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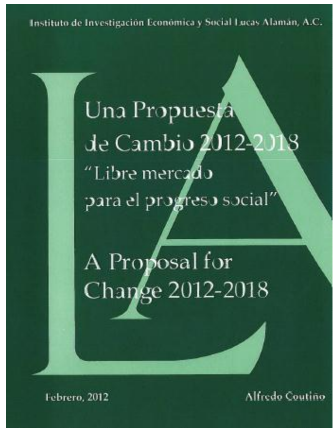


A Proposal for Change 2012-2018

"Free market to promote social progress"

Alfredo Coutiño

February, 2012

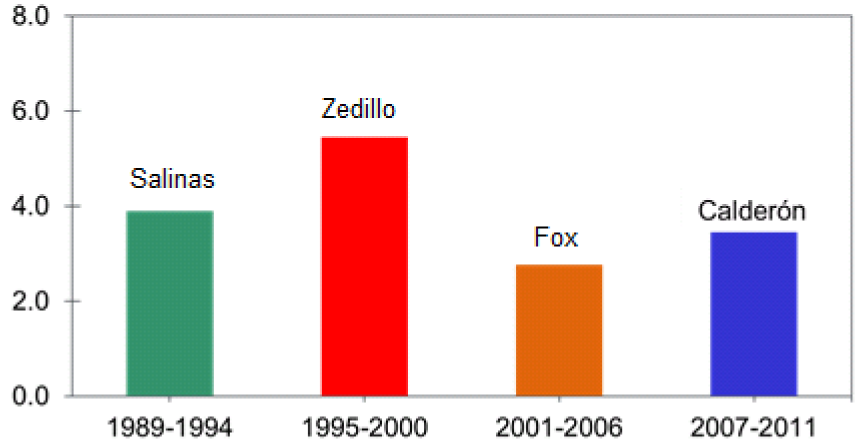
I. DIAGNOSIS: Obstacles to Economic growth

Over the last decade, the Mexican economy lost strength and experienced one of the poorest performances in Latin America, even to the degree of losing positions in the world ranking. The mediocre economic performance has been mainly the result of three factors: absence of structural changes, lack of policy flexibility, and the effects of the political business cycle. As a result, the country’s capacity to grow has been limited to a low rate of only 3.5%. The rigidity of fiscal and monetary policies has become an obstacle for policymakers to respond timely and efficiently to unexpected shocks. Additionally, the economy continues to be subject to both the contractionary and expansionary effects of the traditional political cycle every six years. Indeed, Mexico urgently needs reforms, but not only the ones to produce structural changes but also those to modernize economic policy. To increase the potential capacity takes time and effort, then it is urgent to start implementing the changes required.

I.1). The absence of reforms

Mexico has not been able to grow more than 2% per year in the past decade because its economy does not have the capability for more. The absence of structural reforms has restrained the economy’s production capacity to a potential rate of 3.5%. After growing at an average filtered rate (discounting years of negative growth) of 5.5% during Zedillo’s administration (1995-2000), GDP moderated to an average of 2.8% with Vicente Fox (2001-2006), and advanced only at an average of 3.5% in the first five years of President Calderon term (2007-2012). The past 15-year trend indicates not only that the economy’s production capacity decreased in the last two administrations, but also that the economy was not able to expand beyond its limited potential growth in order to preserve the macroeconomic equilibrium.

Chart 1
Loss of Capacity in the Last Decade
Average GDP Growth (years of positive growth, %)



