and financial crises. And, due to country risk factors, real interest rates would fail to come down to the United States levels.

One of the first indications that dollarization was becoming a relevant topic for debate in Mexico occurred in September 1998, when the Centro de Estudios Económicos del Sector Privado (CEESP) –a major think tank of the private sector- published a report with a formal proposal to adopt the US Dollar as Mexico's currency.³ But in fact, the Mexican government had already started to examine the merits and drawbacks of dollarization.⁴ As J. Friedlander reported in September:

“During the past few weeks, Finance Minister Jose Angel Gurría and Central Bank Governor Guillermo Ortiz have instructed their technical teams to study how the dollar-linked currencies of Argentina and Hong Kong are faring amid the global economic turmoil. Finance-ministry and central-bank officials have held meetings with private economists and columnists here to discuss the pros and cons of tying the peso to the dollar as a first step to monetary integration with the U.S.”⁵

In October that same year Mr. Alfonso Romo, CEO of PULSAR a major holding group, gave a public lecture in Monterrey stressing Mexico's need to join a Monetary Union with the US.

³ CEESP, 1998, *Propuesta de Adopción en México de un Nuevo Régimen Monetario*, Mexico.

⁴ Granados Chapa, Miguel Ángel, (1999), Plaza Pública / Dolarización, Reforma, March 15.

⁵ Friedland, Jonathan (1998), Mexicans Quietly Mull Tying Peso To Dollar, The Wall Street Journal, September 28.

Perhaps the moment when pressure for dollarization reached its peak was in March 1999, when the Mexican Council of Businessmen (CMHN) in their annual meeting with the President explicitly made the central point of their presentation to stress that dollarization should be soon implemented in Mexico. The CMHN is the voice of the Mexican entrepreneurial elite, its membership limited to the 50 most powerful business leaders, and a membership only joined by invitation of the existing members.⁶ Mr. Carlos Peralta, CEO of IUSA telecommunications holding group, was among the various businessmen that backed the Mexican Council of Businessmen's President Clariond's plea for a fully dollarized system. Clariond argued that "sustaining a currency like Mexico's has an enormous cost. Living with its fluctuations is a luxury we can no longer afford" concluding that dollarization would "spur growth, reduce inflation, and lower interest rates on government expenses." (quoted in Boardman 2000). Pro-business politicians, such as Senator Arturo Nava of the National Action Party (PAN) also supported the proposal for dollarization on the grounds that "the Mexican economy has already been dollarized due to the frequent use of the U.S. currency in business transactions." (quoted in Boardman 2000). Some of the top businessmen, however, like Mr. Carlos Gómez y Gómez, President of the Mexican Bankers Association, did not fully sympathize with the proposal of a rush towards dollarization and recommended instead a gradual approach to its implementation so it could be fully operational in the medium-run. Furthermore, while the elite association, the Mexican Council of Businessmen, supported dollarization, other business associations reached no consensus on the issue with the sectoral interests of different firms explaining differing degrees of support. (See Auerbach and Flores-Quiroga 2003: 276)

The business community's support for dollarization also found some resonance among the general public. Boardman (2000) reports that "a poll by *El Economista* newspaper in May 1999 estimated that 86% of Mexicans would like to open up bank accounts in dollars and see dollars move freely in the economy." However, the same poll also revealed that, while wanting greater access to dollars, Mexicans did not want to give up their national currency which they viewed as an important symbol of sovereignty and national identity (ibid).

President Zedillo, as well as the Finance Minister and the Governor of the Bank of Mexico rejected the idea of dollarization. They soon issued formal statements backing Mexico's floating exchange rate regime and saying that there will be no change in this policy in the future. Succinctly they stated that dollarization was not and will not be implemented in Mexico. The main reason given for this policy stance by Zedillo was that "the free-floating exchange regime has allowed us to buffer the effects of international financial volatility even in the most critical moments, and has allowed us to protect our international reserves." (quoted in Boardman 2000). An important element to take into account too, is that a few weeks before -on February 23- Mr. Alan Greenspan voiced his frank opposition to a formal dollarization in Mexico. He declared that the United States had no intention or interest whatsoever in having the Federal Reserve becoming the central bank for the region. And said that the decisions of the Fed on policy matters are and will be taken in regards to the objectives of the United States and not of other nations. The position of the Fed became a part of the Mexican debate as well. Some influential business, such as billionaire Carlos Slim, chairman of Teléfonos de México, aligned themselves with President Zedillo in opposition to dollarization, notwithstanding the position taken the Mexican Council of Businessmen. He argued that "the way you have to stop inflation is by cleaning up your financial house. Besides, the idea that the Federal Reserve would want to take responsibility for our financial system is absurd."

