St. John's University
8000 Utopia Parkway
Queens, NY 11439
www.stjohns.edu

St. John's University
THE PETER J. TOBIN COLLEGE OF BUSINESS

Journal of Emerging Markets

Volume 16, Number 2 & 3 Summer–Fall 2012

The Determinants of Mexico's Limited Economic Cycle

Alfredo Coutiño

The Determinants of Mexico's Limited Economic Cycle

Alfredo Coutiño
CKF
Philadelphia, PA 19104
USA
E-mail: aCoutiño@ckf-forecasting.com

Moody's Analytics
West, Chester, PA 19380
USA

Abstract

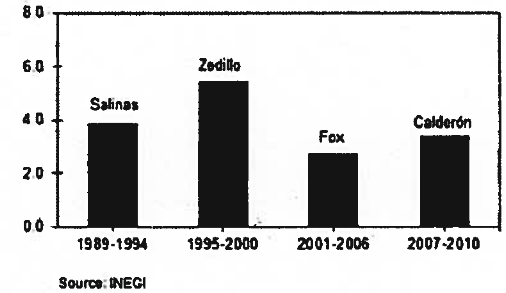
Over the last decade, the Mexican economy lost strength and experienced one of the poorest performances in Latin America, even to the degree of losing positions in the world ranking. The mediocre economic performance has been mainly the result of three factors: absence of structural changes, lack of 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. This paper suggests that Mexico needs reforms that produce not only structural changes but also modernization of economic policy.

I. 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 3.4% in the first three 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.

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 1.7%. The country urgently needs to strengthen its fundamental sources of growth through the deepening of structural reforms.

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



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. Additionally, the poor performance of multifactor productivity and a marginal advance of technological change have reflected the absence of reforms. Therefore, th economy's anemia and inability to grow at sustained rates has been evident.

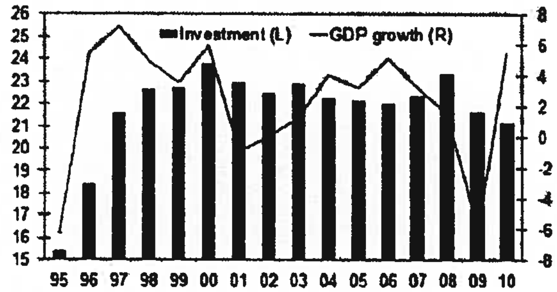
II. Lack of Policy Flexibility

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 stabilit attained in the last decade macroeconomic has not been accompanied by sustained growth because c a simple reason: a failure to promote domestic [0].

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,

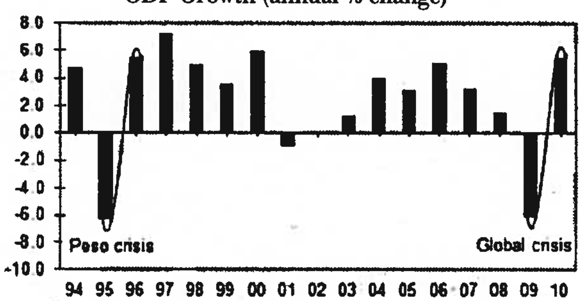
Chart 2
Limited Potential Growth
Investment (% of GDP) and GDP Growth (%)



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.

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



III. The Influence of the Political Cycle

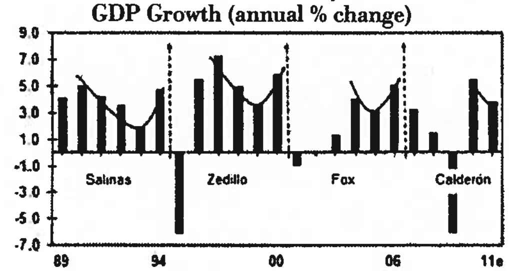
The political cycle has been playing an important role in the economy's performance in at least the past three decades. Particularly, the economy suffers the effects of the change of administration every six years, but it also enjoys the benefits of the expansionary spending during the electoral process 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 ha 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. and Canada. Otherwise, negative effects have been generated by the arriva of a new government every six years in Mexico.

