

The Pact for Mexico after Five Years: How Has It Fared?

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Contents

Executive Summary 3

Introduction 6

The Pact for Mexico: Promises and Results 8

Economic Policy During the Pact 12

Conclusion 19

References 21

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Executive Summary

In December 2012, leaders of Mexico’s then most prominent political parties agreed on the “Pact for Mexico” in the Chapultepec Castle in Mexico City. It was billed as charting a new path for Mexico and its economy, and was signed by the largest political parties at that date: President Enrique Peña Nieto of the Institutional Revolutionary Party (PRI); Jesús Zambrano Grijalva, national president of the Party of the Democratic Revolution (PRD); María Cristina Díaz Salazar, interim president of the Executive Committee of the PRI, and Gustavo Madero Muñoz, national president of the National Action Party (PAN).¹

This paper briefly examines whether there has been progress toward the Pact’s goals since it was signed, and whether any measures taken since then — including current economic policies — are likely to help Mexico break out of its long economic slump. In the twenty-first century, Mexico has ranked 18th out of 20 Latin American countries in the growth of its income per person.

It is clear from the available data that there is little, if any, progress toward the goals put forth in the Pact. For example:

- The Pact promised to increase growth to more than 5 percent annually. Real GDP growth averaged just 2.4 percent annually, and does not appear to be making progress toward the 5 percent goal. Over the same period, real per capita GDP growth averaged only 1.4 percent annually.
- The Pact promised to increase investment to over 25 percent of GDP. Gross fixed capital formation fell from 22.3 percent of GDP in 2012 to 20.5 percent in 2017.
- The Pact also promised to reduce inequality: the income share of the top 10 percent, already high at 34.9 percent in 2012, increased to 36.3 percent in 2016. Meanwhile, the share of income received by the poorest 10 percent remained the same at just 1.8 percent
- The Pact promised to reduce poverty. The national poverty rate has seen a slight drop between 2012 and 2016, from 45.5 percent (of population) to 43.6 percent. However, this was not

1 The only major party that isn't associated with the Pact is Morena, which was only formally created in 2014. Andrés Manuel López Obrador, the 2018 presidential candidate for Morena, has criticized the Pact and advocated for a more developmentalist economic program, including some industrial policy and a somewhat expanded social safety net.

enough to lower the absolute number of people living in poverty, which rose very slightly to 53.4 million in 2016, from 53.3 million in 2012.

- Public investment in state oil company Pemex was about 2.0 percent of GDP (312 billion pesos) in 2012, and fell to 0.9 percent of GDP (191 billion pesos) by 2017.
- The government's oil revenue collapsed, falling from 1,386 billion pesos in 2012 to only 827 billion pesos in 2017, a fall from 8.8 percent of GDP to 3.8 percent of GDP. This is a very large negative fiscal shock.
- On the positive side, underemployment has come down somewhat from 8.4 percent in 2013 (yearly) to 6.8 percent in the first quarter of 2018. (In Mexican statistics, underemployment is a much better measure of the state of the labor market than unemployment — see below.) However, the economic growth that reduced underemployment was driven mainly by consumption, which accounted for an average of 76.9 percent of real GDP growth from 2013 to 2017.

There are a number of reasons to believe that the failure to achieve any significant progress toward the Pact's goals in the first five years is not simply a result of insufficient time, but rather the continued application of a flawed set of policy choices. Among the reasons:

- The government engaged in a fiscal consolidation plan in which spending fell from 24.8 percent of GDP in 2014 to 20.1 percent of GDP (projected for 2018). This is a very large decline in government spending, something not seen for example in the last 70 years in the United States.
- The cyclically adjusted primary fiscal balance, which attempts to adjust for the business cycle, tightened by 2.6 percentage points during this time.
- The government's commitment to further fiscal consolidation makes it very difficult for it to make the public investments it might need in infrastructure, education, and research and development in order to deliver on the Pact's promises to increase growth or reduce inequality or poverty. All of these levels of public investment are currently quite low.

- Beginning in December 2015, the Mexican Central Bank raised interest rates quite aggressively, more than doubling the rate of 3 percent to 7.5 percent by February 2018. There is evidence (see below) that this may have been much more monetary tightening than needed.
- Mexico's hyperliberalization of its financial markets has made it particularly vulnerable to contagion and economic shocks from the world economy, and especially from the United States — upon which it also depends for 80 percent of exports.

Mexico was once a fast-growing developing economy, with its income per person nearly doubling between 1960 and 1980. It thereafter went into a long slump and has never come close to recovering its prior rates of growth and development. This paper argues that vitally important policy choices have been responsible for this long-term failure.

Mexico currently faces serious downside risks from the global economy, as the US Federal Reserve is on track to raise interest rates four times this year, and more in 2019. The Fed's interest rate hikes can have a severe impact on the Mexican economy if it draws away sufficient capital flows. This was seen in the 1994–95 peso crisis, where Mexico lost 9.5 percent of GDP in a downturn that was triggered by the Fed's cycle of interest rate hikes at the time; and in 2013, when the country's hyperliberalization of financial markets also made it vulnerable to the Fed's tapering of quantitative easing in 2013. These hyperliberal financial markets make Mexico more vulnerable than it otherwise would be to turbulence in international financial markets that may already be beginning in this Fed tightening cycle.

Thus Mexico, under the current long-term policy regime described above, is committed to paying down the public debt when growth picks up even slightly; and when there are storm clouds on the horizon (which also include the turbulence of current relations with the United States, and the uncertainty of NAFTA renegotiation), fiscal and monetary policy become even more of a drag on economic growth. Mexico is therefore caught in a trap of low investment and low growth, without making the necessary public investments in infrastructure, research and development, or education. Without such investment, it cannot maintain its international competitiveness (even in US markets with respect to China), boost long-term productivity growth, or even maintain the necessary fiscal revenues from Pemex — not to mention reducing poverty or inequality.

