The United States Should Borrow Mexico's Fiscal Discipline Manual
(With Reference to Cantinflas, Guillermo Ortiz's Quip, Inflation Targeting and Many Comparative Metrics)

Remarks before the Bolsa Mexicana de Valores

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Mexico City
February 29, 2012

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Thank you, Luis [Téllez], for that kind introduction. Luis and I have been good friends for many years, and I delight in our friendship.

I am in Mexico fostering the close relationship and tradition of consultation and exchange that the Federal Reserve Bank of Dallas has enjoyed over the years with the Banco de México. In this regard, I am especially grateful to Governor Agustín Carstens for his hospitality this week. Agustín spent some time at the Dallas Fed when he was a young man, and we take pride in this being a small part of his accomplished career. For many years, the Dallas Fed's El Paso Branch has held joint board meetings and informational exchanges with the regional offices of the Banco de México. Our economists have worked with their counterparts at the Banco to share expertise on regional economic indicators, such as the construction of state coincident indexes. And Governor Carstens' predecessor, Guillermo Ortiz, is an Advisory Board member of the Dallas Fed's Globalization and Monetary Policy Institute. So it is fair to say that the Federal Reserve Bank of Dallas and the Banco de México enjoy a unique and mutually beneficial relationship. That relationship has been enriched by the last few days' exchange between my team and Agustín's.

As Luis and Agustín well know, there is a personal dimension to the Dallas Fed's relationship with the Banco de México. I grew up here in Mexico City in the 1950s and attended an elementary school not far from this very spot. Spanish was my first language in school; to this day, I have many friends in El Norte who say I speak better Spanish than I do English. But I always correct their assertion by saying, *"No, no hablo Español; hablo puro Mexicano!"* So this morning, I will do my level best to speak to you in *"Español Mexicano"* rather than in *"Ingles Texano."*

A Bit of Nostalgia

In the 1950s, Mexico City was an ideal place to grow up. The city was safe; the skies were clear; Cantinflas inspired laughter for every moviegoer and *Marcelino Pan y Vino*, wonderment and tears. The Mexican economy was averaging GDP growth rates over 6 percent a year, and the population was growing over 3 percent per year. It seemed a golden era. The only fear I can recall as a child was of the stern teachers at school who would take a ruler to my knuckles or the palms of my hands at the slightest infraction.

Back then, you could transit the entire length of "Avenida Reforma" in a taxi for one peso, unless you took the cheaper option preferred by my older brothers—Bob and Mike—of riding a bicycle alongside a speeding bus or truck, latching on to it with one hand and having it tow you along, at breakneck speed. Then, a kilo of black beans cost one peso; a liter of gasoline, 30 centavos. Today, you pay 25 pesos for a kilo of beans and 10 pesos for a liter of gas. Noting this, I suggested to my staff that either I am getting old or there has been a great deal of inflation in the interim. They responded that I was correct on both fronts!

Turbulence and Lessons Learned

Mexico was in good shape when my family left in 1959 and would continue to do well for many more years, until the turbulent 1970s.

Between 1975 and 2000, there was one crisis after another: in 1976, 1982, 1985–88 and 1994. Most of those crises corresponded with national elections; presidential sexenios (six-year terms) were routinely welcomed with peso devaluations of 40 percent or more. The peso became the symptom of the diseased and dysfunctional macroeconomy.

In 1982, Mexico defaulted on its external debt, resulting in capital flight, continuing devaluations and soaring inflation. Each crisis resulted in a package of promised reforms, but they all ended in failure—except one. In 1986, Mexico joined the General Agreement on Tariffs and Trade (GATT—now the World Trade Organization, or WTO). Reform efforts then accelerated under President Salinas, who took office in 1988. Privatization of public firms and industry deregulation picked up pace, and banking reforms were enacted. Notwithstanding, this era would also end with a crisis—the Tequila Crisis. But now, with the benefit of hindsight, we know that the foundations then being laid—and built upon by President Zedillo’s and subsequent administrations—would transform Mexico’s macroeconomic structures in a most impressive way.

In 1993, after decades of double-digit inflation, the old peso had to be replaced with a younger model with three fewer zeros. The new peso was slimmer and trimmer, but it soon suffered the same fate as the old peso. After all, it wasn’t the peso that was the problem. The problem was that Mexico had a central bank that was held captive by the fiscal authorities. Mexico was impoverished by the central bank’s complicity with the government’s fiscal mismanagement.

