In December 1994, two weeks after the inauguration of current Mexican president Ernesto Zedillo, Mexico suffered a megadevaluation. The ensuing economic confusion was punctuated by a generalized financial crisis in Mexico. This crisis precipitated fears that some other emerging markets might be susceptible to similar problems. The result was a wave of investor stampedes that jumped to Argentina and Brazil, brushed through Chile, bounced to the Philippines and even found their way to Poland. These events, taken together, came to be called the *Tequila Crisis.*


## Mexico

The purpose of this presentation is to address what has happened to Mexico since the Tequila Crisis. I shall focus on Mexico's recent rapid growth, and on recent Mexican bank credit problems, and on concerns about incipient Mexican reinflation, and on Mexico's exchange rate, and finally on the challenges that Mexico's incoming president, Vicente Fox, will face.

As I noted earlier, Mexico has grown very rapidly since it began its recovery from the Tequila Crisis. Figure 1 compares growth in Mexican industrial production since 1995–just after the beginning of Mexico's devaluation and subsequent so-called Tequila Crisis–with that of Argentina, Brazil, Chile and the United States. Although these other countries have obviously had their shares of recent growth, their expansions since 1995 have not matched Mexico's.

Other evidence of economic improvement in Mexico has also become clear. The Mexican central bank has made strong efforts to reduce inflation. Like many countries in recent years, Mexico has lately launched an official inflation targeting program. As can be seen in Figure 2, the result of Mexico's stabilizing efforts has been fairly persistent reductions in inflation since the 1995 Tequila Crisis.

**Figure 1**

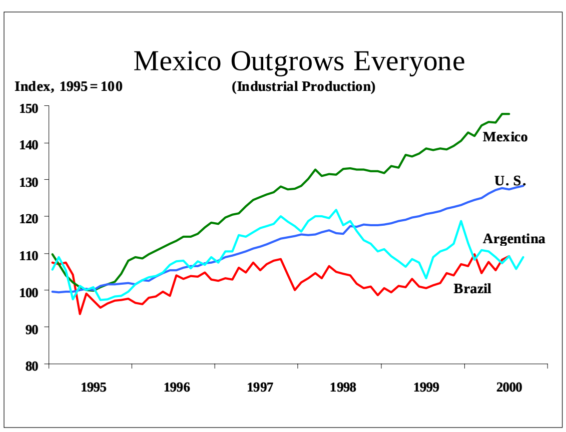
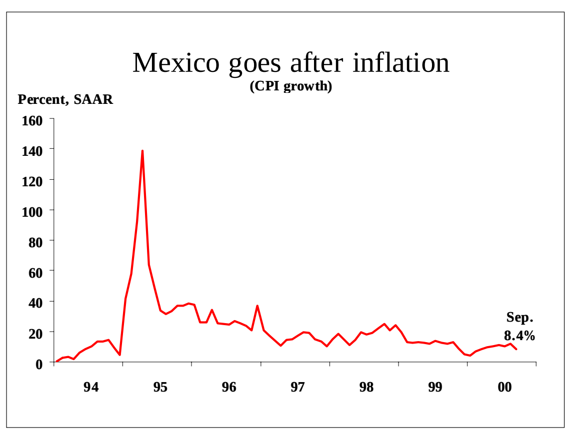



**Figure 2**



These changes have made international financial markets more comfortable with Mexican debt. Figure 3 shows the spread of rates on Mexican long term Brady bonds over U.S. long rates and offers comparisons with similar spreads for Venezuela, Argentina, and Brazil. Note that Mexican rates are now roughly 400 basis points–that's four percentage points–below other Latin American rates. But while Mexico's aggregate economic indicators for the period I have displayed look healthy, problems with the Mexican economy complicate possibilities for the Mexican economy in the future

The principal engine of Mexico's growth since the 1995 Tequila Crisis has been exports. Figure 4 shows growth rates of Mexican exports to the world and separately, of Mexican exports to the United States. Since the North American Free Trade Association began in 1994, Mexican export growth has averaged about 20 percent per year and Mexican exports to the United States accounted for 80 percent of Mexico's total export growth. Obviously NAFTA has helped.

