A Perspective on Mexico

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Dear friends, thank you for the opportunity to speak to you about the economy of the country where I spent a great deal of my childhood and the country that has a special place in my heart. When my parents arrived from South Africa in 1939, the U.S. authorities did not let them enter. They went instead to Mexico, living eight years in Tijuana, crossing the border on foot many a time.

My parents eventually became U.S. citizens—in 1947—but we still proudly joke about being "*gringos mojados*." I was born in Los Angeles in 1949. Soon after, we went to live in Mexico City, where I attended elementary school. Those were wonderful and unforgettable years.

Porfirio Díaz once said: *"Pobre México: tan lejos de Dios y tan cerca de los Estados Unidos.*" Poor Mexico: so far from God and so close to the United States.

I don't think this is at all true. Mexico is, of course, joined at the hip with the United States—and Texas and California, too, for that matter—and it is a good thing for all of us. As for being distant from God, though, I doubt it. Let me share a story my father told me upon our return to the United States. I had been put back a year in school because my English was not up to par.

My father's story imagined a conference of the great leaders of various religious denominations. It included the evangelical preachers, the archbishops of the Catholic Church, the most respected rabbis and the few imams you could find at the time. Never before had there been such an assemblage of spiritual leaders.

Into their midst wandered a small child, an innocent, who asked the religious men a question of great theological import: "Who is special in the eyes of the Lord? Is it the little children? Is it the Israelites? The people who wander the great deserts? The poor and the downtrodden? Who is it, really?"

"Well, little girl," the clerics responded, "you know the Lord plays no favorites. He loves all. But don't take our word for it. We will ask Him. Come, let us pray and ask the Lord to send us a sign as to whom He smiles upon."

They got on their knees. They bowed their heads. And the great men reverently asked the Lord to send the child a signal—"Just a sign, dear Lord, a simple expression, as to who among the peoples of the world you especially favor."

At first there was no answer.

And then a bolt of lightning parted the skies. The sun shone brightly. And a booming voice came down from the heavens: "Bu-e-nos dias…."

This evening, I am going to give you a straightforward brief on Mexico's economic progress and predicament as I see them. My perspective is forged in part by the four years I spent negotiating trade and market liberalization with Mexico. The views I am going to express are just that: my personal expression, backed by the research of our able economists of the Eleventh Federal Reserve District. These views are not those of any other Federal Open Market Committee members or Federal Reserve officials.

I want to cover monetary policy—no surprise there. After that, I will take up Mexico's financial situation as we approach the end of the current *sexenio* and this summer's elections. Stepping back for a longer-term view, I will then discuss some challenges to Mexico's economic prosperity. If I pass over anything too quickly or leave anything out, we might take it up in the question and answer period.

I start with monetary policy because it is my firm belief that economies cannot achieve sustainable growth without monetary discipline. Furthermore, I believe that monetary discipline cannot be sustained without an independent central bank. We live in a globalized world. Capital, labor and ideas are freer than ever to migrate to places where they will earn the best return. A country that debases the returns to those inputs cannot expect to retain them and harness them to work on behalf of its people.

President Zedillo and his successors in the Fox administration understood well the need to bolster Mexico's competitiveness. Safeguarding Mexico's economic health is also manifest in the superb leadership exhibited by Guillermo Ortíz at Banco de México and Francisco Gil Díaz at Hacienda. Together, they have been the Batman and Robin of Mexico, as good a combination of central banker and finance minister as has been seen in the Americas since the tandem of Alan Greenspan and Bob Rubin.

A critical ingredient in Mexico's monetary policy success has been the establishment of a fully independent central bank that makes controlling inflation its main goal. Central bank independence is protected by Article 28 of the constitution, which was amended in 1994 to read:

> *The State shall have a Central Bank which will be autonomous in the exercise of its functions and in its administration. Its primary objective shall be to ensure the stability of the purchasing power of the national currency, thereby reinforcing the State's guiding role in the nation's development. No authority may order the Central Bank to grant financing.*

These are magic words. With a clearly stated goal and constitutional protection, Banco de México under Governor Ortíz has become a no-nonsense practitioner of inflation targeting. As a result, Mexico now boasts its lowest inflation in 30 years, with consumer prices rising at around 3 percent a year.

This is a monumental accomplishment. Inflation is an onerous tax and a disincentive to work, save and invest. In an economy plagued by rising prices, a dollar saved ends up a quarter earned, a fact that does not change if you deal in pesos and centavos. Some cynics worry that a new Mexican administration might decide to interfere with the central bank's independence. It would prove very difficult to do so. Modifying Article 28 to reduce Banco de México's independence would require going through the amendment process defined in Article 135. This would entail

(1) the agreement of two-thirds of Congress and (2) the approval of a majority of the state legislatures. Given Mexico's divided polity, this is highly unlikely.