Without an independent central bank, there arose the age-old problem—the monetization of the government’s debt, or, in plain language, running the printing press to pay the bills. Monetization of fiscal profligacy struck Mexicans hard. Annual inflation averaged 15 percent in the 1970s and 70 percent in the 1980s, before descending to a still punishing level of 20 percent in the 1990s. Living standards stagnated as growth in real GDP per capita slowed to just 0.7 percent per annum between 1981 and 2000. These were, as others have noted, lost decades.

That Was Then. This Is Now: Time to Update Perceptions

As a result of these past crises, some people have negative perceptions of Mexico. And negative stereotypes take a long time to change. I believe it is time to change our perspective on Mexico. Reforms have been instituted and codified in your constitution that, on both the fiscal and monetary front, place Mexico on an exemplary plane. Not only is Mexico doing better, macroeconomically speaking, than the false stereotypes would have us think, Mexico is actually doing better than the United States in many macroeconomic areas.

This may come as a shock to those Americans who tend to look at Mexico solely through the lens of immigration or drug trafficking, or whose most benign perception of Mexico is gleaned from lying on a beautiful beach sipping a margarita in Punta Mita. As I will note in a moment, Mexico is macroeconomically sound and is moving in the right direction to address the vexing microeconomic problems that still hold your country back. In the United States, the opposite is the case. From a macroeconomic standpoint, Mexico's future is bright; its prospects keep improving. Sadly, one cannot say the same about the present macroeconomic trajectory of El Norte.

Los Tejanos Comprenden

Before proceeding, I might mention that Texans have a great deal of empathy for Mexico, not just because we share a common border and a unique, shared history. Or because Hispanics are 35 percent of our labor force and they and their families have energized our economy and enriched our culture. It is because Texas also suffers from outdated stereotypes despite our macroeconomic record. For over two decades, Texas has grown about twice as fast as the rest of the United States, with job growth averaging 2 percent per year, while nominal GDP per capita has caught up with and surpassed that of the nation. Indeed, Texas not only has led the nation in employment growth since 1990, but also has outpaced many of the "advanced" countries—ranging from Germany, France and the United Kingdom to Australia and Canada.

Yet more often than not (and especially during the brief period when a certain Texas governor aspired to be president), many who cling to old stereotypes depict Texas in terms befitting a dysfunctional state. The truth about Texas belies that fiction, just as it does with Mexico.

The Facts About Mexico

So what is the truth about the Mexican economy? We might start by examining some comparative metrics between Mexico and the United States.

For example, it is noteworthy that Mexico has recovered more rapidly from the Great Recession and the global financial crisis. To be sure, Mexico's real output contracted sharply and deeply with GDP plummeting 6.2 percent in 2009. But real GDP roared back, growing 5.5 percent in 2010 and then 3.9 percent in 2011, and reaching its prerecession peak after 12 quarters. It took the U.S. 15 quarters, or almost an additional year, before GDP was back to its prerecession level.

U.S. industrial production is still not back to prerecession levels, but Mexico's industrial production passed its prerecession peak at the end of 2010.

Fiscal Policy

On the fiscal front, it might surprise fiscal authorities in El Norte that Mexico actually has a federal budget! And it might surprise you to know that the U.S. government has not agreed on a budget for three years running.[1] Furthermore, Mexico ran a budget deficit of 2.5 percent in 2011, compared with the U.S. figure of 8.7 percent. Mexico's national debt is small, at 27 percent of GDP; in 2011, the U.S. debt-to-GDP ratio was 99 percent and is projected to be 106 percent in 2012 as the national debt passes $16 trillion.[2]

Mexico has a tool that forces the government to hew to fiscal discipline. Since 2006, you have had a balanced budget rule, passed into law by your Congress. Deviations are only allowed in emergencies. Thus, even with the emergency situation that triggered a deviation from balance during the Great Recession and global financial crisis, Mexico's budget deficit as a percentage of GDP was less than one-quarter that of the United States.

This is a fact: Your government has implemented greater fiscal discipline than mine and has done so in a way that has not hampered economic recovery.