**Figure 3**

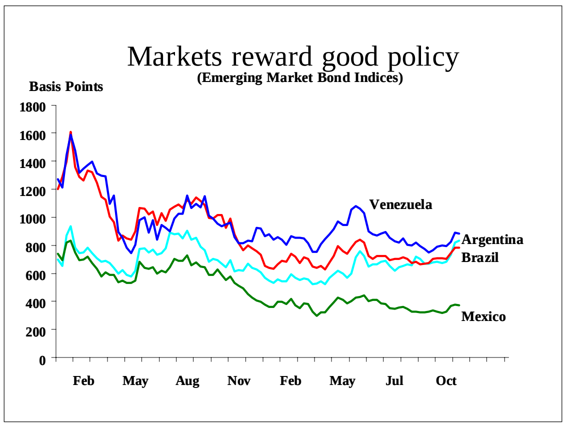
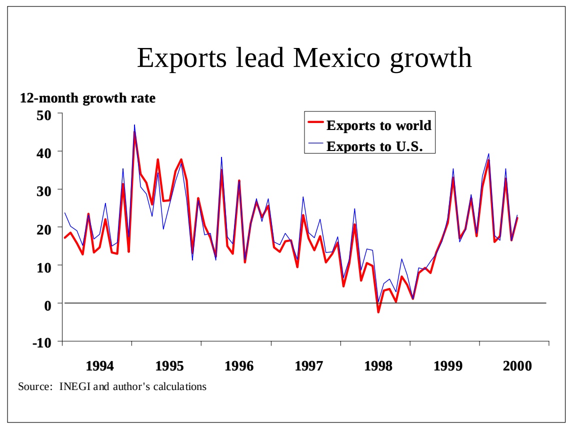
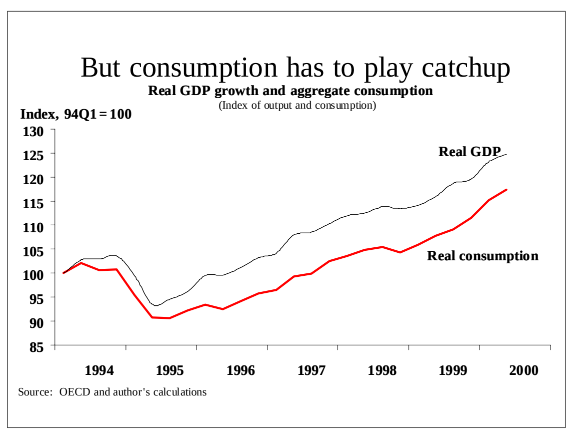



**Figure 4**



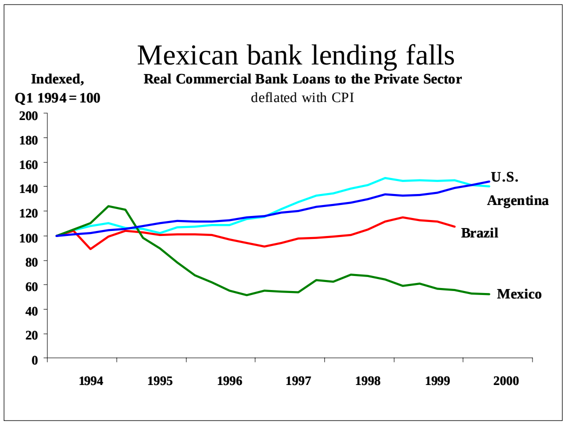

While exports have been very good for Mexican growth, other aspects of Mexico's economy have proved a little less robust. Figure 5 compares growth in Mexican real gross domestic product with real Mexican consumption. Although consumption growth has been catching up very lately, generally speaking, overall GDP growth has markedly outstripped that of domestic consumption. The problem here is not just a lag in domestic consumption, though. There are also impediments to growth in some nonexport sectors of production.

