Mexico ON THE ROPES

BY ROBERT LOONEY

Mexico's modern economic history is one of great promise – and greater disappointment. In the years between World War II and the early 1980s, its future seemed bright, with annual growth averaging close to 6 percent. Indeed, the economy seemed to be on the path to income convergence with the rich countries of Europe and North America. Since then, however, Mexico has suffered through four major recessions and two mild contractions, achieving an average annual growth rate of just 2.3 percent for the period 1982 through 2010 – just one percentage point higher than the growth in population.

Judging by the last decade alone, moreover, the prospects for a return to Asian-style growth seem remote. Not only has Mexico failed to make economic progress, but the country has lost ground to other Latin American economies long viewed as laggards. In 2001, Mexico ranked 42nd on the World Economic Forum's Global Competitiveness Index (a useful catchall, consisting of everything from property rights to trade policy to the quality of science education). Mexico has since slipped to 66th, trailing (among other countries) Chile, Panama, Brazil and Uruguay.

The contrast with Brazil, Latin America's other big economy, is striking. No-nonsense leadership from the pragmatic left has allowed Brazil to reduce social tensions even as business-friendly policies have led to stable prices, high rates of investment and improvement in the standard of living for those at the bottom. Mexico, for its part, is mired in a vicious circle of declining oil production, lagging labor productivity, falling government revenues and infrastructure investment,

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stagnant employment and increasing crime.

One major irony here is that for much of the past few decades Mexico seemed to be following the free-market playbook. Like China, Mexico privatized much of its economy and opened the door to foreign trade and investment. Politically, it went even further, emerging as a genuine democracy in the 1990s after decades of single-party rule. Why, then, has Mexico suffered such a spectacular economic setback?

WHAT WENT WRONG

The Cartels

There is no doubt that the destabilization caused by the drug cartels is partly to blame for Mexico's current economic woes. Drug-related violence in Mexico escalated when routes to the lucrative United States drug market shifted to Mexico from the Caribbean in the 1990s. The violence ramped up still further when, at the urging of Washington, President Felipe Calderón decided to confront the cartels in 2006. By one estimate, some 35,000 Mexicans have since died in the conflagration.

The direct costs of this war on drugs in terms of diverted resources is probably only about half a percent of GDP. But the indirect effects swamp this number. Drug violence has cut foreign investment (particularly in manufacturing) and precipitated emigration of skilled workers that the economy can't afford to lose. Most ominous, the drug war has corrupted government, intimidated the media and reduced Mexicans' already frayed respect for the institutions of civil society. A 2008 Pentagon study suggested the country was on its way to becoming a "failed state" – to use a term usually reserved for the likes of Pakistan, Zimbabwe and Haiti.

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The Failure of Broad-Based Reform

While drug trafficking has exacerbated Mexico's problems, the economy was in decline long before the cartels moved in. That's due in large part to the government's failure to complete critical economic and political reforms begun three decades ago. Until the early 1980s, Mexico pursued the classic Latin American strategy for industrialization, using high trade barriers to nurture key industries (and to protect their owners and/or unions against foreign competition). While this strategy did yield growth, or at least did not prevent it, it left Mexico with an overvalued exchange rate and stagnant exports. That, in turn, led to large balance-of-payments deficits, increased public indebtedness and eventually a severe debt crisis in which public and private borrowers were caught with debts denominated in dollars when Mexico's currency nosedived in value.

The crisis was a catalyst for a sharp break with Mexico's traditional protectionist market policies, as the administrations of Presidents Miguel de la Madrid and Carlos Salinas took a series of steps toward unilateral trade liberalization to attract foreign investment and to make the country's exports (other than oil) more competitive in world markets. Key to this liberalization strategy was the decision to join the General Agreement on Tariffs and Trade (which later morphed into the World Trade Organization), as well as negotiation of the landmark North American Free Trade Agreement with Canada and the United States.

But market reforms were only one leg of the stool. Mexico's new openness to the global economy and pell-mell privatization of the banking system left it vulnerable to the vaga-

ries of international currency flows in 1994, when foreign investors attempted to cash in financial assets in response to worries about ballooning government deficits. Both public and private enterprises were exposed to huge exchange losses when the government was forced to devalue (and the Clinton administration was forced to come to Mexico's rescue with a $50 billion loan).

After the 1994 crisis, the Mexican government shifted its focus to macroeconomic stability and significantly strengthened its supervision of the banking system. As a result, Mexico now enjoys a degree of price stability that compares favorably with much of Latin America. Yet, while macroeconomic stability may be a necessary condition for sustained economic growth, it is not a sufficient one.