Introduction

Mexico has suffered from a long-term economic failure that began in 1980 and has never come anywhere close to recovering its prior rate of economic growth or development. From 1960 to 1980, living standards rose rapidly, with income per person nearly doubling; in the two decades that followed, it increased by just 9 percent.² In the twenty-first century, Mexico's economic performance improved somewhat but still lagged behind most of Latin America, leaving it 18th of 20 countries in economic growth since 2000, with only Belize and Venezuela doing worse.³

Many of Mexico's current troubles, including the rise to power of drug cartels and the tens of thousands of murders and disappearances, the deep corruption of the state, and the associated political discontent, result at least partly from this long-term economic failure. Real wages today are barely above their level of 1980. Poverty has been widespread and persistent; if we measure from the beginning of NAFTA, which was supposed to jump-start the Mexican economy, the Mexican national poverty rate was actually higher in 2014⁴ than it was when NAFTA was implemented in 1994. This meant that an additional 20.5 million Mexicans were living in poverty in 2014, as compared to 1994.⁵

There are multiple causes of this prolonged economic failure, including NAFTA itself, which helped lock in a set of inappropriate economic policies that began in the 1980s and added new ones. About 5 million Mexican family farmers were displaced from agriculture between 1991 and 2007.⁶ Mexico also had the misfortune of tying its economy to that of the United States, just as the United States was about to embark on the building of the two biggest asset bubbles in world history (the stock market bubble in the late 1990s and the housing bubble post-2002), followed by the Great Recession.

The accession of China to the WTO in 2000 put Mexico into direct competition for the US market with a country that had a robust industrial policy, including control over its exchange rate (as opposed to Mexico's inflation-targeting regime), vastly more spending on research and development, and government control over its financial system. Mexico's hyperliberalization of its financial system also presented new instabilities: as the International Monetary Fund (IMF) has pointed out, the country's "deep and liquid foreign exchange and domestic equity and sovereign bond markets can serve as an early port of call for global investors in episodes of financial turbulence and hence are susceptible to

2 Weisbrot et al. (2017).

3 Average per capita GDP growth between 2000 and 2017. IMF (2018a).

4 The historical time series for poverty was discontinued by CONEVAL and values based on this methodology are only available until 2014, while calculations based on the new methodology only begin in 2012.

5 CONEVAL (2014), and Cordero and Campos, coords. (2016, p. 98).

6 Scott (2009, p. 25).

risks of contagion.”⁷ This became evident in May 2013, when the US Federal Reserve announced that it was going to “taper” its quantitative easing, provoking flashbacks of the 1994 peso crisis (which was also caused by a tightening of the Fed’s monetary policy). In 2013, Mexican growth fell to just 1.4 percent as a result of this “taper tantrum.”

In December 2012, leaders of Mexico’s then most prominent political parties agreed on the “Pact for Mexico” in the Chapultepec Castle in Mexico City. It was billed as charting a new path for Mexico and its economy, and was signed by the largest political parties at that date: President Enrique Peña Nieto of the Institutional Revolutionary Party (PRI); Jesús Zambrano Grijalva, national president of the Party of the Democratic Revolution (PRD); María Cristina Díaz Salazar, interim president of the Executive Committee of the PRI, and Gustavo Madero Muñoz, national president of the National Action Party (PAN). The only leader of a significant political party who did not sign the Pact was Andrés Manuel López Obrador of the Morena party, who is currently favored to win the July presidential election. The Morena party was not yet formed at the time of the Pact; however, López Obrador subsequently denounced the Pact.⁸ He has said he favors a more developmentalist economic program, including some industrial policy and a somewhat expanded social safety net.

The Pact pledged to institute policies that would usher in a new era of growth and prosperity for Mexico, through the implementation of a series of structural reforms. The timeline for implementation of the proposed reforms extended to the second semester of 2018.

The purpose of this paper is to examine briefly whether there has been progress toward the Pact’s goals since it was signed; and whether any measures taken since then — including current economic policies — are likely to help Mexico break out of its long economic slump and forge a different path toward economic and social progress.

7 IMF (2013).

8 Notimex (2013).

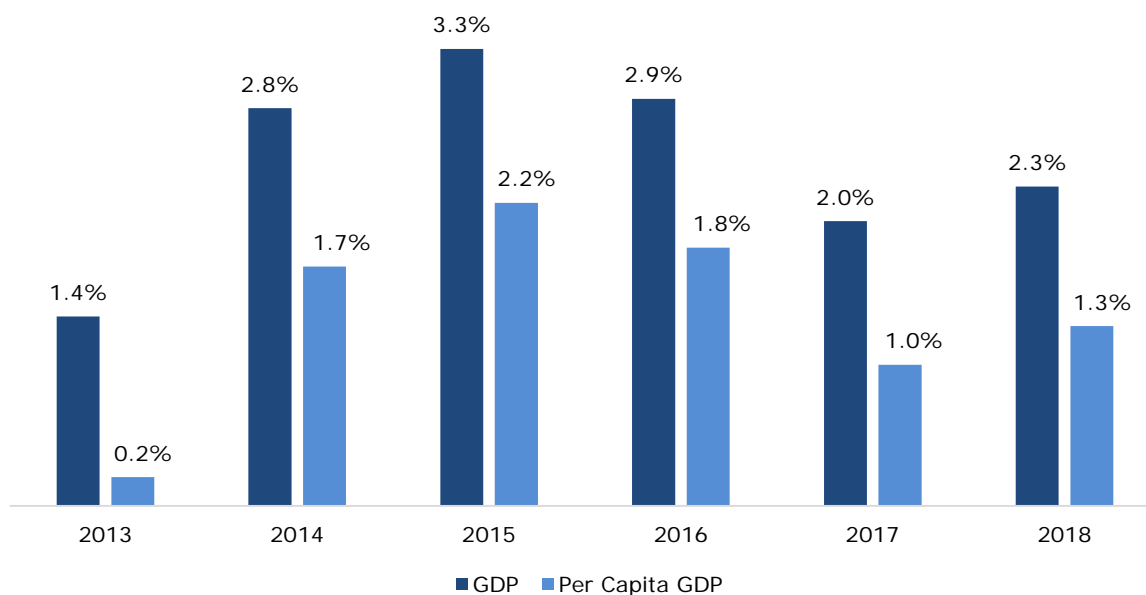
The Pact for Mexico: Promises and Results

The Pact for Mexico⁹ stated it:

...intends to lay the foundations of a new political, economic and social agreement to boost the economic growth needed to generate the quality jobs required by the Mexican people in order to help build a society of rights that puts an end to clientelism, expanding the rights and freedoms with a gender perspective, as well as consolidating the rights and guarantees in the Constitution to achieve the well-being of the entire population and to decrease poverty and social inequality.