**Figure 5**



One reason why Mexican domestic consumption, and also non-export production, have not matched export growth is because neither consumers nor many types of producers have been able to get loans at Mexican banks. When large exporting companies need credit, they often can go to international financial markets. But for consumers, and for companies that are not corporate giants, the banks are important sources of credit. Or they were. Figure 6 shows real values of commercial bank loans to the private sector in various Latin American countries. Mexico is the blue line. The real value of Mexico's loans to the private sector has been sliding since the mid 1990s, when Mexican banks went down in a hail of bad credit. Since 1998 this pattern has become more pronounced. And recall that this has been going on while Mexico's economy was growing rapidly.

**Figure 6**




## Is Mexico in for an Inflation Rebound?

But while some analysts have been concerned about credit shortages, another concern, paradoxically, has been inflation. Officials of the central bank of Mexico have begun to voice concern about whether Mexican fiscal policy will be consistent with lowering inflation over the new few years. The head of the central bank of Mexico has publicly jawboned not only with Mexico's current minister of finance, but with officials in the incoming Vicente Fox presidential administration. The threat of a return to the serious inflation problems is certainly not imminent. Even so, Mexico's central bank has just tightened monetary policy for the fifth time this year and it is useful to ask why.

Figure 7 depicts Mexico's official inflation targets for 2000 and for each of the next three years. The targets are 9 percent this year, 6.5 percent in 2001, 4.5 percent in 2002 and 3 percent in 2003. Mexican central bankers are very, very serious about these targets. It should be emphasized that Mexico will not have trouble meeting its 2000 target.

Moreover, as Figure 8 shows, the seasonally adjusted annualized rate of price increase in September was 8.4 percent, below the central bank's inflation target for this year. So, what is the concern?

**Figure 7**

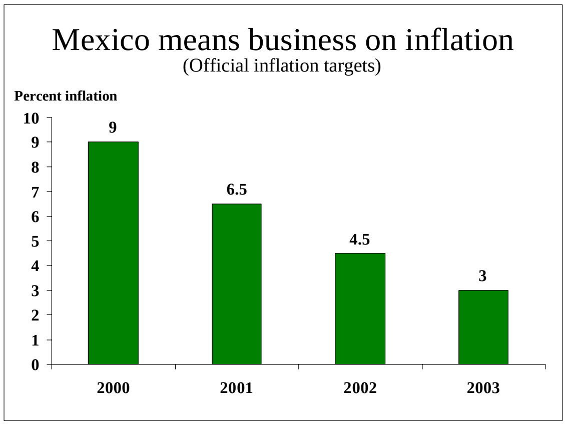
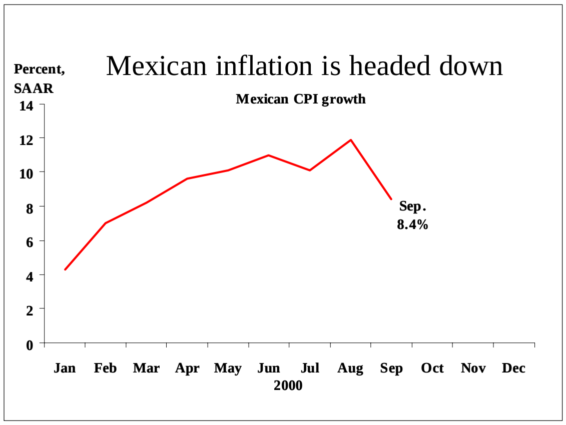