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 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. The combined uncertainty generated by the new economic and political teams alway produces a delay in private investment and consumption decisions, that 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 econom 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 can be anticipated that growth this year (2011) wil be lower than growth in 2010 and 2012. Unfortunately, nothing on the horizon indicates an interru tion of Mexico's political business cycle up to now. Therefore, growth will continue to have politics a one of its determinants, at least in the next few years.

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



Source: INEGI

IV. The Need of 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 requires attaching fiscal policy to 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 to respond to changes in the economy's 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 savings already accumulated. 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.

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.

V. Lessons To Be Learned

The main lesson to be learned from the Mexican economic reality is that macroeconomic discipline i 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.

A second lesson is that the single-objective mandate keeps the Mexican monetary policy tied up, sinc 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 challeng ing global conditions. In fact, the central 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 cos and benefits. In this sense, structural changes delayed and reforms postponed are now taking a heav 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.

Notes

[1] See Coutiño (2009.

[2] For details see Coutiño (2000).

[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).

[6] For details on advantages and disadvantages of the inflation targeting approach, se Mishkin (2000).

[7] On this example see Coutiño (2009a).

[8] Coutiño (2007).

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

[10] See Coutiño (2009a).

[11] For more details see Coutiño (2006).

[12] For estimates of potential output see Coutiño (2000) and Banco de Mexico (2000).

[13] The methodology for the Mexican case can be found in Coutiño (2011a), and for the Chilean case in Velasco, Arenas, Cespedes and Rodriguez (2007) and also in French-Davis (1010).

[14] A proposal for Latin American central banks is analyzed in Coutiño (2011b).

[15] More details on fiscal and monetary flexibility in Coutiño (2011).

[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).

References

Banco de Mexico, 2000). *Informe Anual*, Mexico.

Blinder, A.S. 1998. *Central Banking in Theory and Practice.* The MIT Press, Cambridge, Massachusetts.

Coutiño, A. 2000. "The Steady State of the Mexican Economy", in *Essays on Macroeconomic Aspects of Mexico*, Instituto Lucas Alarn6n de Estudios Economicos, Mexico, Noviembre.

Coutiño, A. 2006. "An Economic Strategy for Mexico 2007-2012", *Dismal Scientist: Latam*, December, Moody's ,Economy.com.

Coutiño, A. 2007. "On The Accuracy of Our Predictions for Mexico", *Dismal Scientist: Latam*, May, Moody's, Economy.com.

Coutiño A. 2009. "Mexico: Current Quarter Forecasts", *in The Making of National Economic Forecasts*, ed. by Lawrence R. Klein, Edward Elgar Publishing, London.

Coutiño, A. 2009a. "Improving Mexico's Economic Defenses", *Dismal Scientist: Latam*, June, Moody's, Economy.com.

Coutiño, A. 2010. "Is Mexico Aiming at the Right Inflation Target?" *Dismal Scientist: Latam*, March, Moody's Analytics.

Coutiño, A. 2010)a, "Mexico's Political Cycle Means Deceleration in 2011", *Dismal Scientist: Latam*, May, Moody's Analytics.

Coutiño, A. 2011. "Will Mexico Catch a Cold if the U.S. Sneezes?" *Dismal Scientist: Latam*, September, Moody's Analytics.

French-Davis, A. 2011a. "Structural Fiscal Rule: A Proposal for Mexico", in EconModels: *Journal of Policy Modeling*, Elsevier, October.

French-Davis, A. 2011b. "Dual-Objective Monetary Policy for Latin America", *Journal of Emerging Markets*, 15(3). Fall/Winter, 48-55.

French-Davis, R. 2010. "Latin America: The Structural Fiscal Balance Policy in Chile: A Move Toward Counter-cyclical Macroeconomics," *Journal of Globalization and Development*, 1 (1) Article 14, The Berkeley Electronic Press.

Friedman, M. and Friedman R. 1990. "The Cure for Inflation", in *Free to Choose*, (Harcourt Brace & Company, New York, 248-282.

Mishkin, F. S. 2000. "Inflation Targeting in Emerging Market Countries," NBER Working Paper 7618, *National Bureau of Economic Research*, Cambridge, MA, March.

Velasco, A., Arenas, A., Cespedes L. F., and Rodriguez J. 2007. "Compromisos Fiscales y la Meta de Superavit Estructural," *Estudios de Finanzas Publicas*, Ministerio de Hacienda, Chile, Mayo.