At that time, most economic analysts and independent consultants in Mexico backed dollarization but only as a long-term policy objective. Among the most well known Mexican analysts holding this view were Mr. Jonathan Heath, Mr. Manuel Sánchez González (of GEA consultants) and Mr. Enrique Quintana, chief editor of economic affairs of the newspaper REFORMA. For example, the latter wrote in early 1999 that a common currency for North America

⁶ The membership has now been reduced to only 30 members.

was unavoidable in the long run, but should be rejected as a short run course of action. As he claimed, Mexico had institutional weaknesses that needed to be corrected way before implementing a formal dollarization program. He identified two main weaknesses: the fragility of its banking system, and the inadequacy of the financial regulatory framework.⁷ As he said, these weaknesses had been dramatically exposed by the tequila crisis in 1994–1995, that led to the virtual collapse of numerous domestic banks. Some analysts strongly argued for a rejection of dollarization as an alternative for Mexico. As an example, Mr Rogelio Ramírez de la O, in 2006 the top economic adviser of Mr López Obrador the PRD candidate to the Presidential election of July 2006, argued that given the likely asymmetry of oil-related external shocks on Mexico and the US economies, Mexico needed an independent exchange rate policy. Many of the economists at UNAM and other public universities shared this view.

The international academia was perhaps more evenly split on this issue regarding the Mexican case. Among the international experts that voiced their full support for dollarization in Mexico, not surprisingly, was Steven Hanke. Writing in 1999, he forecast that the benefits of dollarization were so evident and significant that the PRI (then Mexico's ruling party) would implement it in the very near future. He added that and as a consequence the PRI would win the Presidential elections of July 2, 2000! Both predictions were incorrect. With less optimism than Hanke, other academics of wide international recognition declared their open support for the idea that Mexico should -rather sooner than later- embark on a full dollarization process. The list included, inter alia, Rudiger Dornbush, Ricardo Hausman, and Gary Becker (Nobel prize winner 1992).

A more cautious approach was suggested by others. Albert Fishlow explicitly declared that dollarization should be implemented in Mexico but no sooner than a decade. Robert Mundell (Nobel prize winner) rejected the idea that Mexico should dollarize in the short run. He considered instead that Mexico should first adopt a currency board.

Many other international experts were highly critical of dollarization as a policy for Mexico, both in the short or in the long run. For example, Paul Krugman pointed out in 1999 that dollarization could be harmful for Mexico unless the Fed accepted to act as a lender of last resort for Mexico -and the USA- with full and active participation of Mexico in its decisions. José Antonio Ocampo, at the time ECLAC Executive Secretary, stated that dollarization could perhaps be an alternative for small economies in Central America, but not for Mexico. (06 April 1999). For Jeffrey Sachs and Felipe Larraín, dollarization is applicable only to cases of extreme market instability but a flexible exchange rate policy vis-à-vis the US dollar is much more prudent and preferable for the vast majority of developing countries, and certainly for Mexico.

The debate in Mexico did continue for some time up until 2000, but was always met by the strong rejection from President Ernesto Zedillo, from Mr. Guillermo Ortiz, Governor of the Central Bank, and even from the Finance Minister. In our view, the debate on dollarization in Mexico rather than being settled by analytical arguments simply faded away as a consequence of key events in the evolution of the Mexican as well as the Latin American economies. In fact, during the campaign for the Presidential elections held on July 2, 2000, no candidate included dollarization as an element of their economic programs. Mr. Vicente Fox, who won the elections and is currently Mexico's President (2000-06), had as a key element of his economic platform the proposal that the government should commit to maintain a real exchange rate that helps the competitiveness of Mexican producers in international markets. A position that could not be in more dramatic contrast with dollarization (and, to a large degree, in contrast with the subsequent path actually taken by the peso)! International academic economists, such as the Inter-American Development Bank's Chief Economist Ricardo Hausman, was still publicly advocating in 2001, even predicting, that Mexico

