Mexico's Presidential Election: Background on Economic Issues

BY MARK WEISBROT AND LUIS SANDOVAL

Introduction

Mexico's presidential election on July 2 is seen by many as an important choice. The two front runners, Felipe Calderón Hinojosa of the conservative PAN (National Action Party) – the party of the current President Vicente Fox – and Andres Manuel López Obrador of the PRD (Party of the Democratic Revolution), have offered competing views of what is needed in order to advance economic and social progress. Calderón and the PAN have emphasized the government's achievements with regard to economic stability, low inflation, and attractiveness to foreign investors, arguing that the country should continue along the path of reforms implemented over the last 25 years and by the previous administration[1]. López Obrador and the left-of-center PRD have focused on poverty, advocating a greater government role to help the poor, redistribute income, invest in infrastructure and create employment.

This issue brief will look at some of the most important economic issues facing Mexico, as background for the election.

Long-Term Economic Problems

Figure 1 highlights what economists would consider the most important long-term economic problem facing Mexico: the sharp slowdown in economic growth since 1980. From 1960 to 1980, Mexico experienced healthy economic growth, and GDP (or income) per person[2] grew by 99 percent. From 1980 to 2000, it grew by only 15 percent. For the first half of the current decade, it has grown by a total of just 2 percent.

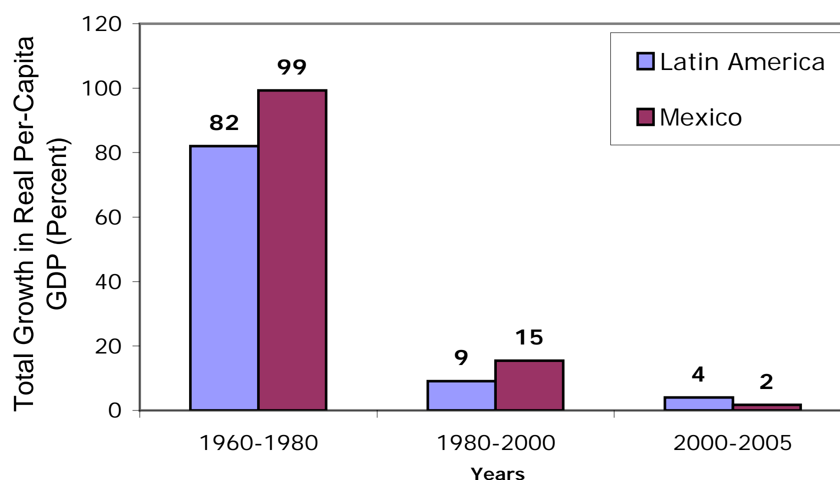
Center for Economic and Policy Research
1611 Connecticut Ave, NW
Suite 400
Washington, DC 20009
tel: 202-293-5380
fax:: 202-588-1356
www.cepr.net

Mark Weisbrot is co-director and Luis Sandoval is a research assistant at the Center for Economic and Policy Research. Dean Baker provided useful comments, and Carla Paredes-Drouet, David Rosnick, and Kathryn Bogel provided valuable research assistance.

[1] Patrick Harrington, "Mexico's Calderon Names 100 Proposals for Presidency," Bloomberg, June 20th, 2006: http://www.bloomberg.com/apps/news?pid=10000086&sid=aNM_ubo9yhj4&refer=latin_america.

[2] Per capita GDP is used here because it is a better indicator of the change in the country's average living standards than GDP; if GDP grows only because of population growth, then the population as a whole is not necessarily better off. All numbers here are real – adjusted for inflation.

FIGURE 1. Mexico and Latin America: Real per capita GDP growth



Sources: Maddison (2005)[3], IMF World Economic Outlook (April 2006), and author's calculations

As can be seen in Figure 1, the sharp slowdown in economic growth in Mexico for the last 25 years mirrors what has happened in the region as a whole. Per capita income in Latin America grew by 82 percent from 1960-1980, but only 9 percent for 1980-2000 and 4 percent for 2000-2005. The last 25 years of economic growth in Latin America have been the worst in more than a century; to find a 25-year period even close to this kind of a failure, one has to go back to 1905 and select a 25-year period that includes both World War I and the Great Depression.[4]

Mexico's economic growth failure has a number of very important implications. First, if the Mexican economy had simply continued to grow at its pre-1980 rate, the country would have a per capita income at the level of Spain today. This illustrates the drastic difference that an economic failure of this magnitude makes over a period as long as 25 years. With regard to the outward migration of Mexicans to the United States, for example, which has become a political issue on both sides of the border, a Mexico that enjoyed European income levels would have far fewer workers willing to take the risks associated with illegal emigration.