Seen on its face, Mexico's continuing efforts to modernize the economy by remaking the financial sector were impressive: the Mexican government encouraged bank privatizations, reformed the deposit insurance system, improved accounting standards and allowed foreign multinationals to purchase controlling shares in the country's largest banks. While this formula has worked in other countries to better mobilize savings and increase the efficiency of lending, it proved problematic in Mexico. Credit became especially difficult for business to obtain. At the end of 2005, commercial loans to manufacturing firms, farms and service enterprises were one-third lower than they had been in 1997.

Why the failure? Lending probably declined because banks, especially those that are foreign-owned, have been reluctant to make major commitments in an environment of uncertain property rights and a corrupt court system. For while Mexico reformed its financial institutions, it failed to address these and other key areas of governance. As a result, the country fell from 51st place in 2001 to 98th in 2010 on Transparency International's Corruption Perceptions Index.

Free-market economists widely expected that Mexico's entry into Nafta would lead to both sustainable economic growth and governance reforms. That's what happened after similar trade liberalization was introduced in South Korea, Taiwan and Costa Rica, as companies that benefited from the new trade began to pressure their governments for reforms to increase efficiency and competitiveness – which in turn led to further openness. And in light of Mexico's strong entrepreneurial class and remarkable growth record for much of the postwar period, the country appeared ideally positioned for such a growth-reform-growth progression.

Exports did, indeed, more than quadruple from 1993 (the year before Nafta) to 2007 (the year before the global recession). But because many Mexican export firms lacked extensive domestic linkages, Nafta produced few winners outside a cluster of largely foreign-owned assembly plants in the northern Mexican states and Mexico City. Nor did the increase in export activity much benefit small- to medium-size domestic enterprises – the businesses most instrumental in creating virtuous circles of growth and reform in post-communist transition states in Central Europe. More recently, the decline of Mexico's share of lucrative U.S. markets, coupled with its inability to reorient its economy to benefit

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from China's growing demand for imports have compounded Mexico's trade problems.

Rent-Seeking and Corporatism

Mexico's stop-go growth – and near stasis in the past decade – ultimately traces back to its failure to push ahead with economic reforms and broad-based improvements in governance. And one need only look to the country's political dynamics to understand why reforms are so problematic. Despite its achievements in moving toward democracy and price stability, power in Mexico remains concentrated in a few interests inclined to seek economic success at the expense of others. Although this focus on collecting "economic rents" rather than adding to productive capacity hinders growth, these groups have little incentive to change the system. As a result, the three pillars that form the foundation of the corporatist system created in the 1930s by the Institutional Revolutionary Party (PRI), Mexico's formerly dominant political party, remain untouched.

The public and private economic monopolies that dominate the economy make up the first pillar. The state-owned oil company (Pemex) and the electric power company (Federal Electricity Commission) have markets to themselves. The private monopolies (in all but name) in telecommunications (Telmex), television broadcasting (Televisa), cement (Cemex), bread and tortilla manufacturing (Bimbo and Maseca, respectively) and banking (Banamex/Citigroup and Bancomer/Banco de Bilbao) face no competition domestically. Indeed, despite attempts at market liberalization, these monopolies are stronger than ever.

The monopolies also undermine the Mexican economy's capacity for both innovation and adaptation to changing market forces – a reality that is arguably more important to the economy's long-term prospects than the "static" inefficiency discussed above. R&D spending is low, and only one-third of it is privately financed – roughly one-half the average rate in OECD countries. In telecommunications, a hotbed of innovation in most countries, Mexico registered no patents with the European Patent Office from 1991 to 2003. India, by contrast, registered 13 patents in 2003 alone.

The unions that have controlled the Mexican labor movement since the 1930s represent the second corporatist pillar. They enjoy "closed shop" privileges (that is, employers may not hire workers who don't belong to the union) along with leadership elections by acclamation, mandatory dues without transparency or accountability and – not surprisingly – immense political power. The teachers' union is the largest in Latin America, while the oil workers' union is the richest.

Like all unions, those in Mexico bargain for better working conditions and wages. But they are more successful than most unions elsewhere and thus have more impact on the allocation of labor. The average union wage premium over comparable nonunion jobs in 2000-5 was 80 percent in petroleum, 57 percent in telecommunications and 53 percent in public school teaching. In manufacturing, where workers do face international competition, the premium was a more modest (but still high) 32 percent.