⁷ Quintana, E. (1999), *Coordenadas/Más allá de la dolarización*, *Reforma*, February 23.

along with Brazil would soon set up currency boards but, for all intents and purposes, the debate had fizzled out in Mexico then.⁸

What are the reasons that the debate on dollarization ended “not with a bang with a whimper”. First of all, from 1996 up until 2003, there has been a gradual but systematic appreciation of the real exchange rate of the peso vis-a vis the US dollar. This appreciation toned down the enthusiasm for the supporters of dollarization. Moreover, the voices of pro-dollarization were gradually replaced by complaints key manufacturing organizations arguing that the real appreciation of the exchange rate had to be soon reversed as it was weakening Mexican producers in the international markets and against imports. This view has been strengthened by the increasing concern among policymakers in Mexico as well as among businessmen and civil society that although Mexico has made substantial progress against inflation, its economic growth performance has been extreme laggard. In addition, the support for dollarization on behalf of the Association of Mexican Bankers ended up as soon as their banks were taken over or bought by foreign banks. The economic collapse and banking crisis of Argentina was a severe blow to the supporters of dollarization, (or of any form of fixed exchange rate regime) not only in Mexico but all over the continent. And finally, the aftermath of September 11, 1999 brought about a substantial decline of Mexico’s place in the United States political and economic agenda. Given this separation, it has been very difficult for supporters of dollarization to argue that transferring the decision of monetary policy from the Mexican government to the Federal Reserve would be in the nation’s best interests.

In synthesis, and with the benefit of hindsight, it seems fair to say that the debate on dollarization in Mexico never reached a scale of social or political relevance. It remained rather circumscribed to the press and the academia. Dollarization was an issue strongly supported by a rather small –though powerful- group of entrepreneurs; and this support lasted for a limited time. The Mexican economy has been marked in the last six years 2000-06 by a combination of one-digit inflation, slow economic growth and widely insufficient employment opportunities, and strictly constrained credit for production and investment purposes. Not surprisingly, given this context, the attention of political and economic analysts has shifted to other matters, far removed from dollarization.

5. Analyzing the debate

The timing of the Mexican debate was influenced by two key developments elsewhere: the impending birth of the euro and the increasing consideration given to dollarization by Argentina following its (at the time and in its own terms) successful experience with a currency board. The influence of developments elsewhere, external to the dynamics of the Mexican economy itself, were therefore critical in stimulating the debate. The terms of the debate were also influenced by these developments and used as reference points.

The terms of the debate also resonate with several of the approaches to globalization. Globalization as a process which strengthens international financial markets and reduces the policy autonomy of nation states was clearly in evidence. Mexico’s turbulent experience with exchange rate crises go back until at least the mid-1970s and includes subsequent crises in 1982, 1986 and 1994. The earlier crises were largely attributed to the influence external shocks such as changes in global growth and oil price shocks. As such, they resembled shocks which affected other countries during these time periods (in Latin America and elsewhere as the ‘sterling crises’ demonstrate) and are therefore not closely linked to the more recent phenomenon of ‘globalization’. The 1994 crises, however, has been interpreted in this way. Kessler (2000: 43), for example, argues that “in the wake of the devastating devaluations in several of the world’s largest emerging markets, including

⁸ See *La Nación*, April 6, 2001.

Russia, South Korea, Indonesia and Brazil, the Mexican experience is now seen as the harbinger of a new economic phenomenon: the volatility of global capital markets.”

The 1994–1995 Tequila crisis can therefore be seen as an episode demonstrating the constraints placed upon national policy-makers by volatile global financial markets. These constraints meant that Mexican policy-makers were faced with either a choice of either adopting super-hard fixes, such as a currency board or dollarization, or abandoning fixed exchange rates and moving to purely floating rates. That is, the Mexican case provides evidence for the bi-polar view. The previous financial crises provided cause for both the Mexican public and international investors to have low levels of trust in the credibility of the country's monetary institutions and so dollarization was an option for active consideration. Thus, the credibility arguments for dollarization were plausible for Mexico.