Source: Author with data from INEGI

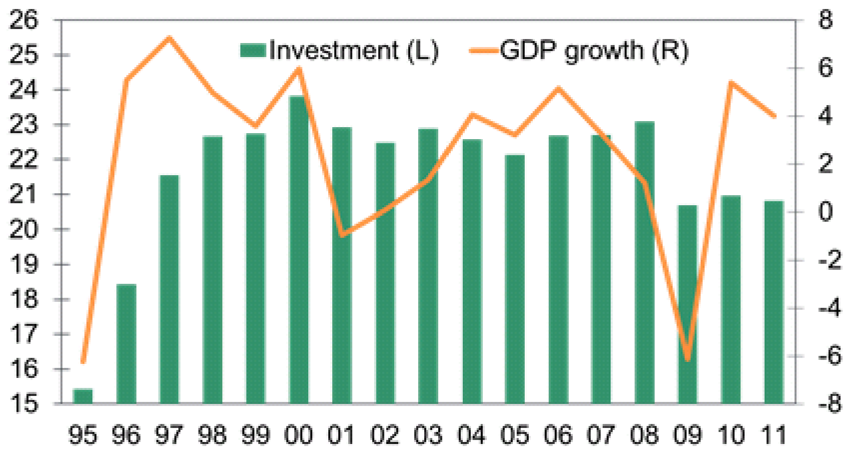
The last main reforms were undertaken in the 90s, with the implementation of NAFTA in 1994 and followed by the opening of the financial sector to foreign investors at the end of that decade. After that, with the arrival of the political alternation in 2000 –which brought the first opposition party into power, the reform process was interrupted since no major changes were implemented in the following 10 years[1]. The absence of structural changes in the last two administrations has condemned the economy to an annual average growth rate of only 2.0%. The country urgently needs to strengthen its fundamental sources of growth through the deepening of structural reforms.

At present, it is obvious that the country needs to increase its production capacity. The economy's potential to grow depends basically on three fundamental sources: saving and investment, productivity, and technological change[2]. Regarding the first, Mexico has not invested enough; it has rather disinvested, with the investment-output ratio declining from 24% in 2000 to 22% in 2006 and further decreasing to 21% in 2010 and 2011. Additionally, the poor performance of multifactor productivity and a marginal advance of technological change have reflected the absence of reforms.

[1] See Coutiño (2009).
[2] For details see Coutiño (2000).

Therefore, the economy's anemia and inability to grow at sustained rates has been evident.

Chart 2
Limited Potential Growth
Investment (% of GDP) and GDP Growth (%)



Source: Author with data from INEGI

I.2). The lack of policy flexibility

The second factor restraining the economy’s performance has been the limitation imposed by an economic policy that in the past 10 years, at least, has been guided mainly by the principle of stabilization as its main contribution to growth and employment. Such an approach has proved that macroeconomic stability is necessary but has been insufficient to promote growth. The great stability attained in the last decade has not been accompanied by sustained growth because of a simple reason: a failure to promote domestic savings.

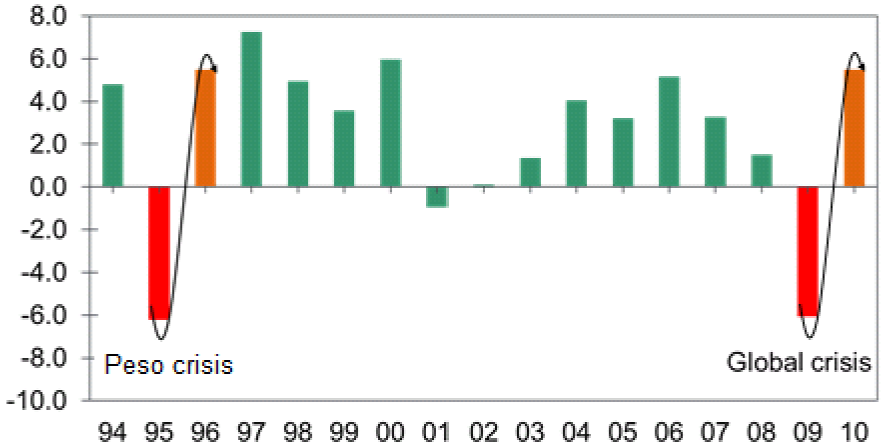
Given the history of recurrent financial and economic crises with high inflation and currency devaluation, the introduction of macroeconomic adjustments and discipline was necessary not only to correct the chronic imbalances but also to generate price stability. As a result, fiscal and monetary policies were mainly focused on the achievement of macroeconomic stabilization. However, during this stabilization process, economic growth was secondary and consequently social well-being had little progress.

