For the first time ever, the King Juan Carlos Prize for Economics was awarded to a Latin American. Towards the end of 1992, coinciding with the Quincentennial Year, Spain awarded this prize to a Mexican, Miguel Mancera, "for his fundamental contributions to Mexican economic policy over the last decade." Throughout Latin America, Mancera is considered an influential force in defense of monetary stability, and controlling public sector spending; he is a proponent of rigorous analyses of economic regulation, and a critic of economic protectionism. In the following pages we present a summary of the speech he delivered upon accepting the King Juan Carlos Prize.

The Mexican economy since 1955

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Towards the middle of the 1950's, Mexico entered one of the most brilliant periods in its economic history, a period which would continue until 1970. From 1955 to 1970, the rate of real growth of the gross domestic product reached an annual average of almost 7%· while the rate of inflation, once the impact of the 1954 devaluation had been absorbed, fell to an annual average rate of 2.5% (1961 to 1970).

Paradoxically, during this period of stability with growth, which one of its most distinguished authors called "stabilizing development," certain policies —which today are out of fashion, if not discredited— were adopted or intensified. I am referring mainly to generalized industrialism, protectionism without regard to foreign trade, and the minute regulation of financial intermediaries.

As opposed to the majority of schools of Economics in the United States and Europe, where most scholars have had a relatively eclectic way of thinking, or a marked preference for economies free from State intervention, in Mexico those schools were dominated —since they were founded in the 1930's, and to a lesser extent today— by the radical left, Marxists included.

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Graduates of these schools gradually came to occupy middle- and high-profile positions in public administration, in journalism, and in the universities themselves. The propagation of their ideas created an unfavorable climate for the acceptance of free market ideas, the merits of which, in and of themselves, are far from self-evident.

Quite a few of these students, however, upon having the opportunity to do post-graduate work and, above all, having contact with the real world, modified their views on economic questions. Thus, in a way, they became more moderate.

There were other influences which led to the abandonment of the market economy or which at least worked in favor of interventionism. The success which the Soviet Union appeared to be achieving and, in some aspects, did achieve during those years, was impressive. At the same time, research carried out by the Latin American Economic Commission (Comisión Económica para America Latina, CEPAL), created by the United Nations, was found to be very attractive.

Keynesian ideas also had a notable influence. They were appreciated not only for their recognized value in focusing on certain economic phenomena, but also because they were politically convenient. There was nothing better than to find support in the teachings —or the supposed teachings— of a great capitalist economist to justify not only government intervention in the markets, but enormous public spending.

The recommendations made by CEPAL were, however, probably the most powerful factor in determining the course which Mexican economic policies, and Latin American economic policies in general, were to follow up until recent years.

" Investment in education is highly profitable. This has been proven by countries such as Germany and Japan "

The CEPAL, which for many years was headed by well-known Argentine, Raúl Prebisch, attempted to construct a whole theoretical framework to give protectionism in developing countries a scientific basis. It did not just try to justify protectionism for nascent industries; this had been done almost one hundred years before. The CEPAL's goal was to legitimize an almost permanent protectionism over a wide range of industries.

The CEPAL model was founded on the assumption of a secular decline in the terms of exchange of raw materials, and thus the need to further the development of national manufacturing industries, protecting them from imports.

Statistics on foreign trade, however, tend to be registered, in simplistic terms, by net weight of merchandise, or in units of the product in question, without taking into consideration the changing characteristics of these products. But how can one consider an automobile made in 1950 the same as one made in 1992, or that a ton of computers manufactured thirty years ago is equivalent to a ton of today's computers?

This model has another questionable side. Even if the permanent decline in the relative price of raw materials can be proved, we must still prove that technological advances are incapable of reducing costs to such an extent that the production of those commodities remains advantageous.

Something more decisive also remains to be proved: that industrialization is only feasible through protectionism. That theory has been completely refuted by nations such as Hong Kong, Taiwan, and Singapore, their meager reserves of natural resources notwithstanding.

Despite its weaknesses, the CEPAL model gained general acceptance throughout Latin America for close to thirty years, from 1955 to 1985. Perhaps those who questioned the model were too few, and their positions not prominent enough, for their voices to be heard.