Business support and the evidence from polls among the general public indicate that credibility was a concern and that dollarization in some form was seen as a potential solution to this. However, while these arguments suggested a policy move in favour of a rapid transition to an officially dollarized economy, other business supporters argued for such a transition to be a long-term goal. The difference in the reasoning between the two groups is that a rapid transition arises from viewing the credibility issue as critical while the longer transition was premised on the integrationist arguments for the use of a single currency. That is, business support for the adoption of a single currency, the U.S. dollar, was also the result of the increasing levels of economic integration between the two countries as a result of the NAFTA. As the data provided above indicate, NAFTA resulted in a large increase in exports, FDI, and intra-industry trade associated with a relatively small number of MNCs. As such, there was a powerful constituency which might potentially benefit from a reduction in transactions costs. Some in the Mexican business community supported dollarization on these grounds but viewed it as more akin to an EU-type process in which monetary union would be the result of a longer process of economic integration. President Fox, an advocate of a North American Common Market, also viewed the further integration of North America as a step-by-step process with the harmonization of external tariffs the next step although did include dollarization as a long-term goal.

Evidence on the degree of business cycle synchronization as a result of NAFTA suggests that the case for the use of a single currency on these grounds may not yet have been reached and that the longer-term argument is more appropriate in an integrationist perspective. Kose et al (2004: 20) find that NAFTA “appears to have been associated with an increased degree of comovement of business cycles of Mexico and its NAFTA partners. The increase in comovement can be seen from the marked increase in cross-country correlations of the major macroeconomic aggregates, including output, consumption, and investment. In particular, the output correlation between Mexico and its NAFTA partners rose from almost zero in the pre-NAFTA period to around 0,75 during the post-crisis period.” This appears to be a very strong result and indicates that the economies of Mexico and the U.S. have moved rapidly from being uncorrelated in their business cycles to now having highly correlated cycles; a result in keeping with Frankel and Rose's (1998) finding and an argument used in favour of the use of common currencies. When analyzing the causes of the variance of output, that is in examining which factors are causing the business cycles to move together, Kose et al (2004: 23) find that “regional factors became more important in driving business cycles in Mexico with the advent of NAFTA. The proportion of output volatility explained by the regional factor in Mexico rose from less than 1 percent in the period 1980–1993 to more than 19 percent in the 1994–2002 period.” While this again shows the increasing importance of regional dynamics, this still leaves 81 percent of the variance in output explained by world, country-specific and idiosyncratic factors. (See also Cuevas et al 2002 for the importance of idiosyncratic factors for Mexico). A regional economy is emerging but it is not yet clear that the immediate adoption of a common currency is warranted on these grounds.

To summarize, for those most concerned about the credibility of Mexico's institutions and the ability of global financial markets to inflict damage, an Argentinian quick-fix solution was more appealing. The relatively large degree of support within the Mexican Council of Businessmen for dollarization was, therefore, based on two quite distinct lines of reasoning. Nevertheless, it constituted an important political force which sought to push Mexican policy-makers in the direction of dollarization as a response to the forces of globalization.

Other interpretations of the 1994–1995 Tequila crisis place much less emphasis on the uniqueness of the crisis as a harbinger of a new world of volatile global financial markets. As the arguments presented in Fligstein (2001) indicate, for some it is not international financial markets that should take the blame for the 1994–1995 debacle (although they may certainly be partly culpable) but rather the mismanagement by both the Mexican and U.S. governments in propping up the peso for political reasons in the first place and therefore inviting a crisis. A similar story is found in Edwards (1997). He argues that Mexico's trade deficit and over-valuation of the peso on the 1987–1993 period were sufficient to suggest that an imminent exchange rate crisis could be expected. However, members of the international financial institutions and private investment agencies chose to overlook this in favour of “inventing” a Mexican “miracle” – an invention made to support Mexico's path of neoliberal reforms based on optimism over NAFTA entry rather than reflecting Mexico's actual performance. When corrective action was required, Edwards (1997: 3) argues that “Mexico had the opportunity to undertake a number of measures that would have allowed a smooth landing. Political considerations and overoptimism, however, stood in the way of corrective actions.” Furthermore, “the US Treasury was fully aware of what was going on.”