With sound management reinforcing the constitutional guarantee of central bank independence, the markets have displayed unprecedented confidence in Mexico. Here is where the treasury comes into the picture. Hacienda has accumulated enough foreign reserves to cover all its overseas obligations over the next two years, which provides strong insurance against the sort of capital outflow Mexico experienced more than a decade ago during the Tequila Crisis.

This insurance strategy is just a small part of 10 years' worth of efforts by Mexico's federal government, under two administrations, to reduce its financial vulnerability. Mexico ran into trouble in 1995 because its debt was (a) large, (b) mostly in foreign hands, (c) mostly short-term and (d) mostly in U.S. dollars. Mexico has been able to address all four sources of vulnerability in large part as a consequence of cleaning up its fiscal and monetary houses.

Mexico's government is now able to rely mainly on domestic lenders. Three-fifths of net public-sector debt is now held by Mexican nationals, compared with a third in 1995. Mexico is also able to issue debt with much longer maturities. The country began issuing 20-year bonds in 2003. In 1995, its longest bond was a one-year bono. It would not surprise me at all if Mexico were to follow the example Russia set in February and issue a 30-year, peso-denominated bond in the near future.

Confidence in Mexico's financial markets has been reinforced by the stability and strength of the peso. The Tequila Crisis of 1994–95 started with a sharp currency devaluation. Mexico simply could no longer defend a fixed value of the peso. That is ancient history now. The peso has been floating for more than a decade, another factor easing markets' fears about the potential for a financial crisis this year.

What are the markets saying now? Foreign investors do not appear concerned about the upcoming presidential election becoming a breeding ground for an end-of-*sexenio* crisis. Mexico's country premium—the added interest it must pay on its debt relative to comparable U.S. instruments—is near all-time lows.

Of course, markets can be rational but at other times appear capricious. When interest rates are low, investors typically "reach for yield" by crawling out along the yield curve. When yield curves are flat or offer insufficient extra yield at longer maturities, investors can alternatively reach for yield by assuming greater credit risk and lending to lower-rated borrowers. If investors underestimate the amount of risk they are taking, subsequent disappointment may prove disruptive as sudden price swings cause investment holdings to turn unprofitable and investors seek to reduce positions.

Of late, we have seen a predictable response to the tightening pursued by the Federal Reserve and the European Central Bank. While the Bank of Japan has technically not tightened policy, the end of the quantitative easing policy is a significant move in this direction. By implication, investors have to reach less far than previously to obtain reasonable yields. As a consequence, emerging market bond spreads have risen slightly, admittedly from very low levels. In addition, the currencies of several high-yield issuers have notably depreciated over the past month. Some examples include the Icelandic krona, Polish zloty, Hungarian forint, Turkish lira, and the Australian and New Zealand dollars.

My personal experience as a funds manager taught me at least two things: first, to respect the bond markets. You may recall James Carville's quip that before he went to Washington with President Clinton, he thought the most powerful force in the world was the presidency or perhaps the papacy, but he quickly came to realize that it was the bond market.

Andrew Mellon may have gotten it right when he said, "Gentlemen prefer bonds." But a gentleman spurned can be unforgiving.

The second lesson I learned as a funds manager is that all financial markets, including those for fixed income and foreign exchange, can be somewhat manic-depressive. Markets can become skittish and are capable of overshooting on both the high and low ends. This is one reason I support the recent trend in increased central bank transparency, which reduces the elements of surprise that can unsettle markets. If the current environment of rising yields of relatively risk-free credits continues, there is a possibility that markets for emerging-country debt will become skittish. If so, even minor market-related developments may induce short-run volatility in those credits. Authorities in these countries will have to be increasingly sensitive about embracing policies or undertaking actions that might exacerbate that volatility.

Against that background, we might now look at July's presidential election. The presidential pyramid famously described by Octavio Paz has been turned upside down. Under the old system of PRI dominance, *el presidente* had near dictatorial and unassailable powers. This is no longer so, and from the standpoint of financial markets, I would posit that this is good news. Central bank independence, greater freedom of the press, an increasingly assertive Supreme Court and a divided Congress mean that whoever assumes office after the elections will have limited scope to single-handedly impose change.

The consensus view in financial markets is that rhetoric aside, none of the three presidential candidates is likely to reconsider Mexico's commitment to macroeconomic discipline once in office. To be sure, the PRI and PRD have complained that monetary policy is "too tight," but both parties appear to understand the importance of monetary discipline in keeping inflation under wraps. Any of the three candidates, once in office, should value the hard-earned financial stability of the previous administration and seek to build upon it. This is comforting.

