Photo by Jeroen Elfferich.

Foreclosure sign in Salton City, California.

U.S.–MEXICO FUTURES FORUM

A Tale of Two Economies

by Brian Palmer-Rubin

The Great Recession has underscored how closely the economic fates of Mexico and the United States are intertwined, with oil, immigration and manufacturing playing lead roles in this tale of two economies. Mexico shares nearly 2,000 miles of border with its northern neighbor, and a substantial portion of the country's income is made up of oil and manufacturing exports to the United States and remittance checks sent home by workers who have immigrated to the world's largest economy. Mexico inevitably experiences crippling shock waves when the U.S. economy falters.

The current economic downturn is no exception. Mexico's economy has been the hardest hit in Latin America; its GDP dropped 10 percent from the second quarter of 2008 to the second quarter of 2009. Furthermore, the crisis has uncovered serious structural flaws in both countries' economies that are likely to inhibit a full recovery, according to the panelists who led a discussion on the Global Economic Crisis at the U.S.–Mexico Futures Forum. Presenters included Robert Reich, Professor of Public Policy at UC Berkeley; J. Bradford DeLong, Professor of Economics at UC Berkeley; and Isaac Katz, Professor of Economics at the Instituto Tecnólogico Autónomo de México (ITAM).

Although much attention has been paid in congressional hearings and in the media to the proximate causes of the crisis in the U.S. — subprime lending and overreach by banks — careful analysis reveals root causes that extend at least as far back as the Reagan administration. Reich and DeLong identified the regressive tax reforms of the 1980s and the Federal Reserve Bank's hands-off approach to overseeing financial institutions as factors that precipitated the downturn. The two experts made the case that the U.S.

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economy, once lauded as the pinnacle of capitalism, faces serious structural problems.

Most dire is the concentration of wealth in recent decades, which has led to anemic demand. Because those with lower incomes spend a higher percentage of their earnings, Reich explained, the concentration of income at the top has hindered consumption. He also posited that growing inequality played a substantial role in the subprime mortgage crisis, as middle-class Americans accumulated unmanageable levels of debt in response to rising housing prices and stagnant wages.

The hubris of the Federal Reserve Bank regarding its ability to avert large-scale crises is also to blame for the current situation, DeLong maintained. After more than half a century without a severe economic crisis in the U.S., the Fed under Chairman Alan Greenspan (1987-2006) endorsed financial deregulation, confident in the stability of self-regulating financial markets. This optimism carried over into the term of Ben Bernanke, Greenspan's successor. As a result of this miscalculation, said DeLong, the Fed did not intervene quickly enough and did not have the right tools to take effective action when important financial institutions, such as Bear Stearns, Lehman Brothers and Merrill Lynch, began to fail.

While many experts predict that the U.S. economy will stabilize by 2010, formally ending the current recession, Reich and DeLong did not see great prospects for a boost in the level of aggregate demand. For Mexico, this spells bad news. Though demand for oil, Mexico's most important export, is expected to rebound, one-fifth of Mexico's economy is based on manufacturing exports to the U.S., a less-promising sector. Since the 1980s, Mexico has implemented an export-led growth model for economic development. As a result, over the past 20 years, the share of foreign trade has doubled, from about one-third of GDP to roughly two-thirds, according to Reich. It follows that low demand north of the border would lead to declining employment and income south of the border. In Reich's words, "Mexico is sleeping with an elephant, and the elephant is very sick."

Even more disconcerting, there is reason to doubt that economic recuperation in the U.S. will be paralleled in Mexico. With stubbornly low levels of demand among American consumers, Mexico's industrial sector is unlikely to lead the way to economic recovery, said DeLong. Moreover, the most viable potential "leading sectors" in generating extra demand in the United States — government health care and import-substitution manufacturing — offer little in the way of support for Mexican production. According to several indicators — GDP, employment, government revenue — Mexico has been the Latin American country hardest hit by the economic crisis. Katz offered two explanations for the

Declining demand from the United States has affected Mexico's export industry.

Photo by Jonathan Tobin.

Photo by Gregory Bull/AP Photo.

Guillermo Ortiz, president of the Bank of Mexico, with a graph of his country's GDP growth over the last few years.

severe impact south of the Rio Grande. First, he echoed Reich and DeLong in noting that Mexico is the country whose economy is most closely linked to the U.S. through trade and remittances. Second, Katz argued that Mexico's economy has a particularly inefficient incentive structure, which stunts research and development and hinders competition.