Moreover, the CEPAL model gave rise to a certain degree of synergy between the ideas of some and the greed of others. By seemingly giving import restriction a theoretical basis, it justified a reduction in competition and, consequently, offered an opportunity to earn juicy monopolistic profits.

Today, most economists would tend to consider the market economy as something similar to that which, in the political sphere, Winston Churchill thought about democracy: it is the worst possible system, unless one considers the alternatives.

This kind of thinking was not prevalent in Mexico until ten years ago, especially among some governmental and intellectual circles which wielded a great deal of influence in designing economic policies. Their concept of a market economy was very different from that of Adam Smith. They thought that the forces of supply and demand should always be regulated, not just in exceptional cases; if these forces were left at liberty, they were usually detrimental to society.

Nor was there much confidence in the inherent goodness of the free market in the financial sphere. Financial intermediaries were highly regulated during those years, not only in Mexico, but all over the world. The bankruptcies among banks and other financial institutions which occurred before and during the Great Depression of the thirties inspired very strict and detailed regulations.

In this international context, and given the interventionist ideas that prevailed in Mexico, a controlled financial policy seemed quite natural. For many long years, Mexican credit institutions were highly regulated; this, not only as regards their financial soundness, but also in matters concerning the granting of credit and interest rates.

" For many long years, Mexican credit institutions were highly regulated "

It is not difficult to infer that numerous and serious distortions and inefficiencies necessarily had to derive, and in fact did, from extreme protectionism, a widespread control policy in industry, and close regulation of intermediary financial institutions. How then can one explain the extraordinary development, with relative stability in prices, which was achieved from 1955 to 1970?

An important factor in explaining such a complex phenomenon is that the economic intervention prevalent during that period was not always unwise. Some of the measures were useful in reconciling certain social costs and benefits with private ones, or in breaking down certain instances of inertia and resistence which do in fact exist in the market, even if they lack a rational basis.

Certainly there were other decisive factors in the successful economic performance of those years. The labor force grew rapidly, at a time in which there were abundant natural resources still to be exploited. Thus, young people entering the work force were highly productive.

Moreover, the educational endeavors which began in the 1920's were beginning to bear fruit. Illiteracy was drastically reduced, the proportion of young people with some level of schooling increased, and the number of university graduates also rose. As a consequence of the relative scarcity of qualified workers, technicians, and professionals, their marginal productivity gain was enormous.

On the other hand, public investments during this period were highly profitable in micro and macroeconomic terms. Worthy of note in this respect are a considerable number of large joint electric energy and irrigation projects.

It is truly fortunate that when the majority of these projects arose in the fifties and early sixties, CEPAL's recommendations against producing raw materials had not yet spread sufficiently to inhibit such investments.

During the fifties and sixties, the world economy enjoyed one of the longest periods of prosperity in history. No doubt this was also a factor in the development of Mexico's economy.

Exports of manufactured goods began during this period. They were no longer merely occasional exchanges, such as those which occurred during the Second World War when traditional sources of supply were interrupted. These were exports by a few efficient companies, which were able to compete in international markets despite the obstacles arising from protectionism —difficulties in obtaining parts and supplies at international price and quality levels.

The favorable international situation and the high performance of the Mexican economy facilitated the opening up of foreign credit markets, which had been closed to Mexico for almost half a century. This financing, though modest in amount, was qualitatively very important, in view of the fact that it was wisely used in the aforementioned public works projects.

There were errors, as there always are, during this brilliant period of "stabilizing growth." Dissatisfaction always exists, and it is not always strictly economic in nature. Towards the end of this era there arose spontaneous, or consciously promoted, political conflicts; in particular, the convulsive student movements of 1968.

In part as a response to this unrest, the origins of which some attributed to overwhelmingly economic concerns, new policies were in order. To exaggerate a bit, and at the risk of overgeneralizing, the mistakes of "stabilizing growth" were continued, while the accomplishments were abandoned.

Protectionism, barring a few brief lapses, continued its upward trend, as did industrial control policies, and excessive regulation in general. Furthermore, during certain periods, political rhetoric became hostile to foreign investment and, in some cases, even towards domestic private sector investment.