Mexico's teachers union (Sindicato Nacional de Trabajadores de la Educacion, or SNTE) has probably had the most destructive effect on the economy, because it has a strong vested interest in the status quo. In an analysis of standardized student tests, Mexico ranked last among OECD countries, and among the bottom three in Latin America. Explaining educational performance is always difficult. But certainly, the centralized bargaining that determines many aspects of school working

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conditions weakens teachers' incentives to excel or even to try new approaches.

The power of the unions is buttressed by money and political influence. Under Mexican law, unions automatically deduct dues from the paychecks of all workers and are not accountable for how this money is spent. The SNTE alone collects an estimated $2 billion (no misprint) annually in dues. Union leaders also add to their coffers by illegal means, such as the sale of jobs. Most union officials belong to the Institutional Revolutionary Party, which had a hammerlock on political power until quite recently, and many are members of Congress. As a result, political favors are often exchanged – as in President Calderón's appointment of the SNTE leader's son-in-law as education under-secretary, presumably in exchange for the union's electoral support.

The third pillar of Mexico's corporatist system is the just-mentioned political monopoly. This monopoly, which for 70 years was held exclusively by the PRI, is now better characterized as a cartel, since it has expanded to include the PRD (left of center) and the PAN (pro-business, right of center). Representatives are barred from immediate re-election, and their single terms result in little individual accountability, a substantially reduced time horizon for policy design, and a focus on short-term electoral prospects rather than long-term planning and reform. This situation is unlikely to change anytime soon because the three parties jealously guard more than $500 million in public subsidies, effectively blocking smaller political groups from providing viable alternatives.

One consequence of Mexico's corporatist power structure is highly unequal income distribution. In 2008, the top 10 percent of families took home 36.3 percent of income, while the bottom 10 percent eked out just 1.7 percent. Moreover, wealth is astoundingly concentrated. In 2008, Mexico had 10 billionaires with a total net worth of $96 billion, up from $25 billion in 2000. Most inherited part of their wealth, and almost half benefited from the privatizations of some of the government monopolies in the early 1990s.

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In fact, according to *Forbes*, the richest man in the world in 2010 was Mexico's Carlos Slim Helú (net worth: $53 billion). Slim made his fortune by acquiring ailing companies, restructuring them and using his political influence to discourage competition. His crown jewel is Telmex, obtained during the 1990 privatization process, which controls 92 percent of all the land lines in Mexico and 73 percent of all cellphone subscriptions.

The World Economic Forum classifies countries in three levels, with the first level being the least developed and the third level being technically advanced. Mexico falls into the second level, which is "efficiency driven." That is, Mexico has yet to achieve a level of efficiency and improved governance that would allow it to compete successfully in international markets. Now, the Forum uses dozens of indicators to construct its competitiveness index. But just four of those indicators – technological readiness, rule of law, infrastructure and innovation – explain three-quarters of the variance in country classification. And Mexico scores relatively poorly in all four, suggesting that, in the absence of major re-

forms, the country may be stuck in the third level indefinitely.

Social Safety Net

According to the Mexican government's National Council for the Evaluation of Social Development Policy (Coneval) roughly one-third of the country lives in what Coneval labels "moderate" poverty (or worse). The United Nations, for its part, estimates that 8 percent live on less than $2 a day, in terms of purchasing power. That's a dismal record for a country generally classified as "upper middle income." The comparable figure in Costa Rica, a country with a per capita income about one-fifth lower than Mexico's, is just 4.3 percent.

Recent (and by no coincidence, more democratic) government administrations have acknowledged the magnitude of Mexico's poverty problem, creating new social programs and expanding existing ones to aid those not employed in the formal "above ground" sector. The new programs have improved access to health care, nutritional assistance and education. But they come at a considerable cost to the government budget. And in light of the evidence that the government bureaucracy does nothing very well other than to butter its own bread, there is little reason to believe the enhanced services are making a big difference.

Indeed, several studies suggest that despite these additional expenditures, Mexican poverty has decreased only marginally and that poverty reduction is more closely linked to economic growth and price stability – which the antipoverty programs may ironically undermine by reducing both productivity and the size of the tax base. For example, the programs give workers in the informal (underground) sector free access to the social insurance that workers in the formal sector must purchase. As a result, the programs serve as a disincentive for workers to move above ground, inadvertently reducing the financial viability of the social security system and lowering the country's overall retirement savings.

Government Revenues and Pemex

While the rhetoric of Mexican politics is largely populist, the wealthy generally get their way – a reality that helps explain Mexico's modest tax burden. Tax revenues total less than 14 percent of GDP, the lowest rate of any OECD country. Mexico is a major producer of oil. But the prices it charges to domestic consumers are kept so low that the government must subsidize operations to break even. As a result, the government depends heavily on export revenues from the oil monopoly, which covers 30 to 40 percent of government spending. And any decline in oil production has major fiscal implications.