In particular, it promised to increase growth to more than 5 percent annually, and to increase investment to over 25 percent of GDP.

FIGURE 1
Real GDP Growth



Source and notes: IMF (2018a).

Figure 1 shows annual real GDP growth since 2013, the first year after the December 2012 signing of the Pact. It averaged just 2.4 percent annually and does not appear to be making progress toward the 5 percent goal. Over the same period, real per capita GDP growth averaged only 1.4 percent annually.

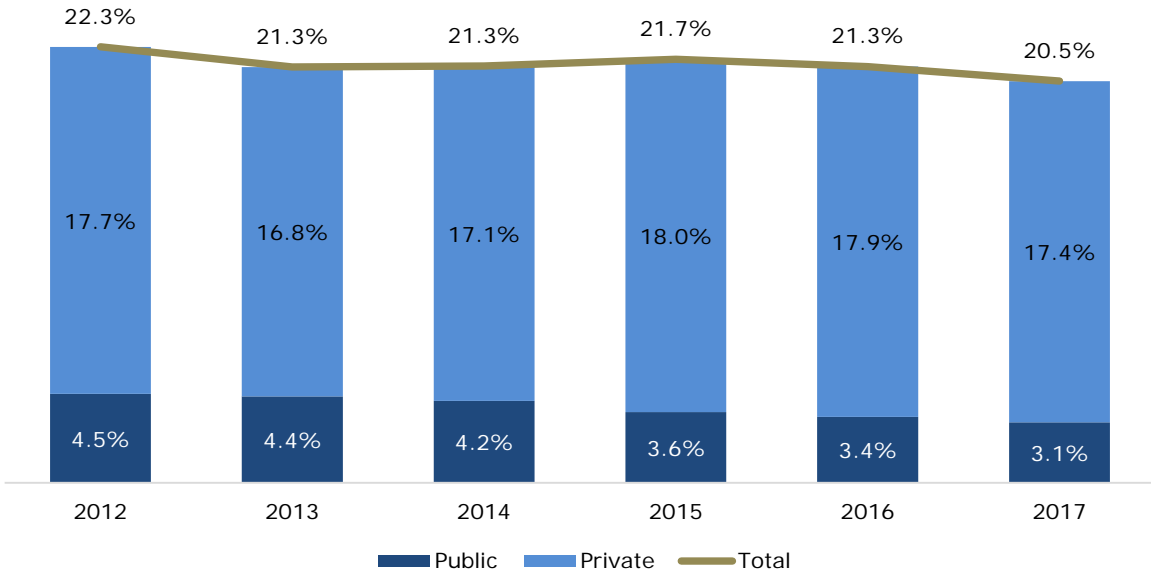
⁹ Peña Nieto et al. (2012).

Of course, per capita GDP measures average living standards but does not tell us what happened to different sectors of the population. For that, we can look at data for income by decile. Here we can see that households in the top 10 percent of the income distribution saw their share of national income increase from 34.9 percent in 2012 (already a large share of national income as compared with most of the world) to 36.3 percent in 2016. Meanwhile, the share of income received by the poorest 10 percent remained the same at just 1.8 percent.¹⁰ Clearly, there has not been progress toward the Pact’s stated goal of reducing Mexico’s severe income inequality.

For the years 2012–2016, real average wages increased by 2.9 percent, or just 0.7 percent annually.¹¹

The national poverty rate has seen a slight drop between 2012 and 2016,¹² from 45.5 percent (of population) to 43.6 percent. However, this was not enough to lower the absolute number of people living in poverty, which rose very slightly to 53.4 million in 2016, from 53.3 million in 2012.¹³

FIGURE 2
Gross Fixed Capital Formation as a Percent of GDP



Source and notes: INEGI (2018).

10 INEGI (2018).

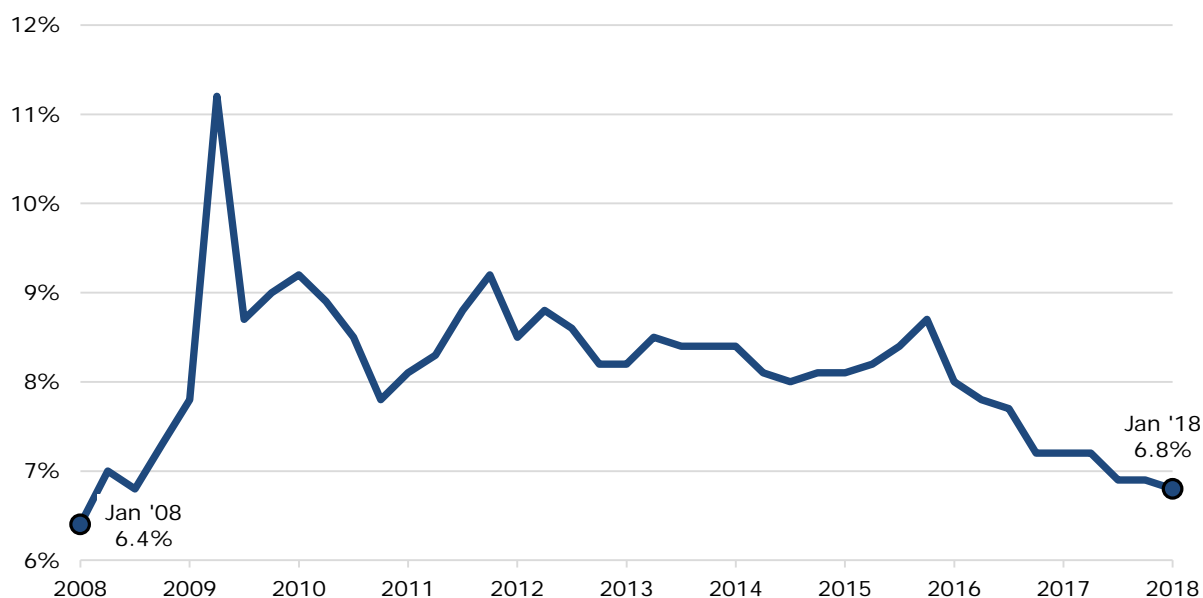
11 CEPAL (2018).