"Towards the middle of the 1950's, Mexico entered one of the most brilliant periods in its economic history"

As private investments became more risky, businessmen's demands for greater protections of all sorts from the government grew; and the government, paradoxically, usually granted them. Any farsighted economist could predict the strange result of such policies: far from achieving the proposed "shared development," an even greater concentration of income in a few hands was produced.

Maxims such as "the production of raw materials is the work of poor nations" and "inflation is the price of development," and other such stock phrases which were quite popular then, reflect ideas which are bound to have serious consequences.

Public investment, which had once been successfully devoted to extremely useful infrastructure projects, was redirected towards industrial and service-oriented activities. Public sector investment ventured into producing steel, chemical substances, automobiles, capital goods, and a wide variety of other products, while service enterprises such as telephone and airline companies and even a nightclub or two, passed from private to government hands.

It is, in principle, feasible for government concerns to be well conceived and well administered. In Mexico, however, this was the exception rather than the rule. Thus, in spite of the increase in the proportion of the gross domestic product devoted to investment during the seventies and early eighties, the rate of economic growth was no longer as strong as before. Nevertheless, on the average it continued to be high, as a result of the enormous growth in demand triggered by the availability of foreign credit and by favorable developments in exchange rates.

One of the causes —and perhaps the most significant cause— of the ensuing foreign debt crisis, was the investment of large amounts of funds in barely profitable, and in many cases, unprofitable projects. This debt became a heavy burden because interest payments could not be met, as they usually would have, with the profits that should have been generated by the respective investments.

Other disturbing factors came to the fore, particularly the attacks —verbal in some cases, but all too real in others— on the private sector and private businesses. Thus, an immensely valuable asset was eroded: Mexicans' confidence in their nation's economy, which had accumulated over the course of many years. More and more capital fled the country, and became an extremely serious problem over the ensuing period.

"Despite its weaknesses, the CEPAL model gained general acceptance throughout Latin America"

During the 1970's and early 1980's, Mexico had access to an enormous amount of foreign credit; but it was not able to rapidly maximize its ability to administer such abundant resources successfully.

The result was notorious waste, which was apparent not only in the public sector but in the private sector as well: given the protection against imports and other such sinecures, the private sector could afford to invest in poorly planned projects and still do a good business.

Thus, starting in 1973 and until the middle of 1981, Mexico had, and lost, a great opportunity. Enormous petroleum deposits were discovered at a time when the prices of oil and other Mexican exports were rising. During this same time, banks in industrialized countries had large sums available which they were willing to loan. These funds, the product of so-called "petrodollars" were enthusiastically offered by those banks in the hope of developing new petroleum-exporters.

This great opportunity, however, never became the wished-for reality. The aforementioned errors prevented this, reinforced by certain external elements which now came into play. Oil prices did not follow the trajectory which national and foreign experts had predicted.

On the other hand, interest rates in the main foreign financial markets began a dizzying rise. This placed an additional and unexpected burden on the debt-service payments contracted during a period of very low real interest rates —rates that were at times negative— which experts predicted might possibly continue.

The combination of errors and external factors unleashed a foreign debt crisis in August 1982, causing, at the same time, a chaotic situation in the nation's economy. The administration which began its term of office at the end of that year took immediate action by reorganizing the economy and reassuring the population.

Among the numerous measures undertaken by the new government, worthy of mention are the reform of public finances, the adoption of a workable exchange policy, the restructuring of the private and public sector's external debt, and the privatization of companies which had come under State control because they were affiliates of banks which had been nationalized in September 1982.

The national and international context was not conducive to rapid and beneficial results on all fronts, in spite of the efforts made by the administration. Large segments of the population were gripped by distrust. Abroad, Mexico's image had deteriorated to a greater extent than anyone had expected. This was due, among other things, to the resurgence of the right in the United States at that time.

The apprehensiveness of the general public was not the only problem which that administration had to confront. During its term of office, two cataclysms occurred. The first was a natural disaster —the 1985 earthquakes which left a trail of human suffering and material damage; the second was an economic one —the collapse of oil prices in 1986. The loss of income caused by this external event represented costs to the Mexican economy equivalent to a doubling of the interest on the nation's already large foreign debt.