It is also important to keep in mind that Mexico's economic growth in the pre-1980 period was good, but still nowhere near what has been achieved by some of the faster growing developing countries, e.g. South Korea or Taiwan, over the same or even much longer periods.[5] Mexico's pre-1980 growth is thus a reasonable benchmark with which to compare the country's economic performance over the last quarter-century.[6]

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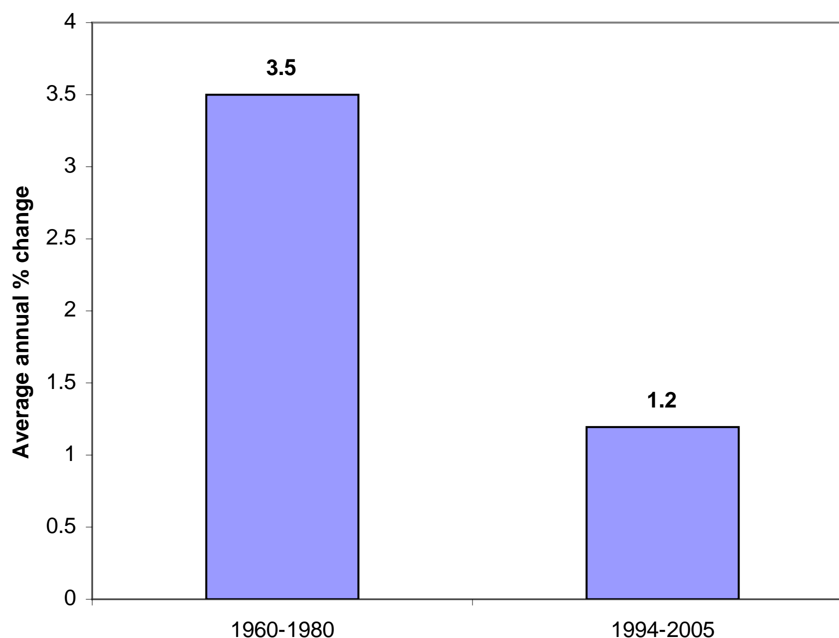
[3] Maddison, Angus. "World Population, GDP and Per Capita GDP, 1-2001AD."

[4] See graph, "Per Capita GDP Growth in Western Hemisphere," in Weisbrot, M. and Loser, C. "Latin America's Electoral Leftward Shift: The Importance of Economics." Debate. Old Ebbitt Grill. Washington, DC. 14 March 2006. [http://www.cepr.net/columns/weisbrot/2006_03_lagrowth_transcript.htm]

[5] Per capita GDP in South Korea grew by 225 percent from 1960-1980 and by 240 percent from 1980-2000; for Taiwan, the numbers are 293 percent for 1960-1980 and 187 percent for 1980-2000.

[6] It is sometimes argued that Mexico's economic growth prior to 1980 was not sustainable. This argument confuses two important issues: Mexico's pre-1980 economic policies and its pre-1980 growth rate. While some of the country's pre-1980 policies (e.g. over-borrowing, or import-substitution) were not sustainable, that does not imply that its growth rate

FIGURE 2. Mexico: Average annual growth in real per capita GDP



Sources: Maddison (2005), IMF World Economic Outlook (April 2006), and author's calculations

It is often argued that despite the setbacks of the 1980s, Mexico's growth since the implementation of the North American Free Trade Agreement (NAFTA) has been successful. Figure 2 shows the average annual growth of GDP (or income) per person for Mexico since NAFTA went into effect in 1994. For 1994-2005, this growth averaged only 1.2 percent. This is about one-third of the country's pre-1980 growth rate (3.5 percent); it is a poor growth performance for a developing country. This is in spite of the fact that foreign direct investment increased from $US 4.4 billion in 1993 to a peak of $22.7 billion in 2001[7] and Mexico's exports nearly doubled as a percent of GDP, from 16.8 percent to 29.9 percent, from 1994-2005 (since NAFTA).