Stability is critical to continued structural reform in Mexico. A look at the country's ability to compete in the world economy is sufficient to understand how far it has to go. In its most recent competitiveness rankings, the Geneva-based International Institute for Management Development put Mexico near the bottom—56th out of 60, surpassing only Venezuela, Indonesia, Argentina and Poland. Mexico's low productivity growth of only about 1.2 percent a year over the past decade is symptomatic of the problem.

In our increasingly globalized world, competitiveness is becoming more important. It is also becoming more complex. Gone are the days when a simple advantage in, say, labor costs or geography will be enough to attract foreign capital. Investors in today's shrinking, interconnected world seek out countries that offer cost advantages, but they also seek out high levels of education and human capital, sound and reliable institutions, and other requisites for sustained long-run growth.

On the human capital side of the equation, Mexico has made great progress in the past few decades by increasing school enrollment and improving facilities. Nevertheless, many problems remain with regard to both the availability and quality of public education. More than half of adult Mexicans have no secondary schooling at all, and only 11.3 percent have any college or university training. Mexican adults have on average attended school for just 6.7 years, about half the U.S. level.

Recognizing this fact, the Mexican government has ratcheted up education outlays in recent years, aiming to improve the nation's schools. Spending per primary- and secondary-school student rose 21 percent in real terms between 1995 and 2002. Still, it remains low by international standards. Measured in purchasing power parity dollars, Mexico spent $1,467 per primary-school student in 2002, compared with the Organization for Economic Cooperation and Development (OECD) average of $5,313 and the U.S. average of $8,049. Moreover, Mexican students' math and reading scores rank dead last among the OECD countries and lag severely even when compared with those of other nations with similar educational spending, such as the Slovak Republic.

There are, of course, limits on how much Mexico's government—or any government, for that matter—can increase spending on education. We know from our problems with education in the United States that added dollars or pesos may not produce results unless accompanied by innovative reforms. In Mexico's case, experts believe such reforms should include improved school administration, better monitoring and incentives, and modernization of curricula and teaching techniques.

The Zedillo and Fox administrations recognized that better education is vital to the human-capital improvements that lead to greater labor productivity and competitiveness. But Mexico has only begun the task. I would expect the next government to continue emphasizing the need for improving the educational system.

From a competitiveness standpoint, of course, spending on schools only pays off to the extent the economy puts educated workers to efficient use. Much of the inefficiency can be found in the sprawling informal sector, which employs roughly half of Mexico's 44 million workers. A dual labor market has its pluses. The informal sector creates jobs for low-skilled workers, many of whom are priced out of the formal market. It is also home to most of Mexico's entrepreneurs—self-employed and often industrious individuals who choose not to navigate the labyrinth of taxes and regulations that govern the formal market.

Informality, however, also has negative implications. The small tax base increases tax rates on compliant firms, and this is both distortionary and unfair. In addition, informality limits firm size and undermines economies of scale. Companies find it difficult to grow, not only because they have little access to financial markets but also because the tax man eventually catches up with larger enterprises. In the end, small is safe but inefficient.

Firms in the formal sector contend with other barriers. Mexican law and convention often constrain employers in how they organize production. Labor rules, for example, dictate that workers must be paid by the day or week, not by the hour. After three months of employment, a worker typically becomes "tenured." Reducing the ranks of tenured employees is very costly; according to the World Bank, dismissal costs in Mexico equal about 75 weeks of pay. When it comes to international comparisons of labor-market rigidity, the only region of the world scoring worse than Mexico is sub-Saharan Africa. While employment in the formal sector is hog-tied with red tape, workers in the informal sector go without any protections at all. Thus, labor-market reform will be a high priority of the next administration. Whatever changes are eventually adopted, the ultimate goal should be to even the playing field by making the formal sector more accessible and less costly.

No manner of labor-market reform, of course, is going to keep Mexicans from seeking a better life on this side of the border. U.S. demographers estimate that 400,000 Mexicans migrate to the United States each year, legally and otherwise. A majority of them are seeking jobs. With about 9 million Mexican workers in the United States, the equivalent of 15 percent of Mexico's labor force is employed here.

Over the past two decades, the U.S. economy has become increasingly dependent on immigrants from Mexico and elsewhere for labor-force growth. In the 1960s, baby boomers contributed heavily to expanding labor supply. In the 1970s and early 1980s, it was the rapid entry of women into the workforce. Since the mid-1980s, it has been immigrants. In the past few years, foreign-born workers have accounted for more than half of U.S. labor-force growth, providing an important impetus for our economic growth. The subject of immigration is one that inflames passions on both sides of the border. For our part, we must be careful that legitimate security concerns do not interfere with the economic benefits of immigration.