**Figure 8**

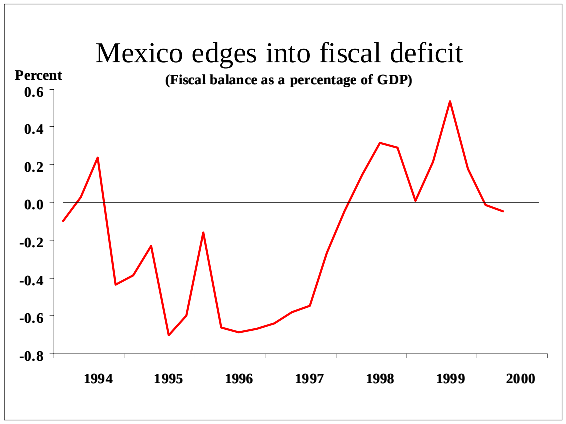


One factor is that, in Mexico, there are increasing hints of possible capacity constraints. Figure 9 depicts Mexico's open unemployment rate. As can be seen, this rate has declined markedly during the last few years. There may be some measurement problems with Mexico's open unemployment rate, but it is striking to see this rate at its lowest level of the entire eleven-year period depicted on this figure. We asked officials at the central bank of Mexico about labor shortages. We were told that while there was still ample unskilled labor, shortages of skilled labor were starting to develop. More telling is the wage increases in new Mexican labor contracts. Next year's inflation target is 6.5 percent, but annual wage contract increases are in double digits.

**Figure 9**


One concern expressed by the central bank of Mexico involves coordination of fiscal policy with monetary policy. As Figure 10 shows, Mexico's fiscal balance has begun to move into deficit. While this move has not so far constituted a serious fiscal deficit problem, an increasing fiscal deficit during a period when the economy is growing rapidly may raise questions about the consistency of government behavior with central bank inflation targets. The present Mexican Minister of Finance, who will be leaving office at the beginning of December, has said he isn't going to do anything about this because inflation is still low and the fiscal situation is not a concern. A central bank that has just tightened for the fifth time this year is probably saying that it does have concerns.

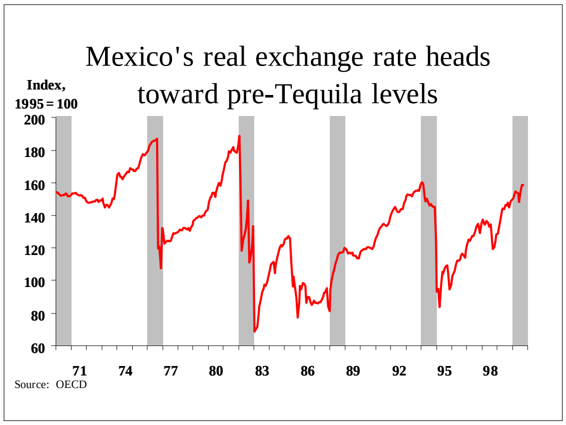
**Figure 10**




## Mexico's Exchange Rate

Another topic of interest in some quarters is Mexico's exchange rate. With one exception, every presidential election year since 1976 has been punctuated by a significant devaluation. There is reason to suspect this will be another exception year–an election year without a devaluation. One reason Mexico will probably not suffer a sudden massive devaluation is because Mexico is on a flexible exchange rate system now. In the past years of presidential elections, Mexico was on a pegged or targeted exchange rate system that either held fast or blew up. Now, the rate just flexes, although under the wrong circumstances it could flex awfully hard. We have here updated some of the statistics David Gould presented last year to suggest there will probably not be an exchange rate crisis.