Two key economic sectors are illustrative of the inefficiencies in the Mexican market system. First, Pemex, the state-owned oil company, is stuck with aging infrastructure and limited resources for investment, as its coffers are regularly raided by the federal government to pay for social programs. Second, lenient competition policy for public utilities has led to inflated prices and spotty service, hampering the growth of all business sectors that rely on those services. Such inefficiencies not only stunt economic growth but also lead to smaller government budgets, since lower business revenue yields lower tax payments.

Given the Mexican government's limited funds, President Felipe Calderón's administration has chosen to stay the course, continuing to emphasize fiscal austerity, as it did prior to the crisis, rather than implementing a stimulus package. Most other Latin American countries have taken the same approach. Yet practically all countries in the region, aside from Mexico, are navigating the turbulent times with a remarkable level of stability.

Chile's handling of the crisis serves as a positive model. Blessed with a thriving copper mining industry, the South American country's export markets flourished in the years preceding the crisis as copper prices reached an all-time high. Rather than spending all its copper tax revenue right away, however, the Chilean government invested a large portion of these funds in a special account to help the country withstand future downturns. This strategy seems incredibly prescient today, as Chile has been able to put in place a $4 billion stimulus package (2.8 percent of GDP) without going into debt. Chile is providing evidence to counter the long-held assumption that reliance on natural resources leads to profligate spending.

In contrast, Mexico's investment rating with agencies such as Standard and Poor's is likely to decline if the country does not resolve its budget imbalance in the coming months. A lower rating would further intensify Mexico's economic woes by discouraging much-needed foreign investment. Given that Mexico's oil fields, from which the government derives one-third of its revenue, are in serious decline, the most obvious option for avoiding future budget deficits is to raise the income tax, Katz argued. He suggested a jump from its current level of about 10 percent of GDP to roughly 17 percent. Such a reform poses immense political challenges, however, and

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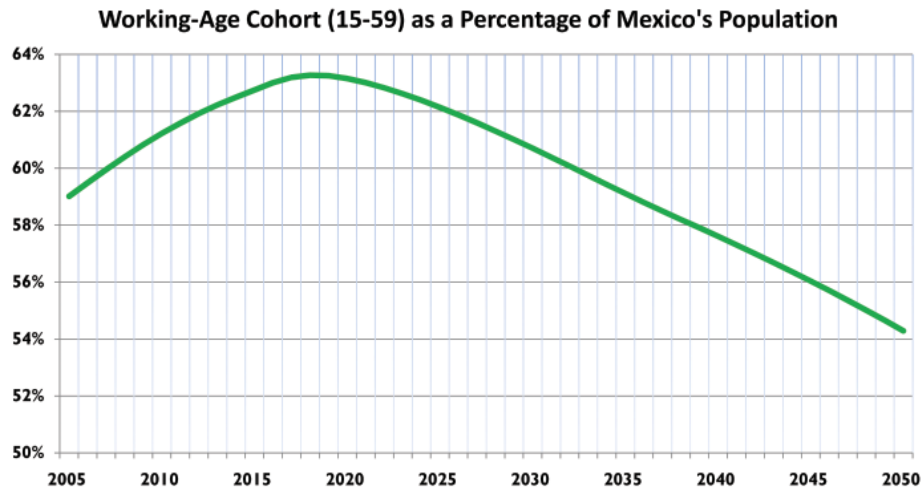
prospects for tax reform in the near future are low.

More so than in other Latin American countries, economic downturns in Mexico are exacerbated by emigration. A lack of attractive job opportunities induces young Mexicans — both skilled and unskilled — to cast their fate as immigrants in the U.S., leading to a shortage of qualified workers for new jobs in Mexico, as well as subpar tax receipts and consumption. Katz maintained that formal Mexican employment would have to grow to offer potential migrants better alternatives than moving across the border, but the trend is in the opposite direction: only the informal sector is growing in Mexico today, and informal employment tends to be precarious and poorly remunerated. Boosting formal employment opportunities, however, would require highly contentious reforms to policy on energy, education, telecommunications and labor law. Unfortunately, Mexico's political parties have demonstrated a stubborn reluctance to reach compromises on these types of reforms, leading to stalemate in Congress. Katz concluded his remarks by noting that Mexico's demographic window of opportunity, the period when the country's working-age population is at its peak, is set to close in 2020. If Mexico does not enact reforms before then, he warned, the country will remain permanently poor.