Nonetheless, government administrations have failed to make reinvestment in Pemex a priority. Pemex's extraction of crude oil fell sharply from 2004 to 2009 because of inefficiencies stemming from its aging infrastructure and its failure to bring new wells online. The company produced 2.6 million barrels per day in 2009, down from a peak 3.4 million bpd in 2004. It exported 1.225 million bpd in 2009, compared with 1.403 million bpd in 2008, which translates to a 10 percent decline in government revenues.

With oil fields aging (and domestic demand rising as the recession ends), Mexico would be unlikely to see a major increase in revenues even if oil prices rose sharply. Belated infusions of cash have apparently stabilized production in the last two years. And to date, the capital markets have been willing to meet Pemex's need for capital. But the debt incurred to improve operations while providing much of the government's revenues have left Pemex nearly bankrupt. The company's huge financial liabilities are a ticking time bomb.

Remedying the problem ought to be simple. Mexico has adequate reserves to revive production levels, and the addition of an international partner would give it both the capital and expertise to increase exploration and production – particularly in fields offshore. But Mexican law, dating from the nationalization of Pemex in 1938, bars the company from equity partnerships with foreign oil producers, and a constitutional amendment would be required to change this rule.

Foreign investment is hard to come by for yet another reason: Pemex may be the most inefficient oil company in the world. In 2008, it kept 141,000 employees on the payroll to generate $103 billion in sales. By comparison, ExxonMobil employed just 107,000 to generate sales of $372 billion.

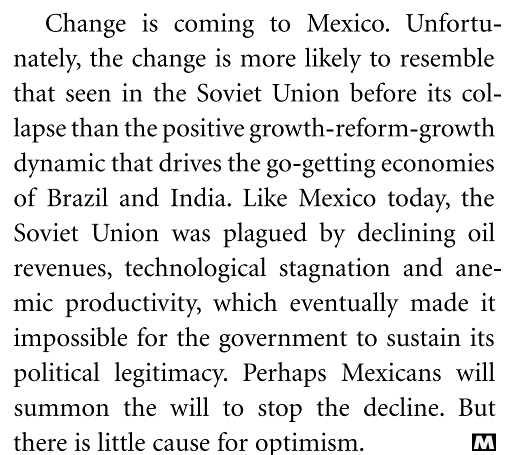
Pemex could increase its efficiency by outsourcing. Such restructuring would allow the company to acquire more advanced technologies and adopt state-of-the-art industrial practices. However, the union has vetoed this approach because it would threaten its role as a patronage machine. Thousands of Pemex workers, after all, are drawing pay for assignments at shuttered facilities.

Mexicans have long viewed Pemex's independence as a symbol of the country's sovereignty. Thus, politicians who dare to confront Pemex must confront Mexican nationalism as well as an entrenched union and millions of consumers who view cheap gasoline as a birthright. There is little reason to believe the political class is up to the task.

WHAT NEXT?

A famous mural by Diego Rivera reflecting on 400 years of Mexican history graces the walls of the National Palace in Mexico City. The mural depicts Aztec kings, conquistadors, priests, politicians and American capitalists who have taken turns plundering the country's riches and oppressing its workers. If Rivera were alive to update his masterpiece, the mural would also show cartel leaders passing drugs to U.S. gangs with one hand and paying off Mexican politicians with the other … students sitting alone in stripped-down classrooms while their teachers demonstrate outside for higher wages … oligarchs playing Monopoly with government functionaries … a union boss at Pemex on the veranda of an estancia looking out at idle drilling rigs … a federal treasury accountant surrounded by stacks of unpaid invoices … and, finally, Mexicans desperate for a better life fleeing the country for menial jobs in the United States.

Without fiscal and governance reforms, Mexican companies will face ever more daunting challenges in competing with regional powers like Brazil – not to mention global powers like China. More workers will be driven into the underground economy, further lowering the country's productivity. Declining oil revenues will probably force cutbacks in government expenditures, robbing civil society of desperately needed infrastructure expansion, educational opportunity and protection from street violence. A deteriorating business climate will further discourage investment from abroad.



Change is coming to Mexico. Unfortunately, the change is more likely to resemble that seen in the Soviet Union before its collapse than the positive growth-reform-growth dynamic that drives the go-getting economies of Brazil and India. Like Mexico today, the Soviet Union was plagued by declining oil revenues, technological stagnation and anemic productivity, which eventually made it impossible for the government to sustain its political legitimacy. Perhaps Mexicans will summon the will to stop the decline. But there is little cause for optimism. M

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