Since economic growth is a concept that is not widely understood, Mexico's long-term economic growth failure *per se* has not been the major electoral issue[8] that would be expected on the basis of its

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was unsustainable. All of the countries that have had successful development experiences have had to change their economic policies at various junctures, as their own economies as well as the rest of the world changed. But they did not, in general, suffer a prolonged period of slow growth in doing so.

[7] It declined to $11.9 billion in 2005.

[8] It has been noticed by the candidates: for example, when asked in a recent interview how his government would differ from that of Vicente Fox, López Obrador replied, "There will be economic growth and job growth. We will try to reduce the number of people who are emigrating [to the United States] in search of work because the economy in Mexico is stagnant," (see "A Talk With Andres Manuel Lopez Obrador," *Washington Post*, June 18, 2006 http://www.washingtonpost.com/wp-dyn/content/article/2006/06/17/AR2006061700570.html). Similarly, Calderón has also stated that "economic growth in Mexico has being lagging behind for several decades" although he has not distinguished between the pre-1980 and post-1980 periods (see for example, Calderón's list of proposals, number 2, Economía Competitiva y Generadora de Empleos http://www.felipe.org.mx/fc/propuesta/elreto.aspx?p=http://www.felipe.org.mx/propuesta/temas/cp2.htm).

TABLE 1

Poverty In Mexico

	1992	1994	1996	1998	2000	2002	2004
	% of Total Population						
Poverty [a]							
Urban	44	43.6	61.9	55.8	43.8	41.5	41
Rural	65	72	80.8	74.9	69.3	65.4	56.9
National	52.6	55.6	69.6	63.6	53.7	50.6	47

Sources: Secretaría de Desarrollo Social (SEDESOL)
Note:
a/ The official poverty rate is calculated to estimate the percentage of the population living in households with a per capita income that cannot cover basic necessities; this income level averaged about $4.00 per day nationally in 2004.

epoch-making importance.[9] Instead, as in the other electoral campaigns where candidates from the left have challenged the status quo on economic policy,[10] the focus has been more on more perceptible effects of this economic failure – e.g. widespread poverty and low incomes – and on inequality. For example, López Obrador repeatedly points out that 80 percent of Mexicans make less than US$500 per month.[11] Of course if the Mexican economy had grown at a reasonable rate over the past 25 years, the income of this 80 percent would be enormously higher. And the poverty rate, which remains stubbornly high at 47 percent of the population, would be much lower.

Table 1 shows the percentage of people below the official poverty line in Mexico. As can be seen from the table, the overall poverty rate climbed considerably from 52.6 percent in 1992 to 69.6 percent in 1996, as a result of the peso crisis and contraction in the economy. It then declined to 47 percent for 2004. Rural poverty remains considerably higher, at 56.9 percent.

Current Economic Situation and Vulnerabilities

Despite the sluggish growth described above, a number of Mexico's economic indicators have improved in recent years and the economy is much less vulnerable today to the type of crisis that occurred with the peso collapse in 1994-1995 (see Table 2). Consumer price inflation, which averaged 21.6 percent annually from 1994-2000, is currently at 3 percent. The country's public debt is at a manageable 22.35 percent of GDP, down from 40.91 percent in 1995. With a government

[9] For an analogy, imagine a discussion of major league baseball in which most of the participants seem not to understand exactly what a batting average is or its importance, and most of the others do not distinguish between good and bad averages, labeling a batting average of .175 as "outstanding."
[10] The others were Néstor Kirchner of Argentina (2003), Lula da Silva of Brazil (2002), Lucio Gutiérrez of Ecuador (2002), Tabaré Vázquez of Uruguay (2005), and Hugo Chávez of Venezuela (1998 and 2000), Evo Morales of Bolivia (2005) and most recently Ollanta Humala of Peru (2006), who unlike the others, lost the election in the second round.
[11] See e.g., Mexican Presidential Debate. World Trade Center. Mexico City, Mexico. 6 June 2006. [http://www.razonypalabra.org.mx/publicado/debate.html]