12 This decline is according to a new methodology introduced in 2014 by CONEVAL that is only calculated going back to 2012. Available data going to 2014, based on the old methodology, actually show an increase in poverty between 2012 and 2014, and that 55.1 percent of the population lived in poverty in 2014. For more details, see Cordera Campos and Provencio Durazo, coords. (2016).

13 CONEVAL (2017).

There is no sign that the Pact’s promise with regard to investment is materializing. **Figure 2** shows gross fixed capital formation as a percent of GDP. It fell from 22.3 percent of GDP in 2012 to 20.5 percent in 2017. Most of the drop was in public investment, which was already low at 4.5 percent of GDP. But in any case, it is difficult to imagine Mexico raising its rate of economic growth, much less accomplishing the other goals of the Pact, without a sustained increase in the rate of investment.

FIGURE 3
Underemployment Rate



Source and notes: INEGI (2018).

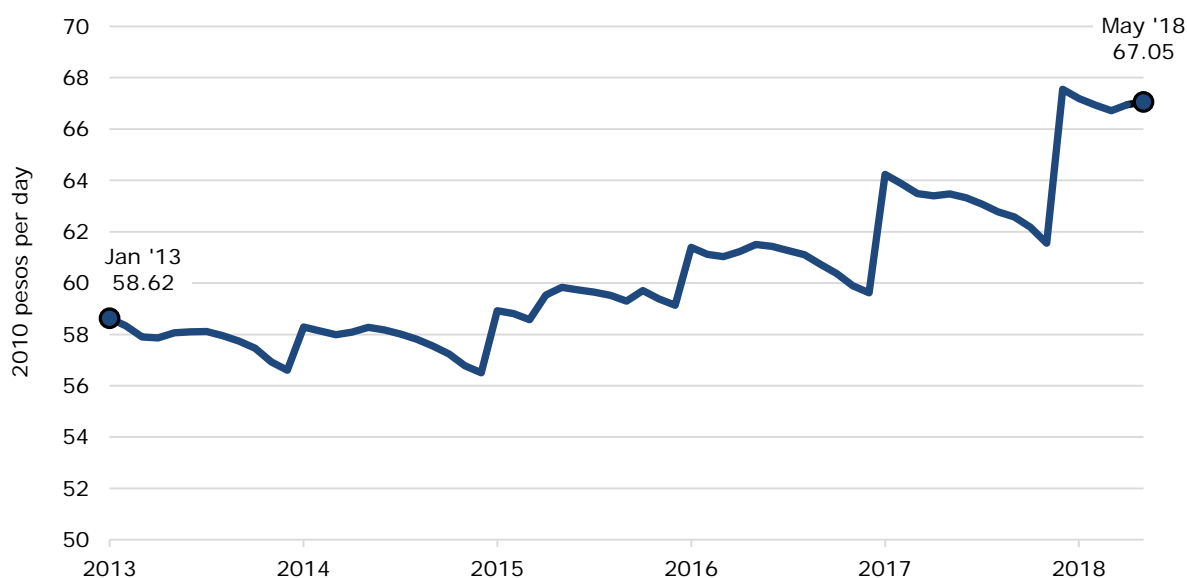
On the positive side, underemployment (which is a much better measure of the state of the labor market than unemployment)¹⁴ has come down somewhat from 8.4 percent in 2013 (yearly) to 6.8 percent in the first quarter of 2018. This can be seen in **Figure 3**.

However, the recent growth that has improved the labor market has been driven mainly by consumption. For the years 2013 through 2017, consumption accounted for an average of 76.9 percent of GDP growth.¹⁵ A sizeable increase in remittances, which rose by 28 percent from \$22.4 billion in 2012 to \$28.8 billion in 2017, also contributed significantly to this recent growth.

14 Given Mexico’s large informal sector, the official unemployment rate does not capture the full extent of unemployment. In order to be counted as unemployed, a worker needs to not have worked even one hour in the reference period. Given the lack of a proper safety net, most of the unemployed engage in at least some informal work. For more details and information on unemployment in Mexico, see Salas (2013).

15 Authors’ calculations, INEGI (2018).

FIGURE 4
Real Minimum Wage



Source and notes: Banco de México (2018a).

Also on the positive, the real minimum wage has increased in real terms by about 14 percent since 2013, with sizeable nominal increases in the run-up to this year's presidential election. This can be seen in **Figure 4**. If legislators continue this trend, it should make a dent in the poverty rate, and have some impact on reducing inequality. However, there is no indication so far that it will continue.

Public investment in state oil company Pemex was about 2 percent of GDP (312 billion pesos) in 2012, 2 percent of GDP (329 billion pesos) in 2013, and fell to 0.9 percent of GDP (191 billion pesos) by 2017.¹⁶

Along with the decline in investment, production declined sharply. This drop can be seen in **Table 1**.

