11.1 Mexico Abandons Import-Substituting Industrialization

In 1994, Mexico, along with Canada and the United States, signed the North American Free Trade Agreement (NAFTA)—an agreement that, as we explain in Chapter 12, has become highly controversial. But Mexico’s turn from import-substituting industrialization to relatively free trade actually began almost a decade before the country joined NAFTA.

Mexico’s turn toward free trade reversed a half-century of history. Like many developing countries, Mexico turned protectionist during the Great Depression of the 1930s. After World War II, the policy of industrialization to serve a protected domestic market became explicit. Throughout the 1950s and 1960s, trade barriers were raised higher, as Mexican industry became increasingly self-sufficient. By the 1970s, Mexico had largely restricted imports of manufactured goods to such items as sophisticated machinery that could not be produced domestically except at prohibitive cost.

Mexican industry produced very little for export; the country’s foreign earnings came largely from oil and tourism, with the only significant manufacturing exports coming from maquiladoras, special factories located near the U.S. border that were exempt from some trade restrictions.

By the late 1970s, however, Mexico was experiencing economic difficulties, including rising inflation and growing foreign debt. The problems came to a head in 1982, when the country found itself unable to make full payments on its foreign debt. This led to a prolonged economic crisis—and to a radical change in policy.

Between 1985 and 1988, Mexico drastically reduced tariffs and removed most of the import quotas that had previously protected its industry. The new policy goal was to make Mexico a major exporter of manufactured goods, closely integrated with the U.S. economy. The coming of NAFTA in the 1990s did little to reduce trade barriers, because Mexico had already done the heavy lifting of trade liberalization in the 1980s. NAFTA did, however, assure investors that the change in policy would not be reversed.

So how did the policy change work? Exports did indeed boom. In 1980, Mexican exports were only 10.7 percent of GDP—and much of that was oil. By 2012, exports were up to 34 percent of GDP, primarily manufactures. Today, Mexican manufacturing, rather than being devoted to serving the small domestic market, is very much part of an integrated North American manufacturing system.

The results for the overall Mexican economy have, however, been somewhat disappointing. Per-capita income has risen over the past 25 years, but the rate of growth has actually been lower than that achieved when Mexico was pursuing a policy of import-substituting industrialization.

Does this mean that trade liberalization was a mistake? Not necessarily. Most (but not all) economists who have looked at Mexican performance blame the relatively low growth on such factors as poor education. But the fact is that Mexico’s turn away from import substitution, while highly successful at making Mexico an exporting nation, has not delivered as much as hoped in terms of broader economic progress.

11.2 India’s Boom

India, with a population of more than 1.1 billion people, is the world’s second-most-populous country. It’s also a growing force in world trade— especially in new forms of trade that involve information rather than physical goods. The Indian city of Bangalore has become famous for its growing role in the global information technology industry.

Yet a generation ago, India was a very minor player in world trade. In part this was because the country’s economy performed poorly in general: Until about 1980, India eked out a rate of economic growth—sometimes mocked as the “Hindu rate of growth”—that was only about 1 percentage point higher than population growth.

This slow growth was widely attributed to the stifling effect of bureaucratic restrictions. Observers spoke of a “license Raj”: Virtually any kind of business initiative required hard-to-get government permits, which placed a damper on investment and innovation. And India’s sluggish economy participated little in world trade. After the country achieved independence in 1948, its leaders adopted a particularly extreme form of import-substituting industrialization as the country’s development strategy: India imported almost nothing that it could produce domestically, even if the domestic product was far more expensive and of lower quality than what could be bought abroad. High costs, in turn, crimped exports. So India was a very “closed” economy. In the 1970s, imports and exports averaged only about 5 percent of GDP, close to the lowest levels of any major nation.

Then everything changed. India’s growth accelerated dramatically: GDP per capita, which had risen at an annual rate of only 1.3 percent from 1960 to 1980, has grown at close to 4 percent annually since 1980. And India’s participation in world trade surged as tariffs were brought down and import quotas were removed. In short, India has become a high-performance economy. It’s still a very poor country, but it is rapidly growing richer and has begun to rival China as a focus of world attention.

The big question, of course, is why India’s growth rate has increased so dramatically. That question is the subject of heated debate among economists. Some have argued that trade liberalization, which allowed India to participate in the global economy, was crucial.[[1]](#footnote-1) Others point out that India’s growth began accelerating around 1980, whereas the big changes in trade policy didn’t occur until the beginning of the 1990s.[[2]](#footnote-2)

Whatever caused the change, India’s transition has been a welcome development. More than a billion people now have much greater hope for a decent standard of living.

1. See Arvind Panagariya, “The Triumph of India’s Market Reforms: The Record of the 1980s and 1990s.” Policy Analysis 554, Cato Institute, November 2005. [↑](#footnote-ref-1)
2. See Dani Rodrik and Arvind Subramanian, “From ‘Hindu Growth’ to Productivity Surge: The Mystery of the Indian Growth Transition,” IMF Staff Papers 55 (2, 2005), pp. 193–228. [↑](#footnote-ref-2)