When the bottom dropped out of oil prices, it became necessary to accelerate the so-called "slide" in exchange rates, that is, the small daily devaluation which had been in effect for several years. This had a tremendous impact on inflation, but enabled the nation to survive the crisis without causing a disaster in exchange rates; and in turn, made it possible to move decisively as regards the structural reform of the economy.

Already in July 1985, what could be called a watershed in Mexican economic policies had been reached. Starting that same month, a vigorous trade liberalization began, and the privatization or liquidation of companies belonging to the then unwieldy public sector was undertaken.

The liberalization of restrictions on imports was carried out with a determination which had few, if any, precedents. In two and a half years, Mexico went from a system of high tariffs, with a vast majority of its import categories requiring import permits, to a new situation in which the maximum tariff was reduced to 20%, and in which previous licensing requirements became the exception rather than the rule.

In just three years, nonpetroleum exports —chiefly manufactured goods— grew to such an extent that they almost completely made up for the income lost through the collapse in oil prices.

Over the following years, these exports have continued to rise, to the extent that in 1991 they made up 70% of Mexico's sales of merchandise abroad, as opposed to 1985, when they represented only 32%, and 1982, when they were only 22%. However, the rapid downward slide in exchange rates in 1986 and 1987 was followed, as has already been mentioned, by a serious inflationary spiral which, at the end of 1987, had reached a point which could have been chaotic. This, paradoxically, in spite of the solid performance of the Mexican economy in several fundamental aspects, including public finances and the balance of payments.

> *"We have, gradually moved from a detailed regulatory banking system to a liberal regime"*

The 1987 fiscal deficit was equivalent to 16% of the gross domestic product. But it was a deficit caused exclusively by the enormous inflationary effect of the interest rates prevailing in the country at that time. The primary balance in public finances, that is, the difference between income and expenditure without including interest, showed a substantial surplus of almost 6% of the gross domestic product.

For these reasons, a dramatic drop in inflation, coupled with a decline in nominal interest rates and service payments on the internal debt, could lead to the disappearance of the global budget deficit in public finances, as if by magic. Later on, this indeed happened.

In 1987, the balance of payments was also very healthy. Despite capital flight and the large-scale reduction of foreign debt, a net increase of almost 7 billion dollars in international reserves was achieved, while the economy became more competitive.

In the light of such basic strengths, it was necessary to take on the inflationary spiral. Wages rose because prices rose, and vice versa. This powerful spiral effect carried with it an especially important price: the exchange rate.

Under these circumstances, the government called together the employers, and the labor and farming sectors, in order to reach an agreement which would be called the Economic Solidarity Pact (Pacto de Solidaridad Económica). The parties to this agreement committed themselves to a concerted effort to stop, or at least moderate, the continuing rise in wages and prices and thus in the exchange rate.

Agreements of this type had been recently attempted in other countries, including some in Latin America. But not everywhere have they met with success. Thus, the Pact's credibility was precarious and the risks involved were high. However, as opposed to situations were this strategy had failed, in Mexico's case there existed solid bases, both fiscal and as regards the external sector— which augured well for the success of the plan.

The Pact was signed in December 1987, and has been renewed under different names and methods in accordance with the circumstances of successive stages. Its success is quite evident. The inflation rate, which in 1987 reached 160%, had fallen to 11.9% in 1992. The inflation rate will, in all probability, fall to single digit proportions this year, and it is not impossible that in 1994 it will settle at levels close to the average for industrialized countries.

Thanks to the relative moderation in wages which the Pact has provided, it has been possible to reduce inflation without falling into a recession. Rather the contrary, an economic recovery has been achieved. This, unfortunately, has lost some of its strength in the last few months as a consequence of the economic sluggishness of industrialized nations.

The success of the Pact is not solely attributable to its efficiency in weakening the inflationary spiral. Other decisive elements have been brought into play. I already mentioned the reform of public finances, which has now resulted in a surplus, without even counting the proceeds from the recent privatizations, as well as the opening up to foreign trade.