To introduce government discipline, fiscal policy was attached to an objective of fiscal deficit as a ratio of GDP, which obviously made the federal budget highly dependent on the volatility of the business cycle[3]. This fiscal procyclicallity introduced a strong rigidity during economic downturns, thus preventing the government from using fiscal policy as a countercyclical instrument. On the other side, monetary policy was attached to a single-objective mandate to specifically attain price stability[4]. Undoubtedly, this policy has been successful in bringing inflation down to rates consistent with the economy's structure[5]. However, now that inflation has been domesticated, the anti-inflationary mandate has become a limitation for monetary policy to promote growth, unless it can be violated[6].

The country's lack of policy flexibility was demonstrated during the 2008-2009 global recession[7]. Despite Mexico's much better macroeconomic situation, the economy was severely hit in 2009, contracting 6.1% when the U.S. only fell 3.5%, practically replicating the fall during the peso crisis in 1995. First, the government's fiscal stimulus was neither sufficient nor timely. The country did not generate enough fiscal savings during the boom years to carry it through a crisis. Additionally, bureaucratic restrictions did not allow the extra government spending to be implemented in time. Second, monetary policy was not coordinated with the fiscal stimulus, which put an additional brake on the economy. Monetary policy management was limited by the constitutional mandate to respond to the economic emergency. All this shows that the policy steps taken to protect the country from the external storm were not wrong but were rather too little, too late and not flexible enough to be useful.

[3] More details in Coutiño (2011) and Coutiño (2011a).
[4] This lack of policy flexibility is discussed in Coutiño (2010).
[5] Basically because inflation was mostly a monetary phenomenon as described in Friedman and Friedman (1990). History shows that Mexican structural inflation is closer to 4% rather than 3%, see Coutiño (2010).
[6] For details on advantages and disadvantages of the inflation targeting approach, see Mishkin (2000).
[7] On this example see Coutiño (2009a).

Chart 3
Two Similar Crisis
GDP Growth (annual % change)



Source: Author with data from INEGI

I.3). The influence of the political cycle

The political cycle has been playing an important role in the economy's performance in at least the past three decades. Particularly, the economy suffers the effects of the change of administration every six years, but it also enjoys the benefits of the expansionary spending during the electoral process at the end of each administration. Certainly, during the past two administrations, the Mexican economy has avoided the curse of the six-year political crisis from the past, but the economy still has not escaped its traditional deceleration induced by the political transition.

Only once in the past four decades has Mexico's economy escaped its "political curse"[8]. In the past 40 years, the Mexican economy has suffered a traditional deceleration-recession at the beginning of each new presidential term. The only exception was 1989, when the recently-inaugurated President Salinas started to generate an extraordinary boom of optimism around the potential Free Trade Agreement with the U.S. Otherwise, negative effects have been generated by the arrival of a new government every six years in Mexico.

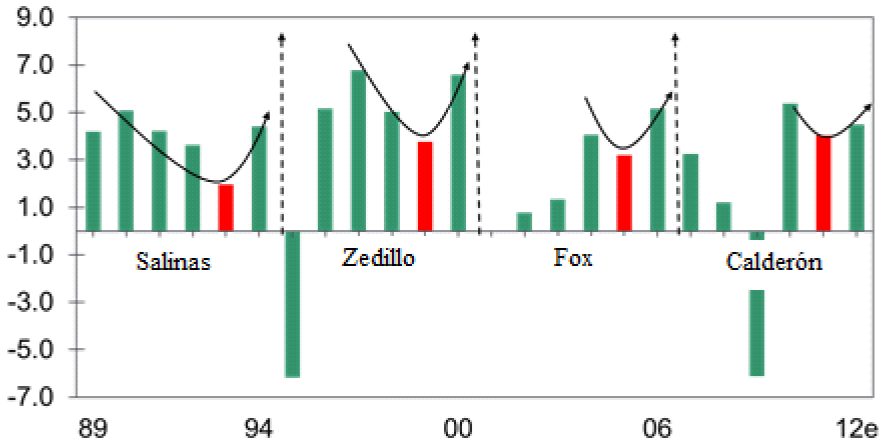
[8] Coutiño (2007).