TABLE 1
Output of Oil Products

Production	Units	2012	2013	2014	2015	2016	2017	% Change
Liquid hydrocarbons	Mbd	2913.1	2881.7	2788.1	2591.0	2458.3	2226.8	-23.6%
Natural gas	MMpcd	6384.7	6370.3	6531.9	6401.0	5792.5	5068.0	-20.6%
Refined products and liquefied petroleum gas	Mbd	1404.8	1456.7	1385.0	1267.3	1119.2	915.1	-34.9%
Petrochemicals	Mt	10694.1	11477.7	11318.2	9939.4	8968.9	7425.1	-30.6%
Naphthas	Mt	2807.5	2834.9	2963.8	2676.0	2402.5	2006.3	-28.5%
Crude oil processing	Mbd	1199.3	1224.1	1155.1	1064.5	933.1	767.0	-36.0%

Source and notes: Pemex (2018).

¹⁶ Secretaría de Hacienda y Crédito Público (2018).

The drop in production, which also coincided with a fall (and only partial recovery) in oil prices, meant that the government's oil revenue collapsed, falling from 1,386 billion pesos in 2012 to only 827 billion pesos in 2017, a decline from 8.8 percent of GDP to 3.8 percent of GDP.¹⁷ This is a very large negative fiscal shock. The IMF has noted “continued improvements in PEMEX’s profitability and efficiency” is “essential for the fiscal outlook.”¹⁸ But it is difficult to achieve such improvements with declining public investment.

One of the main reforms of the Pact for Mexico was to allow private and foreign investment in the oil sector. However, as of the end of 2017, Mexico had only managed to secure \$3 billion in energy sector investment.¹⁹

Economic Policy During the Pact

The Pact for Mexico put forth some goals for the economy and Mexican society that the leaders of the largest political parties, with the exception of López Obrador of Morena, were willing to sign on to. As we have seen, there has been little or no measurable progress toward those goals in the five and a half years since the Pact was signed. However, it could be argued that this is not enough time and that the current government has begun to lay the foundations for these new policies and goals for the future.

To evaluate this possibility, we must look at the government's overall economic policy priorities, including macroeconomic policy (in particular fiscal and monetary policy), the stated goals of those policies, and the arguments for them. One of the best sources of this information — complete with data — can be found in a regular publication from the IMF, called an “Article IV Consultation” report. The Article IV Consultation involves a visit by an IMF team to the respective country to meet with the government (in particular the finance ministry and central bank), and some research and sharing of ideas, after which a report is published by the IMF.²⁰

The policy analysis and prescriptions in this report thus generally represent an elite consensus between the IMF and government officials (including the central bank) on the state of the economy and what policy measures are appropriate going forward. They are not merely the opinions of the IMF staff or

¹⁷ Pemex (2018), INEGI (2018), and authors' calculations.

¹⁸ IMF (2017a, p. 27).

¹⁹ IMF (2017b, p. 5).

²⁰ IMF (2018b).

board of directors. The report, therefore, can shed much light on the government’s policies and thinking on a whole range of the most important economic decision-making.

The most recent Article IV report for Mexico was published in October of last year. It places a very strong emphasis on fiscal consolidation — that is, reducing the public debt as a percentage of GDP, through budget tightening. The report notes that the government, “consistent with past Fund advice,” have “adhered to their commitment to the fiscal consolidation path until 2018” and that “the fiscal consolidation plan announced by the authorities [the Mexican government] in 2014 is nearly completed.”²¹

TABLE 2

Fiscal Indicators						
Indicator	2014	2015	2016	2017	2018	
Cyclically Adjusted Primary Balance	-1.5	-1.2	-0.7	1.5	1.1	
General Government Overall Balance	-4.5	-4	-2.8	-1.1	-2.5	
General Government Primary Expenditure	24.8	24.2	22.7	20.8	20.1	
General Government Revenue	23.4	23.5	24.6	24.8	22.1	
General Government Expenditure	28	27.5	27.4	25.9	24.6	
General Government Gross Debt	48.9	52.9	56.8	54.2	53.5	

Source and notes: IMF (2017c), IMF (2017a), estimates are after 2017.

This fiscal consolidation can be seen in **Table 2**. As measured by primary (noninterest) expenditure, government spending has fallen from 24.8 percent of GDP in 2014 to 20.1 percent (projected for 2018).²² This is a very large decline in government spending, something not seen, for example, in the last 70 years in the United States.²³

Some government spending varies with the business cycle (e.g. spending on welfare for low-income residents is greater when the economy is slowing or in recession); also, with respect to the impact of fiscal tightening on the economy, it is not only changes in spending but tax revenue that affects the growth of the economy. We can, therefore, look at an estimate of the cyclically adjusted primary fiscal balance, also shown in Table 2. This measure attempts to adjust both expenditures and revenues for the business cycle and also excludes interest payments. It is estimated to have tightened from -1.5 percent in 2014 to 1.1 percent in 2018, or 2.6 percentage points.

This is a sizeable fiscal adjustment; in a separate study, the IMF estimated that it would subtract 0.5 percent annually from GDP growth annually for the years 2015–2020.²⁴ However, the IMF notes that

21 IMF (2017a, p.17).

22 Ibid., p. 42.

23 BEA (2018).

24 IMF (2015, p. 9).

their estimate of the multiplier for this tightening should be interpreted as a lower bound, and the impact could be larger for a number of reasons.²⁵

The fiscal consolidation succeeded in bringing the debt-to-GDP ratio down from 56.8 percent in 2016 to 53.5 in 2018. Nonetheless, the Article IV paper calls for more fiscal tightening. The government and the IMF are in agreement that “fiscal policy should continue to aim at keeping the public debt-to-GDP ratio on a downward trajectory.” In order to accomplish this, the IMF estimates that the government would need to run a primary budget surplus “slightly above the debt-stabilizing level of 0.9 percent of GDP.”