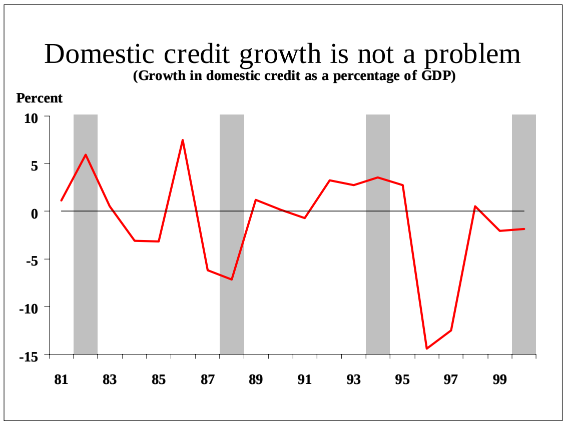
**Figure 11**



Although there are indicators that exchange rate pressures are not a problem, it is worth noting that Mexico’s real exchange rate has appreciated. More specifically, Mexico’s real exchange rate has approached the value it took on just prior to Mexico's big devaluation of December 1994. Figure 11 shows that the exchange rate appreciation that typically occurs around the time of a Mexican election has again occurred in the year 2000. Note that the grey columns depict election years. I want to address indicators that suggest a different result than the devaluation of most recent election years.

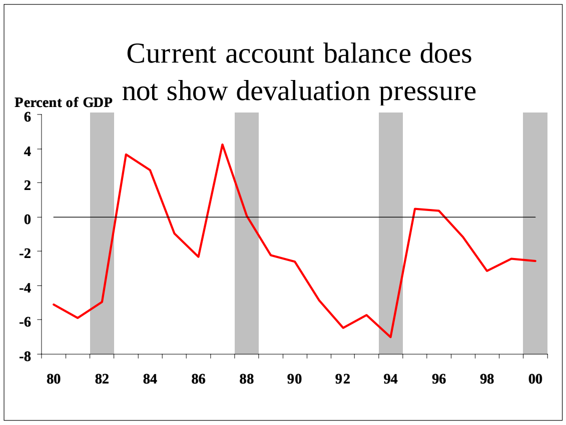
Figure 12 shows one of three indicators of the sort of economic overheating that leads to an exchange rate crisis. The indicator says we probably won’t get a devaluation. The figure depicts growth in overall domestic credit in Mexico–regardless of credit origin or destination. Unlike the commercial bank credit chart presented earlier (*Figure 6*), this one includes credit from Mexican government development banks, the central bank and any other sources of loans–including those most typically used by the government to heat up the economy in an election year. The grey columns depict presidential election years. As can be seen, in 1982 and 1994, growth in domestic credit as a percentage of GDP was high, creating a consumption boom, again, in an economy with a pegged exchange rate. The same occurred in the 1976 exchange rate crash. Note that in 1999 and 2000, we are actually seeing declines in domestic credit.

**Figure 12**




Negative current account or trade balances can certainly be good under some circumstances, but when very negative balances have occurred near Mexican elections, they have been good predictors of devaluation. Figure 13 shows that–as has been typical in other election years–Mexico is again running a current account deficit. However, it can be seen that the size of the deficit as a percent of GDP is markedly smaller than just before a typical large devaluation. This deficit is probably not large enough to suggest much serious exchange rate pressure even if the exchange rate were pegged or fixed–and remember that Mexico’s exchange rate is now flexible.

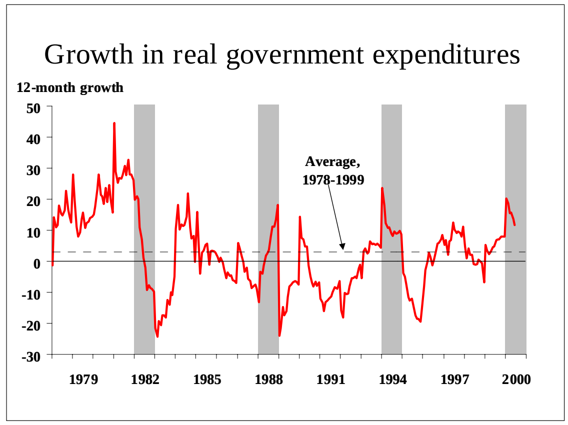
**Figure 13**




The third indicator of exchange rate pressure is growth in real government expenditures, as depicted in Figure 14. Real government expenditures typically take a jump before a devaluation. In the year 2000, real government expenditures growth has again taken a jump. The way this indicator looks, it would suggest problems if it happened to be accompanied by problem signs with the other two indicators. But the jump in real government expenditures was not accompanied by problem signs in the other two indicators, even though Mexico’s real exchange rate has appreciated. And, again, recall that Mexico’s exchange rate is a flexible rather than fixed or pegged rate. A crash is probably not in the cards.