TABLE 2

Mexico Selected Economic Indicators

	2000	2001	2002	2003	2004	2005	2006 Most Recent Data	2006 Projections
Real GDP (annual % change)	6.6	-0.2	0.8	1.4	4.2	3.0	5.5 [1]	3.5 [a]
Gross Total Public Debt (%GDP)	23.24	22.49	24.02	24.20	23.02	22.35	21.70 [2]	…
Gross External Public Debt (%GDP)	10.95	9.34	9.53	9.51	8.77	7.51	7.07 [2]	…
Gross Domestic Public Debt (%GDP)	12.29	13.14	14.49	14.68	14.25	14.83	14.59 [2]	…
Current account balance (% of GDP)	-3.20	-2.84	-2.08	-1.35	-1.09	-0.70	0.43 [2]	-0.6 [a]
Trade balance (% of GDP)	-1.43	-1.55	-1.18	-0.90	-1.29	-0.99	0.37	…
Real Effective Exchange Rate (CPI based) (average, annual % change, depreciation -)	8.70	6.98	0.25	-11.34	-4.53	3.70	3.57 [3]	…
Total reserves minus gold (current bn US$)	35.51	44.74	50.59	58.96	64.14	74.05	78.37 [4]	…
Memorandum Items								
Inflation, consumer prices (annual % change, average)	9.50	6.36	5.03	4.55	4.69	3.99	3.00 [5]	3.5 [a]
GDP current prices (Billions of US$)	581.43	622.08	649.08	639.11	683.49	768.44	…	846.78
GDP per capita (PPP US$)	8,921	8,991	9,092	9,272	9,788	10,186	…	10,604 [a]

Sources: IMF World Economic Outlook (April 2006); IMF International Financial Statistics; World Bank World Development Indicators; Banco de Mexico; Bank for International Settlements

Notes:

1/ First Quarter, year-over-year % change

2/ First Quarter

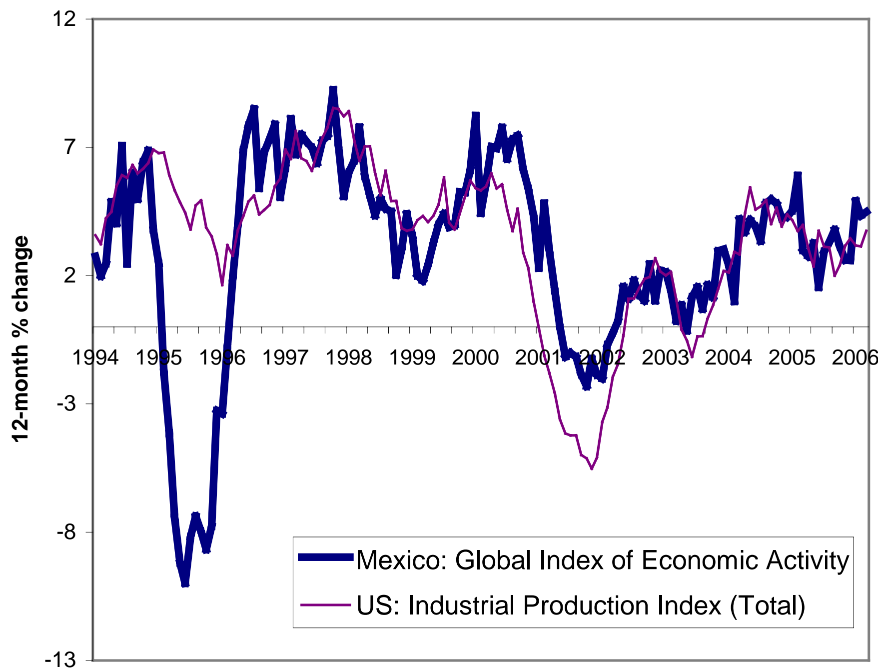
3/ January-May 2006, annualized

4/ As of June 22, 2006

5/ May 2006, year-over-year % change

a/ IMF, World Economic Outlook, April 2006

FIGURE 3. Economic activity in Mexico and the U.S.