The Fund recommends “further strengthening the fiscal framework” in order to make sure that this happens. This means reducing the “excessive discretion” that the government has to invoke “exceptional circumstances” “in terms of when and how much the fiscal stance can deteriorate and how it can be brought back to equilibrium.” And further:

It would be desirable to have a tighter link between the desired level of public debt and PSBR (Public Sector Borrowing Requirement) targets, to limit the exceptional circumstances clauses to cases of large output or oil price shocks, and to have explicit guidance on the return path after such clause is invoked. One-off transfers from the Bank of Mexico to the budget should be entirely used to reduce the PSBR and public debt.

What does all this mean in practice? It means that reducing the public debt must have an even higher priority than it does now, in comparison to other social or economic objectives. This would make it very difficult for the government to make the public investments it might need in infrastructure, education, research and development, in order to deliver on the Pact’s promises to increase growth or reduce inequality or poverty. All of these levels of public investment are currently quite low.

For example, less than a third of Mexicans graduate from high school. It is difficult to imagine how the government would be able to substantially raise educational levels under the type of fiscal straitjacket that is described here.

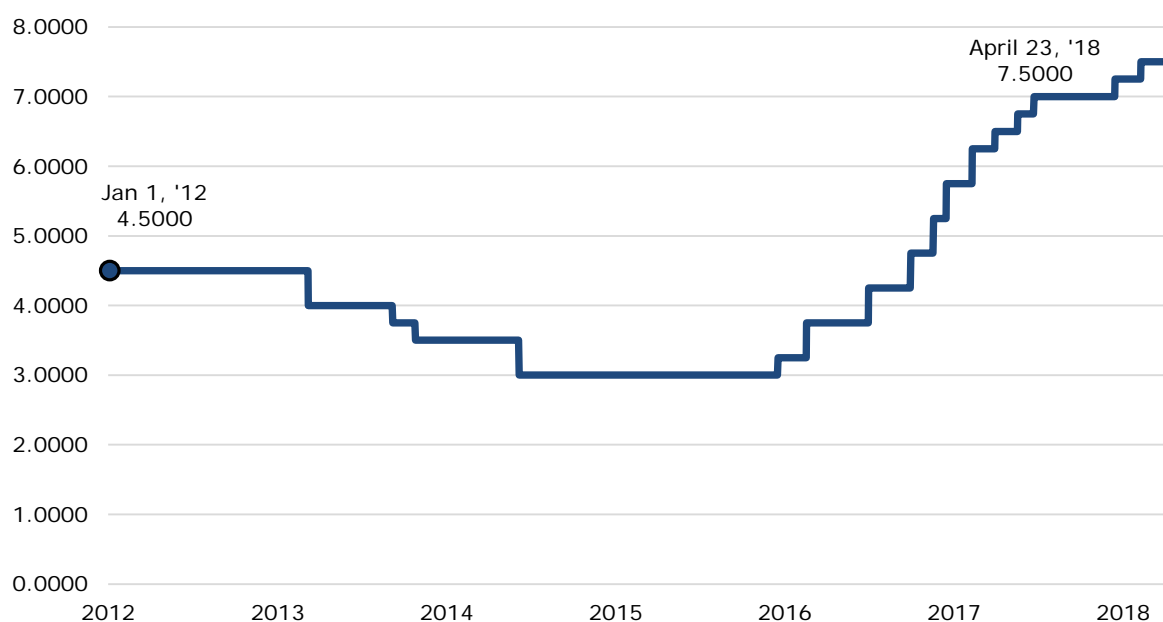
The overemphasis on fiscal tightening also implies a tendency toward slower economic growth generally. Furthermore, it is not clear why the goal of pushing debt below the level of 50 percent of

²⁵ In addition, as noted above, the IMF estimate of potential GDP for Mexico is questionable; and to the extent that they are underestimating the gap between potential and actual GDP, they will also underestimate the multiplier.

GDP is so important. The interest payments on the debt — a better measure of the actual debt burden — are currently 2.8 percent of GDP, which is not excessive.²⁶ Only about 34 percent of the public debt is denominated in foreign currency.²⁷ As a result, the annual interest on the public debt that is paid in dollars is about \$13 billion, or about 3.2 percent of export earnings.²⁸ This is a very low level of foreign public debt service. It means that the public debt is not likely to contribute to any balance of payments problems, which is the most serious risk of public borrowing if it were to become excessive.

Another harmful and related bias evident in the paper can be seen in the definition of potential output. An economy that is operating at its potential output is basically at full employment. The Article IV paper shows Mexico to be operating at potential output in 2017. Yet this is clearly contradicted by the government’s measure of underemployment, which is really measuring millions of people who are scrambling to do something for pay, as little as one hour per week and therefore not counted in the official unemployment rate.²⁹ By defining potential output and unemployment in these ways, the IMF and Mexican authorities are defining away the problem of unemployment, and therefore also contributing to the prolonged wage stagnation that Mexico has suffered, as well as the persistent inequality.

FIGURE 5
Policy Rate



Source and notes: Banco de México (2018c).