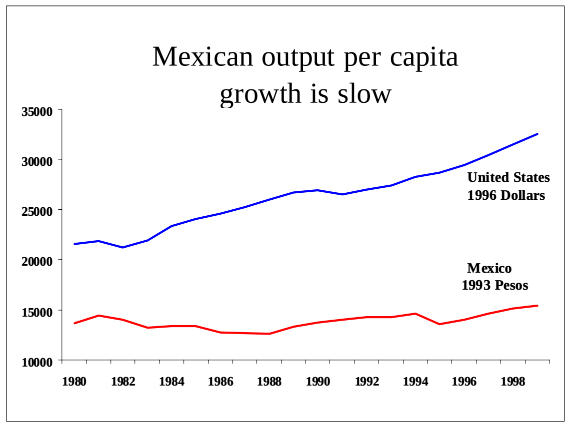
## Vicente Fox Quesada

**Figure 14**



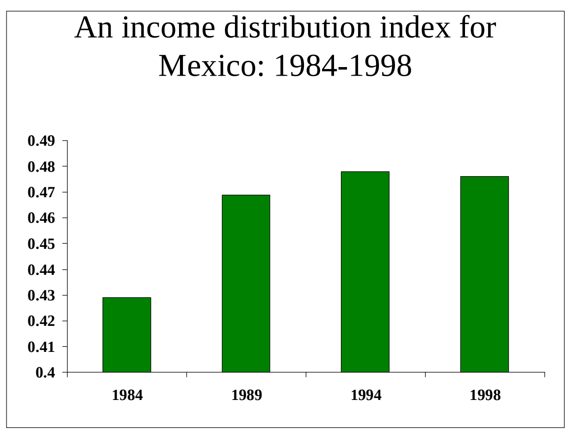

Last July Vicente Fox Quesada , a presidential candidate from the opposition National Action Party, won Mexico's presidential election. This ended a 71-year period of control of the presidential chair by the ruling Institutional Revolutionary Party, and an even longer period of control if you add in the time during which the founders of the Institutional Revolutionary Party held the president's chair. Mr. Fox has a host of challenges and it is to some of these now that I wish to turn.

**Figure 15**




Let's begin with a few of the problems that Mr. Fox faces, on top of what I have already touched. The first problem can easily be seen in Figure 15. That is, despite Mexico's growth in recent years, Mexico's real gross domestic product per capita has increased by less than 6.8 percent since 1981. I want to emphasize that this growth is not 6.8 percent per year. It is 6.8 percent for the entire period. This compares with a 48 percent increase over the same period in the United States. Latin American countries in general suffer higher economic volatility than industrial countries. Their GDP fluctuates more. Their recessions are deeper. Their recessions are longer. Their capital flows are more volatile. Their tax collections bounce around more. All of these together go to make a serious challenge for any national president in Latin America, and certainly for one whose election captured hopes for a new way to run Mexico.