I started this speech mentioning Cantinflas. He was the master of the *chiste*—the joke, be it a sight gag or a funny line, often directed at the government. The Mexican government's fiscal reforms have been anything but jokes; they have been serious reforms with a significant impact. In contrast, American politicians and policymakers have proven incapable of fiscal reform. U.S. fiscal authorities have not gotten their act together to figure out how to construct and implement a budget that restores confidence by reeling in the nation's long-term deficits and unfunded liabilities while encouraging investment, job creation and risk taking. The Congress of the United States, and those who aspire to the presidency in 2012, might well benefit by broadening their perspective on Mexico from focusing solely on illegal immigration and drug and gun trafficking—important as those issues are—and take a chapter from Mexico's book about implementing real fiscal reform.

Monetary Matters

Turning to monetary matters, it must be noted that the peso has been volatile in recent years, responsive to market forces acting on a currency which now freely floats. Before the financial crisis, it averaged about 11 pesos to the dollar; since 2009, it has averaged about 13 pesos to the dollar. Last year, it depreciated by 15 percent from July to December alone, but has since appreciated slightly against the dollar. What is striking, however, is that the pass-through of the peso's weakness into inflation has been muted and temporary. Inflation was 3.6 percent in 2009, rose to 4.4 percent in 2010 then retreated to 3.8 percent in 2011. This is within the bands of the Banco de México's inflation target. By comparison, the pace of inflation realized in the United States last year was 3.0 percent, as measured by the Consumer Price Index (CPI).

I attribute this muting of inflation to the reform that made the Banco de México an independent central bank in 1993 and to the adoption of explicit inflation targeting in 2001.

Pre-central bank independence, Mexico's inflation averaged a 43 percent annual rate; post-independence, this fell to 11 percent; since inflation targeting was implemented, the average inflation rate has fallen further to 4.4 percent per year.

It is important to note that as experience and credibility are gathered in the exercise of inflation rate targeting, a central bank can influence inflation expectations. The Banco de México appears to have done this successfully. The inflation target has been ratcheted downward: It was 6.5 percent in 2001; now it is 3 percent.

As a result of these important changes, the peso is now a store of value and not shunned as the financial leper it once was. The central bank's short- and long-run commitments to low inflation have, over time, led to the development of a peso-denominated bond market and falling interest rates on government debt.

Previous to 1995, the Mexican yield curve ran all the way out to … 27 days! Cetes were the only form of issuance. In 1995, the Mexican government began to progressively build a yield curve. That year it issued notes up to one year in maturity; in 2000, notes up to five years; in 2004, bonds up to 20 years; and in 2006, 30-year bonds. Interest rates have fallen on each successive issue. In January, Mexico issued $2 billion in peso denominated 10-year bonds, yielding 3.7

percent and a bid-to-coverage ratio of 2½ to 1. This was the lowest rate the government has obtained for this maturity for which there is now 247 billion Mexican pesos outstanding.

Another note on Mexico's debt: the market indicator that measures Mexico's country risk (CDS spreads) has remained at low levels and, as of October 2011, fell below that of France (finally, revenge on Maximiliano!).

The point is that with regard to both inflation and cost of debt, Mexico's monetary policy reforms are beginning to pay off.[3]

On the monetary front, I believe it is fair to say that the United States compares more favorably than on the fiscal front. At the last meeting of the Federal Open Market Committee in January, the Federal Reserve formally adopted a long-term inflation target of 2 percent. Simultaneously, we stated that though we have a dual mandate, unlike the Banco de México, we could not provide a numerical target for employment because "nonmonetary" factors have as much or more influence on employment dynamics as does monetary policy. I personally consider this an important signal to our fiscal authorities that they cannot expect inflation to absolve them of their duty—the need to institute fiscal and regulatory reforms necessary to restore sustainable employment growth.

This Time It Wasn't Mexico…

I'll bet that everyone in this room can recall Guillermo Ortiz's quip in Davos in 2008: "This time it wasn't us." It wasn't you in significant part because of your government's investment in fiscal and monetary reform. These reforms have not been perfect. Much work remains to be done. But Mexico has come far.

You have gone laudably far with trade liberalization since joining GATT in 1986. You ratified the North American Free Trade Agreement (NAFTA) in 1994. Your government has since implemented at least 13 trade agreements with 45 nations that I am aware of and is currently negotiating additional trade agreements with South Korea and Brazil.

Trade liberalization has benefited the Mexican people. Average tariffs fell from 27 percent in 1982 to 1.3 percent in 2001, benefiting Mexican consumers and manufacturers. And the volume and composition of Mexican trade has changed significantly. In 1980, trade as a percentage of GDP was only 17.5 percent; today exports and imports are equivalent to 62 percent of economic output. In 1980, oil accounted for 58 percent of Mexico's exports; today it accounts for only 16 percent. Thanks to the evolution of Mexico's world class manufacturing industry, some 80 percent of Mexico's exports are now manufactured goods.