26 Based on IMF Projections for 2018. IMF (2017a, p. 41, Table 2).

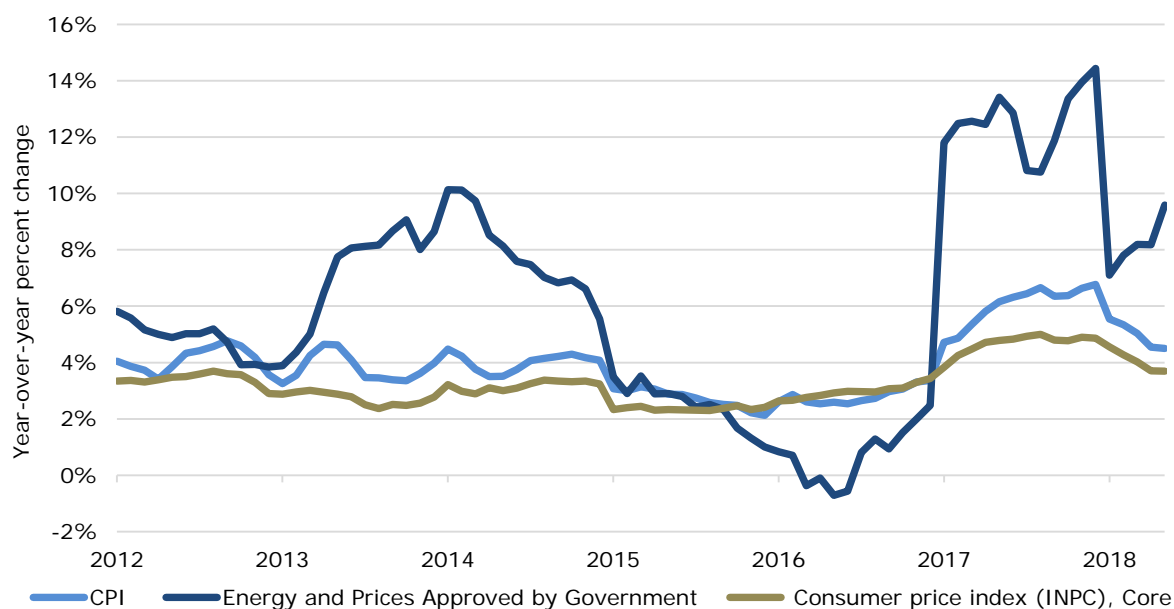
27 Based on IMF Projections for 2018. IMF (2017a, p. 55).

28 Authors’ calculations, Banco de México (2018b).

29 Salas (2013) and Weisbrot et al. (2017).

The same can be said for Mexico’s monetary policy, which has been overly tight. The Mexican Central Bank raised interest rates quite aggressively, more than doubling the rate of 3 percent in December 2015 to 7.5 percent in February 2018. This is seen in **Figure 5**. It is true that they were dealing with an increase in inflation, which shot up from 2.1 percent in December 2015 to a peak of 6.8 percent in December 2017, before falling back to 4.5 percent in May 2018, as can be seen in **Figure 6**.

FIGURE 6
Inflation Rate



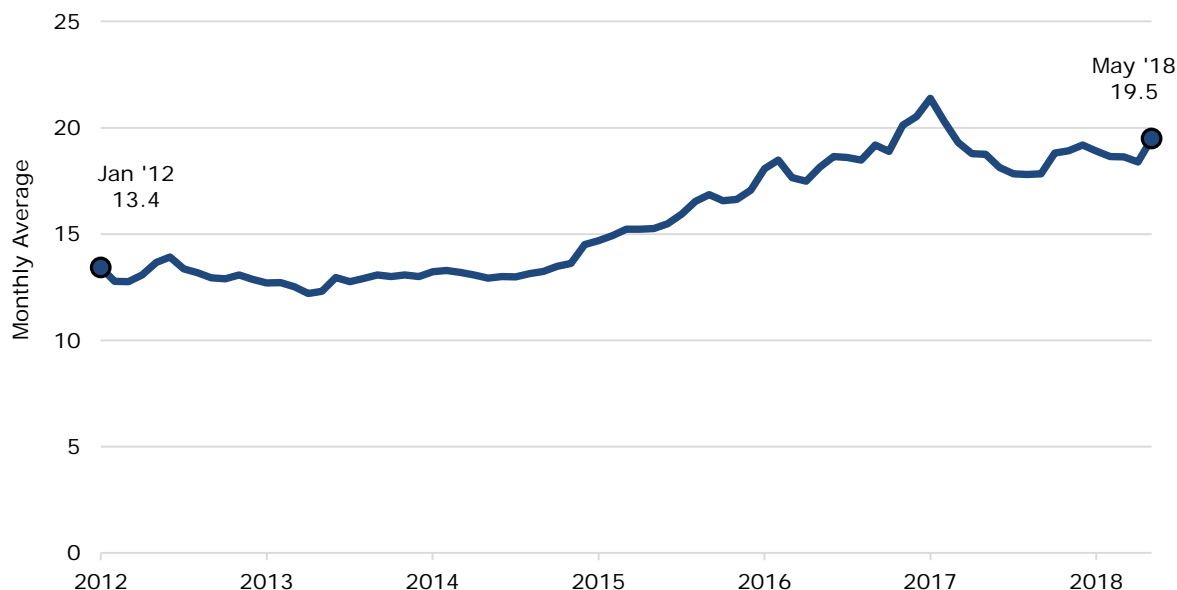
Source and notes: Banco de México (2018d).

However, the burst of inflation between 2017 and 2018 was not a result of an overheated economy operating above potential output, or wages rising faster than productivity. On the contrary, it was primarily a result of two negative shocks: first, and most importantly, the liberalization of energy prices. On January 1, 2017, the government officially stopped regulating prices for gasoline, leading to a big jump in prices.³⁰ The contribution of this increase in energy prices can be seen in Figure 6. Energy price inflation grew from 2.5 percent in December 2016 to 14.4 percent in December 2017, before falling to 8.2 percent in April 2018.

As shown in Figure 6, core inflation, which excludes energy and food, rose by from 3.4 percent to 4.9 percent during the same period, before falling to 3.7 percent as of May 2018. It is therefore questionable whether so much firepower was needed to counteract a temporary shock to prices that can be expected to dissipate, and did.

³⁰ Agren (2017).

FIGURE 7
Exchange Rate Peso/Dollar



Source and notes: Banco de México (2018e).

The same can be said for the depreciation of the peso, which fell from 12.9 pesos to the dollar in May 2014 to 21.4 in January 2017, before bouncing back some (**Figure 7**). The impact of this shock would also be expected to dissipate. Mexico also has a very low pass-through from nominal exchange rate depreciation to consumer prices. The IMF estimated Mexico's two-year cumulative pass-through at just 8 percent, which is vastly lower than for other developing countries, as shown in **Figure 8**.