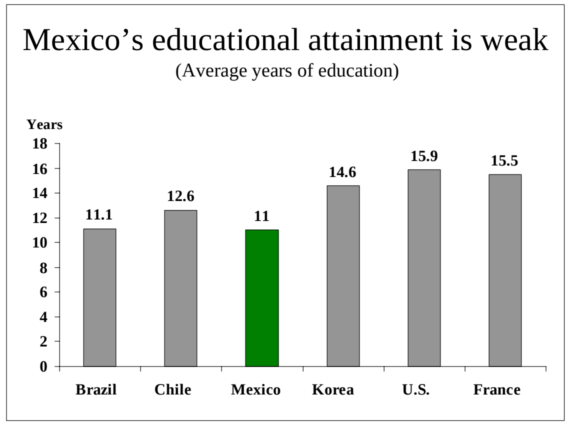
**Figure 16**




An additional problem on top of very weak expansion in income or output per capita can be who is getting it. Figure 16 shows changes in a Mexican index of income distribution. The index ranges from zero–in which everyone gets the same income–to one. The higher the index value, the more uneven the distribution. According to measures like this one, Mexico not only has a more uneven income distribution than the United States, but than Equador, El Salvador, or Bolivia. What this Figure 16 shows, however, is that income distribution in Mexico has been growing steadily more uneven since the mid-1980s. Typically, when countries have growth in income per capita, the poorest share at least some in the growth. Mexico's challenge is not only to raise real income per capita, but to create opportunities so that its poorest manage to share some of the increase. If that is not possible, political pressures may militate against the very measures we know are most likely to increase income per capita.

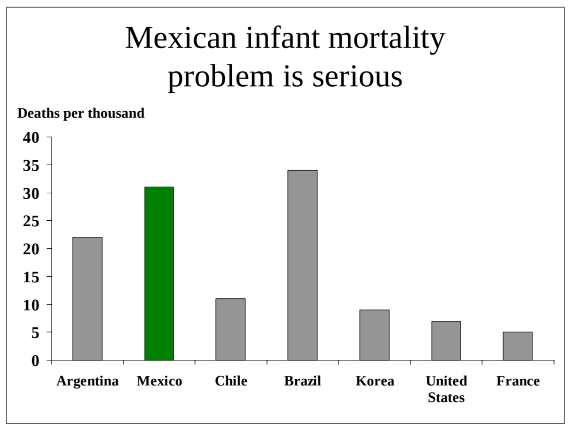
An important aspect of creating a basis for growth in income per capita is raising educational levels. Figure 17 presents average levels of education in Brazil, Chile, and Mexico, as well as in Korea, the United States and France. Clearly, Mexico comes out the loser, even when compared with a low income per capita country such as Brazil. Indeed, improving Mexico's educational system is one of the policy changes to which President Fox has declared the strongest commitment.

**Figure 17**




A more general commitment of President Fox is to lift Mexico's general social welfare above what is normally associated with the third world. Mexico's income per capita already places it above roughly two- thirds of the countries in the world and below about one-third of the world's countries. But even though Mexico's income per capita is at least above the world average, the average conditions under which people live is markedly below those even of some other Latin American countries. Figure 18 allows comparison of infant mortality per thousand in Mexico with three other Latin American countries, Argentina, Chile and Brazil, as well as with Korea, the United States and France. Note that while Mexico's infant mortality per thousand is below that of Brazil, it is still markedly above that of Argentina and far above that of Chile, not to mention those of Korea, the United States, and France.

**Figure 18**




## Goals of Vicente Fox

These challenges are clearly expressed in some of the goals Vicente Fox has already articulated. He wishes large increases in educational spending to increase productivity and, for the same reason, he wants increases in infrastructure and social spending. To address the credit availability of small borrowers, he is attempting to institute some government-led financial development including a Grameen style bank. The original Grameen bank of Bangladesh pioneered a highly successful type of very small lending that targets low income borrowers looking for micro-business capitalization. Finally, Mr. Fox wants a balanced budget. To pay for these programs, he wants to broaden tax coverage. Mr. Fox's focus has been to bring in Mexico's large informal sector into the tax-paying fold. By definition, this sector does not pay taxes, leaving the fiscal burden to the formal sector.

## Conclusion

Mexico is growing rapidly. Financial sector problems have impeded growth in small and middle-sized firms and in consumption. Mexico has some concerns about inflation, but they are not yet serious. An exchange rate blowout is not likely. And finally, Vicente Fox sees a significant portion of his challenges as involving making labor and capital more productive through education and infrastructure investment, and with some more social spending. Mr. Fox plans to tax the informal sector in order to increase spending on these programs.