The Mexican political business cycle has two well-defined phases. The first is an expansionary phase, which covers the first six months of the last year of the outgoing government. In this phase, fiscal policy is used not only to finance the electoral process and to complete the infrastructure programs of the government in turn, but also to spur the economy and produce a sentiment of well-being, hoping to induce voters to maintain the status quo. The second, contractionary phase begins when the fiscal stimulus is withdrawn after the July elections, and it extends until the first half of the first year of the incoming administration. With each new administration, there is always a delay in the execution of the federal budget. Combined with the uncertainty generated by the new economic and political teams, this always produces a delay in private investment and consumption decisions, which is reflected in the overall deceleration of economic activity.

In addition, historically, the engines of growth tend to cool off in the fifth year of each six-year presidential term, not only to correct incipient or potential imbalances but also to leave the economy in shape for the electoral year[9]. Each of the last three administrations induced economic slowdowns in their fifth year. This was designed to leave the economy ready for a strong rebound during the presidential election year. For this reason alone it was easy to anticipate that growth in 2011 was going to be lower than growth in 2010 and 2012. Unfortunately, nothing on the horizon indicates an interruption of Mexico's political business cycle up to now. Therefore, growth will continue to have politics as one of its determinants, at least in the next few years.

[9] An analysis on this example can be found in Coutiño (2010a).

Chart 4
Political Business Cycle
GDP Growth (annual % change)



Source: Author with data from INEGI

II. PROPOSAL: A More Flexible Economy

To achieve a sustained and higher growth without developing macroeconomic imbalances, Mexico needs more reforms, deregulation, and more flexible economic policies that allow the economy to attain a balanced growth with low inflation. The economic overhaul includes both short-term and medium-term measures[10].

In the medium term, Mexico needs to strengthen its fundamental sources of growth. The formula is well understood: reforms and more reforms. This will allow the country to increase its production capacity and consequently its steady state growth. A complete second round of structural changes needs to be done to reinforce savings and investment, multifactor productivity, and technological change. The most urgent reforms includes fiscal, labor, financial, energy, education, and political and justice institutions[11]. The list of reforms is certainly long, but it will be longer if they continue to be postponed.

In the short run, it is necessary to ensure that economic policy will be able to respond to the country's reality, which requires two things: First, it is important that fiscal policy generate the flexibility necessary

[10] See Coutiño (2009a).
[11] For more details see Coutiño (2006).

to respond to changes in the economy's cycle. This requires attaching fiscal policy to potential growth rather than to the business cycle. Otherwise, the ups and downs of the cycle make the federal budget too volatile, which is precisely what it needs to avoid. The better choice is to attach the federal budget to the potential growth rate, which is around 3.5 %[12]. The government should base its spending plans on revenue levels generated at the potential growth rate, regardless of the observed growth. This will automatically generate a fiscal surplus in boom times; if the economy grows above 3.5%, revenues will exceed spending. When growth is below potential, the deficit generated can be financed with either savings already accumulated or conditioned debt. Fiscal policy can thus be used as a countercyclical tool to reduce business cycle volatility. This can be done with the adoption of a structural fiscal rule, as in the successful case of Chile[13].

Second, monetary policy requires more flexibility; it must be released from its constitutional limitation and allowed to respond to growth and inflation. The single-objective monetary policy has fulfilled its task: Inflation has been reduced. With a more flexible mandate, monetary policy can respond in timely fashion to changes in the business cycle[14]. In fact, the central bank cannot synchronize its monetary policy with a fiscal stimulus in crisis times precisely because it can be accused of violating its mandate to combat inflation. Now that inflation is low and consistent with the economy's structure, it is necessary to liberate monetary policy from its single objective, assigning it the dual mandate of promoting low inflation and steady growth[15].