Many benefits have also resulted from such measures as the renegotiation and corresponding reduction of the foreign debt; the privatization of many, often very large, public sector enterprises; the use of proceeds from these sales to pay a considerable portion of the internal debt and some of the foreign debt; the negotiation of a free trade agreement with Canada and the United States; the reduction in taxation levels combined with a more efficient collection system; the reform of rural property-holding systems, and the improvement in the quality of economic regulation in general, a process which in many cases has implied extensive deregulation.

We have, for example, gradually moved from a detailed regulatory banking system to a liberal regime. Mexican banks, insofar as transactions in Mexican currency are concerned, are no longer required to reserve funds for credit nor are they obliged to grant credit along certain predetermined lines; interest rates are not fixed by the authorities.

Monetary control is primarily exercised through open market mechanisms which, thanks to the existence of a significant market in public stocks, bonds and certificates, are easily put into effect. But, quite sensibly, economic policies have not only been liberalized; more attention has also been given to regulations on the financial solvency of the financial intermediaries.

At present, Mexico is at a stage in which it has already overcome serious difficulties; there are now excellent opportunities for progress. Despite this, we continue to face challenges from complex problems whose solutions are far from simple.

“Interest rates in the main foreign financial markets began a dizzying rise”

The strong inflationary pressures and trade imbalances which many nations, Mexico among them, suffer, have led government officials and academics to focus their attention on macroeconomic aspects at the expense of good microeconomic government, which is crucial in achieving an increase not only in productivity but in standards of living as well.

The markets are plagued by imperfections and undesirable practices. Perseverance and courage are required to correct them, since the work involved is often dull, and implies attacking an infinite number of special interests.

Saving is not one of the cardinal virtues today in most of the Western world. I have spent many hours thinking about how voluntary saving could be stimulated in my country, without arriving at a satisfactory answer. We know that price stability, the smooth functioning of financial markets, a sensible system of taxation, and a climate of security are all contributing elements. But they are not enough.

For proof of this, we need only look at the United States, where these factors are combined and reflect a higher level of quality than in other countries. Yet, the rate of saving is lamentably low. We should study Chile more carefully, because savings there have shown an impressive growth. The Far East, which is made up of a wide range of countries with different characteristics, has one thing in common: an extremely high savings rate.

One of the most serious consequences of monetary instability is high interest rates. Those who propose inflationary policies for the sake of a supposedly faster growth of the national product are not aware of the damage which such policies do to economic development in the long term. Once the populace has seen its savings decimated by inflation, it becomes distrustful; and distrust is not erased by decree. It only diminishes and, eventually, disappears, through perseverance in the application of proper economic policies.

In speaking of the significant problems which my country faces, I don't want to omit mentioning one in particular: the notorious inequality in the distribution of wealth.

The formula for attacking this problem which immediately comes to mind is the adoption of a system of taxation and subsidies tending towards a more equitable distribution of wealth. This would, however, have a relatively limited effect, since, in developing countries, the rich are relatively few. The amounts that could be taken from them through taxes would not be enough to substantially alleviate the poverty of the many.

But more important than this is another factor, eminently pragmatic in nature. Capital, as well as qualified labor, can easily travel over borders which separate one country from another, more so when those countries have a very close geographic and economic relationship, as is the case of Mexico and the United States.

Under these circumstances, high taxes measured against international norms give rise to damaging consequences: capital flight, and, worse still, brain drain. The damage which can be done by these phenomena are easily appreciated when we remember that economic underdevelopment is determined by a marked scarcity of capital and, specifically, lack of a qualified work force.

“Saving is not one of the cardinal virtues today in most of the Western world”

There is no doubt that the most efficient method for promoting equality and development is to extend quality education to include the whole of society. Without this, deep and undesirable differences among the various social groups are perpetuated. The marginal productivity of the few tends to remain large, and that of the many, small.

Investment in education is highly profitable. This has been proven by countries such as Germany and Japan, which from the ashes of a war that had destroyed almost everything in existence, except for the majority of their human capital, were quickly able to recover.

The development of the United States itself can be attributed in large part to the massive importation, over centuries, of human talent formed and educated in other nations