… Yet There Is More to Do

As to the opening up of the domestic economy, some progress has been made but much remains to be done. I hope you will allow a friendly neighbor to point out some concerns.

The good news is that around 1,000 plus Mexican public companies were deregulated in the late 1980s and early 1990s. Yet deregulation has been a mixed success. Banking privatization resulted initially in a banking crisis and expensive bailout, though now the Mexican banking system is on firmer footing. Mexican banks proved resilient during the recent global financial crisis. The majority of Mexican banks have capital levels that allow them to fully comply with

Basel III capital regulation. Telephone deregulation, on the other end of the spectrum, has not been a success. It has resulted in a telecom monopoly that to this day remains a significant structural impediment to Mexican economic development. In a recent report, the Organization for Economic Cooperation and Development (OECD) estimates that lack of competition in the communication sector led to welfare losses of $129.2 billion from 2005 to 2009, a loss equivalent to 1.8 percent of Mexico GDP.[4]

I also worry about the future ability of the Mexican government to fund itself in an era of declining oil production. As you know, oil revenues have accounted for 34 percent of public revenue, while crude oil production has declined 25 percent from its 2004 peak to new lows of just 2.5 million barrels a day. Meanwhile, without oil, taxes as a share of GDP are still among the lowest in Latin America, despite the current government's bold efforts to increase tax revenue. New ways may have to be found to maintain the balanced budget your Congress demands and to do so without choking off economic growth.

One concern that I have about Mexico's long-term growth prospects is that Mexico ranks second to last in the OECD in high school completion rates; only 45 percent of Mexican students who enroll in upper secondary school graduate. Meanwhile, fully one-quarter of all Mexicans aged 15 to 29 are neither in school nor in the labor force. When young people are not in school or at work, more often than not there exists a potential for social instability and criminal activity to ensue.

It breaks my heart that violence continues to plague this great nation. The majority of companies in your industrial heartland in Northern Mexico report they have been directly affected by organized crime. This is testing the resolve of would-be investors, and inducing some prominent Mexicans to move their families and their businesses to Texas and elsewhere up north. This is a brain and productivity drain Mexico can hardly afford.

All of this and more, such as the monopolistic practices in the communications sector, restrain Mexican progress and productivity that should ensue from the great macroeconomic strides that you have made.

I do not wish to offend *mis compadres Mexicanos* by pointing to these problematic issues. I am simply making the point that macroeconomic reform is a necessary but insufficient condition for economic progress. The rule of law, making for practicable education and removing impediments to a fulsome deployment of human, physical and financial capital are necessary to make hard-won macroeconomic reforms result in the improved welfare of the Mexican nation.

Conclusion

While the work of improving the lot of the Mexican people is far from complete, it is time to discard old stereotypes of Mexico and give the fiscal and monetary authorities here credit where credit is due. To those who doubted Mexico's ability to reform, to cast off the old and embrace the new, I would like to suggest that the performance of the Mexican economy during and since the recent financial crisis should be enough to allay their fears. Mexico's rapid recovery in all dimensions of its macroeconomy and financial sector is proof positive that the gain from reform is worth the pain. I would go so far as to say there are lessons to be learned here, lessons for the U.S. and even lessons for Europe. Mexico's achievements have come through both monetary and fiscal reforms. They have worked in concert to provide the blueprint for a stable, strong macroeconomy. For this, Mexicans should be proud. And other nations, including my own, should be inspired.

Notes

[1] While there has been no budget resolution for three years, agencies have been funded through appropriations committees.

[2] The U.S. debt figures cited here refer to "gross federal debt," which includes virtually all debt issued by the U.S. government. It includes intragovernmental debt, such as debt the General Treasury owes to the Social Security Trust Fund, as well as publicly held debt. This measure is roughly comparable to the Mexican measure of gross federal government debt.

[3] See "The Conquest of Mexican Inflation," by Mark Wynne and Edward C. Skelton, Federal Reserve Bank of Dallas *Globalization and Monetary Policy Institute 2011 Annual Report*, February 2012, pp. 13–20.

[4] OECD (2012). *OECD Review of Telecommunication Policy and Regulation in Mexico*, OECD Publishing. Available at http://dx.doi.org/10.1787/9789264060111-en.