To reduce the effects of the political business cycle it is necessary to arrange accords between the outgoing and the incoming administrations in order to avoid interruptions and delays in the execution of the federal budget. The law must ensure that the federal budget must be executed regardless the change of the executive or the arrival of a new responsible of fiscal policy, the same way that monetary policy functions with no interruptions when the central bank changes its governor or a member of the board.

[12] For estimates of potential output see Coutiño (2000) and Banco de México (2000).
[13] The methodology for the Mexican case can be found in Coutiño (2011a), and for the Chilean case in Velasco, Arenas, Céspedes and Rodríguez (2007) and also in Ffrench-Davis (2010).
[14] A proposal for Latin American central banks is analyzed in Coutiño (2011b).
[15] More details on fiscal and monetary flexibility in Coutiño (2011).

If the aforementioned reforms –in the economy, institutions, and policies– can be implemented, then the Mexican economy will be able not only to increase its potential capacity but also to smooth the ups and downs of its business cycle. While new reforms will increase the growth rate at which the economy can function without generating imbalances, policy changes will allow policymakers generate countercyclical power to be used to reduce the cycle volatility. All this will allow the economy to perform at more sustained and balanced rates, with price stability and flexibility to promote social development. The resulted improvement in fiscal and monetary synchronicity will eliminate the inefficiencies generated by policies with different mandates and, in some cases, with conflicting interests.

Certainly, the approval of new reforms requires political leadership and negotiation ability for the administration in turn to convince Congress and society about the benefits of structural changes. Also, politicians in Congress, not policymakers, are the ones in charge of changing the central bank's mandate. Hence, a political agreement among government, Congress, and parties is necessary to generate a more stable business cycle.

III. LESSONS TO BE LEARNED

The main lesson to be learned from the Mexican economic reality is that macroeconomic discipline is only a necessary condition; it is not sufficient to generate growth and employment or to avoid a crisis. The government must also acquire the fiscal flexibility to deal with adverse times. History shows that Mexico has always been dragged down by a merciless external recession. Economic discipline helps mitigate the external shock, but it is insufficient to avoid a fall. The country needs to reinforce its macroeconomic defense system through policies and mechanisms to build a more flexible economy.

A second lesson is that the single-objective mandate keeps the Mexican monetary policy tied up, since it cannot be used for any purpose other than to fight inflation. It is a duty of Mexican politicians to grant the Bank of Mexico with a dual monetary mandate, where economic growth has the same priority as inflation. This dual-objective mandate does not imply less monetary independence[16]; on the contrary, it will represent the modernization of monetary policy to better respond to the challenging global conditions. In fact, the central

[16] A complete analysis on central bank independence and the optimization problem can be found in Blinder (1999). For more details on monetary independence see Mishkin (2000).

bank has to resolve an optimization problem by finding the policy balance to attain the maximum growth subject to the minimum inflation, or vice versa.

It is also important to learn that whatever the government does, or does not do, generates future costs and benefits. In this sense, structural changes delayed and reforms postponed are now taking a heavy toll on Mexico's economy. Indeed, it is necessary to give macroeconomic policies more flexibility, but they have to be flexible enough to respond effectively and efficiently to the changing economic environment. This implies that having economic growth as an "implicit" objective is not sufficient.

And as a final remark, Mexico does not need to change its economic model, rather needs to reinforce and complement it with a strategy that combines free-market and more flexible policies to accommodate more social content. The national history has demonstrated that growth by itself does not generate social progress. Therefore, **Mexico needs a proposal, which preserves the economic model and also represents a political and social difference**.

ANNEX

Structural requirements to increase production capacity.

From the previous analysis, it is evident that Mexico's main problem is the structural limitation to grow; it says, production capacity is limited to a growth rate of only 3.5%; beyond that, the economy generates macroeconomic imbalances. Production capacity depends on the economy's structure, not on government or private sector desires. Therefore, it has to be created over time through building more and better infrastructure. There is a mistake when it is said that the country needs to grow more. Indeed, higher growth can be attained easily through expansionary policies, but this can be only transitory and fictitious, since the economy will need to adjust sooner or later in order to correct the imbalances generated by overheating. Then, the country needs to increase the structural capacity to grow through building more production infrastructure, which will allow the economy to grow beyond 3.5% with macroeconomic stability.