Of course, goods and services, as well as people, cross the border. You know the numbers. Since NAFTA took effect, U.S. trade with Mexico has risen 250 percent. Yet, neither Mexico nor the United States has done enough to handle the growing traffic. Surface trade is still much more inefficient and costly with Mexico than with Canada. The situation has become even more complex since the 9/11 tragedy increased the need for national security at our borders.

For Mexico and the U.S. states along its border, the stakes are high. Geographic proximity to the United States and ease of transport are key aspects of Mexico's comparative advantage vis-à-vis nations in Asia and Eastern Europe. A loss of competitiveness in Mexico is a loss for the entire border economy, where so much of our growth is linked to expansion on the more populous Mexican side. We must pay greater attention to the changes in infrastructure, regulations and other areas that are needed to maximize mutual economic benefit from trade.

Despite the impressive gains in U.S.–Mexico trade, old barriers persist and new obstacles have been erected. Shippers and visitors pay a huge cost in time and money for bottlenecks at the border. Examples include restricted movement of commercial vehicles, Mexican customs brokers' practices, inadequate agency staffing and inspection facilities, and cumbersome U.S. customs processing and inspections. These transaction costs reduce the volume of trade and traffic and increase prices for traded goods. For example, about 47 percent of trucks cross the border empty—even empty trucks have to pass inspection—so this slows down the border crossing process. The U.S. Transportation Department estimates that cargo headed for the Mexican interior spends three to five days in a border warehouse before being released to continue its southbound journey. Both producers and consumers bear the burden of the higher transaction costs, and the U.S.–Mexico trade relationship is harmed. Solutions to the bottlenecks in cross-border transportation require changes in government and business practices on both sides.

Before closing, I want to discuss the need for reform in two other areas—the judiciary and the energy sector. Bluntly stated, Mexico's court system does not typically function in a way that creates an environment favorable to lending and investment. Most critical for economic growth, property rights are often not effectively enforced in Mexico. According to the World Bank, average commercial dispute resolution time—how long it takes from the filing of a lawsuit to payment—is 421 days in Mexico, compared with 226 days in the other OECD countries.

This state of affairs has a number of consequences. First and foremost, banks and other financial institutions are reluctant to lend in an environment where contracts are difficult to enforce. Although credit has been expanding faster over the past two years, particularly in the consumer and residential segments, Mexico continues to have one of the world's smallest financial sectors. The ratio of private loans to GDP is 10 times lower in Mexico than it is in the United States. If you factor in financial markets, there is more than 15 times more financial intermediation in the United States than in Mexico.

The factors that restrict access to capital hinder Mexico's ability to grow. Weak enforcement also encourages resources to shift to the informal sector, which accounts for an estimated one-third of the overall economy's output. Operating in the formal sector and abiding by labor laws and the tax code is costly. In most countries, a firm is partly "compensated" for assuming these burdens by gaining access to formal sources of financing, such as bank loans and export finance. In Mexico, however, outside financing is difficult to come by for most firms, even if they choose to operate in the formal sector. This further decreases incentives to follow the rules.

The Mexican government is aware of this problem and is improving matters. Bankruptcy and lending reforms adopted in 2000 and 2003 made it easier for creditors to collect debts in cases of insolvency by creating Mexico's first effective legal framework for granting collateral. As welcome as these and other recent reforms are, they address only part of the issue. Mexico's main problem is that its laws are often not well enforced. Having a reliable and transparent judiciary to enforce commercial as well as criminal law is a requirement for sustained growth in any country.

Another key element to economic success is infrastructure, an area in which Mexico needs further improvement. Necessary investments are hindered by lack of both funds and alternative providers. In the energy and electricity sectors, production and distribution are largely controlled by the public sector. Not surprisingly, given Mexico's limited ability to raise taxes, capacity expansion has not kept pace with demand, and manufacturers and households must cope with frequent power interruptions. Meaningful energy reform will have to involve Pemex, a public-sector institution that has long been seen not only as a cash cow but as a politically sacred cow. Competition remains limited in other key industries as well. In the telecommunications sector, Telmex continues to control nearly 95 percent of all phone lines in Mexico. It should come as no surprise, then, that Mexico's phone charges are among the world's highest.

My friends, time is short. I think I have laid out enough challenges to keep Mexico very busy for at least another *sexenio*. Before ending, let me remind you of how far the country has come. Just the fact that we now compare it to other developed countries, that we talk about Mexico as one of the world's most promising economies, is a tremendous change and reflects an incredible achievement. Mexico will face up to these challenges. Macroeconomic stability, out of reach for so long, is allowing Mexico to pursue the necessary reforms. The institutions are now in place for the transformation to really take hold and improve the lot of all Mexicans, *más cerca de Dios y más cerca de los Estados Unidos!*

Thank you.