According to these interpretations, therefore, it is not so much the power of international financial markets as the folly of domestic governments that caused the financial crises. On this reading, the 1994–1995 crisis does not necessarily mark the arrival of a new type of financial crisis accompanied by new constraints on government policy; it resembles more a continuation of the old problems associated with policy mismanagement. The implications of this are that pressures for dollarization are more likely the result of ‘contingent neoliberalism’ than globalization imperatives. In support of this position, that is national rather than global pressures that provide the explanation, it should also be noted that, contrary to the assertions of some, Mexico is not, by international standards, a highly dollarized economy. In fact, unofficial dollarization beyond that has been relatively modest. In Mexico, Balino et al (1999) report an estimate for the ratio of foreign currency deposits to broad money to be 7.2%, substantially below the level of other Latin American countries. Estimates computed by Feige et al (2002) suggest an unofficial dollarization rate of 20 per cent, still low compared to other Latin American countries such as Uruguay, Argentina, Peru and Bolivia and below the 35 per cent which they calculate to be the threshold at which network externalities occur. Furthermore, the structural differences between the Mexican and U.S. economies remain large, the importance of trade integration through NAFTA in synchronizing business cycles discussed above notwithstanding, so that the maintenance of a separate currency to adjust to external shocks remains a powerful argument and indeed was the one used by Mexican officials in rejecting the calls for dollarization.

According to this interpretation, the interest in dollarization was supported by business as they saw it as a means to cement neoliberal policies in favour of small government; that is, dollarization would play the same “locking-in” role for the monetary sector as NAFTA played in the trade and investment sector. This is the “ideological dogma” to which Ibarra and Moreno-Brid (2001) refer in the quotation which opens this chapter. In this instance, this refers to the strong anti-government position of the Mexican business community and some academics, a position which regards limitations to state authority and discretionary policies as a key medium term objective. That is, the continuing neoliberal agenda in Mexico placed dollarization on the policy agenda more firmly than might otherwise be expected. Thus, Auerbach and Flores-Quiroga (2003: 275) argue that “the demand for dollarization is yet another expression of the private sector's persistent 20-year

campaign to impose constraints on the Mexican government's policymaking discretion. Regarding monetary policy, the first step was to take it away from the president's direct control. The last step would be take away that instrument entirely from the Mexican government's hands by adopting another country's currency."

Thus, the support for dollarization can be seen as part of the Mexican business community's wider neoliberal agenda to constrain the state. Government leaders, as well as key institutions such as the Bank of Mexico, might be expected to resist this pressure, as indeed they did, out of their own institutional interests and desire to retain policy discretion.

However, the debate can not simply be reduced to institutional interests; it must also be remembered that it was the PRI which initiated the neoliberal reform agenda in Mexico in the mid-1980s and which was widely praised by the international financial institutions and in international business circles for its 'radical reforms'. It was these politicians who had deliberately removed their (and subsequent government's) policy discretion in the trade and investment areas when they entered NAFTA. But now, it was these same politicians which now explicitly rejected dollarization. As did neoliberal economists both inside and outside of Mexico. And as did Mexico's wealthiest businessman, Carlos Slim, as indicated above, and who argued that it was necessary for Mexico to put its own financial house in order.

These factors reinforce the point that while institutional interests may play some explanatory role, there is also the wider context of disagreement between neoliberals mainstream views. Those who rejected the idea of dollarization believed that Mexico was capable of putting its own financial house in order. In early 1994, ironically only months before the financial crisis, the government amended Article 28 of the constitution to provide greater independence to the Bank of Mexico. Under this amendment, the Governor of the Bank would be appointed for a fixed-term and the terms of other board members would be staggered. The scope for "political interference" in monetary policy was therefore reduced. Subsequently, President Zedillo sought to increase the transparency of the financial system "by issuing a weekly report on the level of international reserves and money supply, which is scrutinized carefully by investors trading peso futures at the Chicago Mercantile Exchange" (Boardman 2000).