For these reasons, it appears that Mexico's monetary policy, like its fiscal policy, may be unnecessarily slowing economic growth and employment, and discouraging investment over the long term.

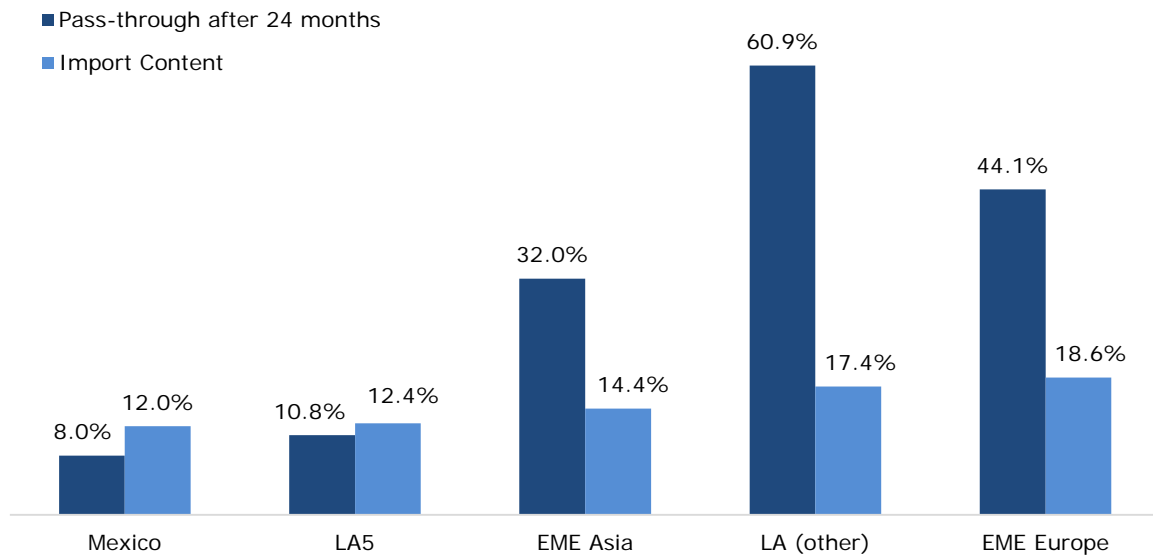
Another problem that Mexico faces, whose solution is also constrained by its commitment to reducing government spending, is its low level of investment in research and development. Since 2013, this has been unchanged at about 0.5 percent of GDP (for comparison, China spends over 2 percent of its GDP on research and development).³¹ The Pact also called for increasing investment in science and technology. However, government figures for public physical investment in science, technology and innovation, and education has been cut in half since 2013, from an already very low level of 0.18 percent of GDP to just 0.08 percent of GDP.³²

31 OECD (2018).

32 Secretaría de Hacienda y Crédito Público (2018) and authors' calculations.

FIGURE 8

Exchange Rate Pass Through and Import Content



Source and notes: Modified from Carrière-Swallow et al. (2016). LA5 includes Brazil, Chile, Colombia, Mexico, and Peru. EME Asia includes China, India, Indonesia, Malaysia, Pakistan, the Philippines, and Thailand. LA (other) includes Argentina, Bolivia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Panama, Paraguay, and Uruguay. EME Europe includes Bulgaria, Hungary, Poland, Romania, Russia, Turkey, and Ukraine.

Conclusion

Five years into the Pact for Mexico, it is clear from the available data that the Pact's promises to launch a new era of economic and social progress have not begun to materialize. But the problem seems to be much deeper than any administrative or political obstacle. Rather, it seems that the country's persistent sluggish growth, poverty, and inequality are rooted in a set of important economic policy choices that have been made consistently for a long time. And as can be seen from the IMF Article IV Consultation and other public statements and actions by officials, the current political and economic authorities are committed to continue with this economic program.

After decades of poor economic performance that left Mexico in 18th place among 20 other Latin American countries in terms of income growth per person for the twenty-first century, the country faces serious downside risks in the years ahead. Most importantly, the US Federal Reserve is on track to raise short-term interest rates four times this year, with more increases in 2019. In the United States, all of the recessions in the post-WWII era were triggered by the Fed raising interest rates, with the exception of the last two, which were caused by the bursting of asset bubbles (in the stock market in 2000 and in the housing market in 2007).

Mexico's dependence on the US economy for about 80 percent³³ of its exports means that it is quite vulnerable to a US recession; but even without a US recession, the Fed's interest rate hikes can have a severe impact on the Mexican economy if it draws away sufficient capital flows. This was seen in the 1994–95 peso crisis, where Mexico lost 9.5 percent of GDP in a downturn that was triggered by the Fed's cycle of interest rate hikes at the time. And as noted above, the country's hyperliberalization of financial markets also made it vulnerable to the Fed's tapering of quantitative easing in 2013. These hyperliberal financial markets remain a source of vulnerability, and they make Mexico more vulnerable than it otherwise would be to turbulence in international financial markets that may already be beginning in this Fed tightening cycle.

Thus Mexico, under the current long-term policy regime described above, is committed to paying down the public debt when growth picks up even slightly; and when there are storm clouds on the horizon (which also include the turbulence of current relations with the United States and the uncertainty of NAFTA renegotiation), fiscal and monetary policy become even more of a drag on economic growth. Mexico is therefore caught in a trap of low investment and low growth, without making the necessary public investments in infrastructure, research and development, or education.

33 Banco de México (2018f).

Without such investment, it cannot maintain its international competitiveness (even in US markets with respect to China), boost long-term productivity growth, or even maintain the necessary fiscal revenues from Pemex — not to mention reducing poverty or inequality. It seems clear that a new policy regime should be considered.

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