Sources: Instituto Nacional de Estadística Geografía e Informática (INEGI), Banco de Mexico, and the U.S. Federal Reserve

budget deficit of 0.1 (as of Dec. 2005) percent of GDP, this is sustainable.[12] Of the pubic debt, only about 7 percentage points are foreign owned. The current account deficit is presently just 0.7 percent of GDP, with improvement in recent years resulting from a surge in remittances and rising oil prices and oil revenue.

These are significant improvements, and supporters of the current government and the PAN have emphasized them, while warning that a change in regime could lead to economic instability and crisis.[13] However, the Mexican economy faces likely external shocks in the foreseeable future, and it is not clear that a continuation of present policies (e.g. inflation targeting) will be appropriate to deal with them, or to restore economic growth to a level that can satisfy public demands for greater improvements in living standards and poverty reduction.

The main source of vulnerability for Mexico is the U.S. economy, which is the destination for about 85 percent of Mexico's exports. As can be seen from Figure 3, Mexico's economic activity closely follows that of the United States. The U.S. recession of 2001, caused by the collapse of the stock market bubble here, also triggered a recession in Mexico.

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[12] The IMF also reports an "augmented public sector debt" and deficit which includes the government's obligations to certain off-budget programs, including the IPAB (Institute for the Protection of Bank Savings), which provides deposit insurance (See IMF, Mexico 2005 Country Report No. 05/427).

[13] For example, Calderón has stated: "We can maintain the economic stability we have today and convert it into economic growth and jobs through investment or we can risk losing what we have already achieved," "Mexico's Calderon Names 100 Proposals for Presidency," *Bloomberg*, June 20, 2006.
http://www.bloomberg.com/apps/news?pid=10000086&sid=aNM_ubo9yhj4&refer=latin_america

The United States economy currently faces major imbalances that, when corrected, are likely to have a profound effect on Mexico's economy. The most important is the housing bubble. U.S. house prices, after increasing at about the same rate as overall inflation from the early 1950s to 1997, have in the last 8 years increased by more than 50 percent after adjusting for inflation.[14] As a result, more than $5 trillion in bubble wealth has been created. The evaporation of these paper gains, along with the shrinking of the residential construction sector of the economy as the bubble deflates, will very likely cause a recession in the U.S. economy. While it is difficult to predict the timing or depth of such a recession, it is worth noting that house prices are already beginning to fall in some bubble areas. Also, the U.S. recession of 2001 was relatively mild because the housing bubble was already in full swing, and counteracted the effects of the stock bubble collapse, not only through construction and employment but by allowing for trillions of dollars of borrowing as homeowners "cashed out" their home equity. It is not yet clear what major sources of demand will stimulate the recovery from a downturn caused by the deflation of the housing bubble, especially as the Fed currently seems to be concerned with new fears of rising inflation.

The second major imbalance in the U.S. economy that concerns Mexico is the unsustainably low level of current long-term U.S. interest rates. The interest rate on 10-year U.S. Treasury bonds is about 0.8 percent above inflation; historically the difference has averaged more than 3 percent. The low yield on long-term U.S. treasuries is a result of purchase by central banks, mainly from Asia; these could adjust their holdings at any time. An anticipated decline in the U.S. dollar could also push up long-term rates here. In any scenario, a rise in U.S. interest rates could cause an outflow of funds from Mexico; this is what precipitated the peso crisis at the end of 1994, when the Fed doubled short-term rates (from 3 to 6 percent) over the year beginning in February of 1994.

A repeat of the 1995 peso crisis is unlikely, however, most importantly because Mexico now has a floating rather than a pegged exchange rate. Nonetheless the Mexican economy is likely to be adversely affected by interest rate increases here, especially if the Mexican authorities react too strongly by tightening monetary policy (see below).

The third major imbalance in the U.S. economy is the U.S. trade and current account deficit, which almost all economists recognize to be unsustainable at 7 percent of GDP (current account). As the dollar falls to adjust this imbalance, it will have an enormous impact on the growth of the U.S. import market, which Mexico has become dependent on. The U.S. current account does not have to be brought into balance but in order for the level of U.S. foreign indebtedness to stabilize, the adjustment in the dollar and the trade deficit will cause the U.S. import market to grow very slowly or not at all, when measured in non-dollar currencies, over the next decade.[15] This adjustment will have a significant negative impact on Mexico's economy, and the Mexican government may want to look for ways to diversify its export markets.