Therefore, the fundamental problem is not to grow more rather to increase the capacity to grow, which can be done by creating more and better production power through the strengthening of the permanent sources of growth: saving and investment, productivity, and technological change. Only this way growth can be higher, sustained, and more balanced. However, for growth to be more stable, the country needs more flexible policies to smooth the ups and downs of the business cycle.

Based on the traditional Solow's growth model with a Cobb-Douglas production function with capital, labor and technology, it is possible to determine the steady state of the Mexican economy; it means the situation in which the economy functions at its natural rate given by its production structure. It is also possible to determine the structural requirements to increase the economy's potential capacity beyond the existent 3.5% growth. From the model we know that production capacity depends basically on the capital accumulation, multifactor productivity, and new technology. Assuming that employment depends on the economy's capacity to grow and technology does on agents' saving and investment decisions, then production capacity mainly depends on the accumulation of productive capital, including physical and human capital. Since infrastructure and human capital have to be created over time, it is a mistake to say that the country has potential capacity to grow at rates of between 6% and 7%, precisely because that capacity does not exist.

Updated estimates generated with the Solow model applied to the Mexican economy[17] indicate that the potential growth rate decreased in the last decade to 3.1%, from 3.5% in the previous three decades, as a result of the disinvestment process suffered by the economy during the last two political administrations. It is then imperative to increase the structural capacity to grow through a sustained process of capital accumulation. Our estimates indicate that an increase in the country's potential growth by one percentage point requires an increase of 1.4 percentage points in the investment-output coefficient. In other words, to increase the potential growth rate from the actual 3.1% to the desired 6%, it is necessary to increase total investment by five points as a percentage of GDP, from the actual 21%.

Indeed, more structural capacity requires a sustained investment process, which implies not only to preserve macroeconomic stability and generate the necessary business environment, but also implement the largely-desired structural reforms and deregulation. Hence, to increase the potential growth rate to 6% requires real gross

[17] See Coutiño (2000).

investment to increase at an average rate of 9% each year during the first five years of the new administration, to put it at 26% of GDP in year 2017. This will allow the economy to report a sustained growth from a rate of 3.5% in 2013 to 6.3% in 2017. However, it requires an effort from the public and private sectors of an average of $16 billion of additional investment every year during the first five years of the new government. These resources, however, have to be invested in new production infrastructure rather than to buy plants already established in the country.

Based on our estimates, in the fifth year of the new government, when the economy reaches its new potential growth of 6.3%, the creation of employment would be 950,000 new jobs with an average increase in productivity of 1% per year after null advance in the past six years. However, if the new government continues to increase production capacity in its sixth year, putting total investment at 27% of GDP in 2018, GDP would increase at a potential rate of 7% and new employments would surpass 1 million. With these results, the country would be able not only to absorb the additional labor force every year but would also start to reduce extreme poverty quickly, consequently improving social well being.

It is important to remark that a potential growth of 7% requires the creation of the necessary production capacity to achieve it, which does not exist at present. It also demands the active participation of not only the government, private sector, and political parties but also the whole society to support reforms and structural changes. Social progress necessarily requires a broad political accord among the different participants, which will only be possible if the new government demonstrates political leadership and negotiation abilities to convince the Mexican society about the benefits of structural changes.

Chart 1
Requirements to increase potential output

Year	GDP (% change)	GROSS FIXED INVESTMENT (% of PIB)	(% change)	(million dls)	EMPLOYMENT (new jobs)
2012	4.5	21.5	8.5	8693	530377
2013	3.5	22.0	5.9	8998	392100
2014	4.2	23.0	8.9	14417	514436
2015	4.9	24.0	9.5	16628	647032
2016	5.6	25.0	10.0	19238	792929
2017	6.3	26.0	10.6	22330	955617
2018	7.0	27.0	11.1	26004	1139168

Source: Author's estimates based on the Solow's Growth Model.

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