However, the move to central bank independence did not reassure international investors sufficiently to prevent the Tequila crisis. And the ability of the Mexican political elite to respect this new independence was still open to question. Thus, at the end of 1997, just as the issue of dollarization was becoming an intensely-debated topic as a result of developments in Europe and Argentina, further questions were being asked about the management of Mexico's financial system. It was then that President Zedillo appointed his Minister of Finance, Guillermo Ortiz, as the new central bank Governor. This appointment raised a "storm of controversy" (Salinas-León 1998) partly because Ortiz was seen as being too close to the government and that his appointment was due to the unwillingness of Zedillo to appoint the bank's deputy governor as he was seen as being "too independent." Some critics of the appointment went so far as to call his appointment another "December mistake" in reference to the mistakes which lead to the Tequila crisis in December 1994 (Salinas-León 1998). As it happens, Ortiz displayed his independence in 1999 when the Bank of Mexico formally adopted inflation targeting as its sole objective.

During the period of the dollarization debate, from 1998–2001, there was room for disagreement as to whether Mexico would best be served by dollarization which would remove from Mexican authorities the capacity to exercise monetary autonomy or from changes to the institutional structure and functions of central banking. The business community largely took the first position, as did many neoliberal-oriented economists and policy analysts inside and outside of Mexico. The PRI government, some academics and some businessmen opted for the second route. Neoliberals in the private sector tended to side with dollarization as the institutional fix to avoid the dirigisme of the past while officers in government had more faith in reforming Mexican institutions.

The latter group won out in the debate and the continued stability of the exchange rate and low inflation in subsequent years, as well as Argentina's failure, has meant that there has been no basis for re-opening the debate. The 'contingent neoliberalism' approach also has some traction, therefore, in explaining the Mexican debate.

The "imperialism" approach, however, finds no support. The U.S. made it explicitly clear that it was not interested in Mexico officially dollarizing. Mexico's state-owned industries and banks were being privatized anyway, many being sold to U.S. interests. There was no added benefit from official dollarization and, indeed, the U.S. regarded the fragility of the Mexican banking system as constituting considerable potential added costs. There was simply no interest by the U.S. in extending the official role of the U.S. dollar. Furthermore, the support for dollarization came from the Mexican business elite rather than from US business interests. There were arguments from the political left in Mexico against dollarization (see Auerbach and Flores-Quiroga 2003) on the grounds that it would lead to the further subordination of the Mexican economy to the demands of capital accumulation in the U.S. But this is not something that the U.S. state or its corporations actively sought. This does not necessarily rule out U.S. ambitions pointing in this direction. Carchedi (2001: 162), for example, argues that "it is (fractions of) the local bourgeoisies of the dominated countries (especially of Latin America) which push for dollarization. The US need not push. The job is being done for them." While it is certainly the case that the Mexican bourgeoisie has closely aligned itself to US interests, nevertheless its support for dollarization is better explained by the contingent neoliberal ideological preference of (some of) the Mexican business community. And it should be remembered that no less a figure than Alan Greenspan actively intervened in the debate to say that the U.S. did not support official dollarization in Mexico.

The regional approach has some appeal. The regionalization of trade and production networks under NAFTA provided a basis for monetary integration to also be considered. Even so, it was the Mexican Council of Businessmen rather than US based multinationals that were the most vocal supporters of dollarization suggesting that domestic rather than regional issues were key here. Nevertheless, the European experiment with the euro attracted attention in Mexico and helped to put on the agenda the question of whether this might also be a model for North America. However, it is also clear that regionalism, as a political project, is quite different in North America than in the EU and that the paths being taken in each are quite distinct. There is only a very limited regional political superstructure in NAFTA and so the institutional foundations for a common currency are non-existent. This was realized in the Mexican debate where the only serious discussions were about a currency board or dollarization. And while the U.S. dollar has circulated in Mexico for a long time, there is no evidence that unofficial dollarization has increased with the current phase of regional integration. In fact in recent years, the dollar's role as a regional currency has been reduced in Mexico.

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