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[14] See, e.g., Dean Baker (2006) "The Menace of an Unchecked Housing Bubble," *The Economists' Voice*: Vol. 3: Iss. 4, Article 1. http://www.bepress.com/ev/vol3/iss4/art1/.

[15] See Baker, D. and Weisbrot, M. (2004) "Fool's Gold: Projections of the U.S. Import Market" Center for Economic and Policy Research, Washington, DC. Updated version forthcoming June 2006.

Economic Policy

Mexico's Central Bank (the Bank of Mexico or BOM) is presently following an inflation targeting[16] regime, with the current target at 3 percent, combined with a floating exchange rate. These policies can have their disadvantages, which may become more pronounced depending on the external shocks that the country faces in the near future. They may have already played a role in producing the sluggish growth that Mexico has experienced in recent years. For example, the BOM raised its short-term (overnight) interest rate from 4.25 percent in mid-2003 to 9.75 percent in June 2005. Core inflation was steady at about 3.6 percent and overall inflation was at 4 percent and falling when the BOM began its interest rate increases. The economy slowed, beginning in the fourth quarter of 2004. The BOM began to ease its monetary policy in August 2005, and economic growth has since picked up.

Some economists and central bankers, including former Federal Reserve Chairman Alan Greenspan, have opposed inflation targeting as too restrictive, in that it can cause the monetary authorities to raise interest rates and slow the economy unnecessarily. This is even more true if, as in Mexico, the central bank targets the overall inflation rate, rather than the core rate (which excludes the more volatile food and energy prices). When inflation is targeted, the monetary authorities might slow the economy in the face of an external shock such as an increase in imported food prices. A depreciation of the currency also causes at least some inflation as import prices rise; if the central bank is determined to avoid this, it can also slow the economy both by reducing domestic economic activity through higher interest rates and by preventing the exchange rate from falling to a more competitive level that would improve the trade balance.

These macroeconomic policies matter for several reasons. First, overly restrictive monetary and fiscal policies may have contributed to the long-term growth slowdown, and it may be difficult or impossible to return to higher growth rates without re-examining these policies. Second, the government and monetary authorities' response to future external shocks can make a big difference in terms of how much economic pain is involved in the adjustment process. The adjustment to the peso devaluation and crisis of 1995 is often considered a successful one because it is compared to the Asian economic crisis two years later. But despite negotiation of a financial package worth more than $50 billion dollars with the international financial institutions, the Mexican economy shrank by more than 6 percent in 1995. This is more than the Argentine economy lost after defaulting on more than $100 billion of debt and suffering a collapse of its banking system, and of course its own devaluation. It is at least possible that overly tight fiscal and monetary policies contributed to Mexico's losses.

Given the Mexican economy's vulnerability to what appear to be inevitable shocks from the United States, the country's current economic policies could cause problems in the near future. For example, an outflow of capital could cause the Mexican peso to depreciate; if the central bank responds by raising interest rates to negate the inflationary impact of the depreciation, that could cause unnecessary slowing of the economy. The government may also need to stimulate the economy in the face of a reduction of demand from the U.S. import market.

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[16] This means that the Central Bank targets a particular rate of inflation and adjusts interest rates in order to keep inflation within a narrow band around that rate – as opposed to a more broadly defined goal of "price stability," in which the allowable rate of inflation may vary with economic conditions.

Conclusion

Mexico's most important economic problem is the same as that of the overall region: the long-term economic growth failure of the last 25 years. This, rather than any changes in income distribution, is the major cause of the high poverty rates and low incomes for the majority of Mexicans. It is not clear that this long-term failure can be reversed while maintaining the present macroeconomic and development policies, including the central bank's inflation targeting. Rather, it seems likely that at least some of these policies will need to be re-examined, and new development strategies considered, if Mexico is to embark on a solid growth path that can substantially reduce poverty.

In the short run, the Mexican economy is also vulnerable to shocks from the correction of major imbalances in the U.S economy, including the U.S. housing bubble, current account deficit, and long-term interest rate adjustments. It is not clear that Mexico's current economic policy framework, despite the present stability of the economy, will be the best set of policies for dealing with these expected adverse external shocks to the economy.