Poverty indicators lend credence to this sobering assertion. According to figures calculated by Coneval, the Mexican government's Council to Evaluate Social Development Policy, the number of Mexicans living below the poverty line has increased by roughly 6 million, from 44.7 to 50.6 million since 2006. This despite the country's concerted effort to decrease the incidence of poverty, which climbed to a high of 64 million in the aftermath of the 1996 peso crisis. The latest increase in the poverty level reflects the fact that many Mexican citizens who had been precariously perched above the poverty line before the crisis today struggle to make ends meet. According to data from the Encuesta Nacional de Ocupación y Empleo (ENOE, National Survey on Occupation and Employment), formal unemployment has only increased from 3.5 percent to 5.2 percent since the second quarter of 2008, but underemployment — defined as involuntary part-time employment — has almost doubled during the same period, rising from 6.9 percent to 11.1 percent of workers.



Mexico's demographic window of opportunity.
(Source: "De la población de México 2005-2050," Consejo Nacional de Población/www.conapo.gob.mx.)

In light of their pessimism regarding traditional manufacturing and oil, participants at the forum suggested other economic sectors — such as green energy and health tourism — that could lead the way to a bilateral economic recovery. Special attention was paid to potential economic reforms that could generate bilateral synergy, casting Mexico and the United States as partners in new ventures rather than as competitors.

David Bonior, a former Democratic Whip of the U.S. House of Representatives (Mich., 1991-2002) and current president of American Rights at Work, a nonprofit labor rights organization, offered two proposals for reforms that could lead to greater long-term economic health for the United States. The first was investment in "green energy" technology, such as solar power, which, according to Bonior, has the potential to strengthen the U.S. manufacturing sector in the immediate term and also to insure the country against rising fossil fuel prices.

Bonior's second proposal was the passage of legislation, such as the Employee Free Choice Act, that would strengthen the bargaining power of U.S. unions, ameliorating rising inequality and the ongoing crisis of insufficient demand from middle-class consumers. While Reich, a former U.S. Labor Secretary (1993-97), concurred that improving the bargaining power of the U.S. working class would be a step in the right direction, he warned that American manufacturing jobs are facing several threats, including the automation of industrial production and the outsourcing of jobs.

Harley Shaiken, Chair of UC Berkeley's Center for Latin American Studies, agreed that potential advances in low-carbon energy technology offer an opportunity for the U.S. and Mexican economies to turn the corner. Shaiken further emphasized that these countries can learn a lesson from China about the close relationship between manufacturing and development. Rather than designing high-tech products domestically and outsourcing the manufacturing, Shaiken argued that the U.S. should retain domestic manufacturing jobs, as China has done, by sustaining a close linkage between the research and production processes of such energy-efficient technology as hybrid cars, solar-power components and advanced battery systems.

Despite the dire economic prospects faced by the U.S. and Mexico, the two countries' shared suffering has the potential to yield a positive outcome. With both countries facing a need for far-reaching economic reform, new opportunities may arise for closer bilateral collaboration. Rafael Fernández de Castro, Presidential Adviser on International Affairs and Competitiveness in Mexico, shared his vision of "Nafta 2.0," a set of reforms that would usher in a period of greater economic cooperation. Potential components of Nafta 2.0 include: allowing U.S. retirees to use Medicare in Mexico, thereby contributing to the Mexican economy and accessing less-costly treatment than that provided by U.S. doctors; creating a North American market for the copper trade; improving border infrastructure, particularly by installing the necessary facilities to safely allow the passage of Mexican trucks into the U.S.; and implementing bilateral agreements on labor policy. Such proposals are likely to be met with great resistance; in particular, healthcare policy and border security are highly contentious political issues in the United States.

Whether such reforms take place depends on political will and the outcome of future bilateral negotiations. What the speakers at this panel made clear, however, is that the economic fates of the United States and Mexico are intimately linked. Without much-needed reforms, both economies are likely to continue to stumble for the foreseeable future.

The Economic Crisis Panel was one of four sessions of the U.S.–Mexico Futures Forum held at UC Berkeley on August 23-25, 2009. The presenters included J. Bradford DeLong, Professor of Economics at UC Berkeley; Isaac Katz, Professor of Economics at the Instituto Tecnológico Autónomo de México; and Robert Reich, Professor of Public Policy at UC Berkeley and former U.S. Secretary of Labor (1993-97).

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American retirees go to Mexico for low-cost health care and affordable retirement options.

Photo by Steve Liss/Time Life Pictures/Getty Images.