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A NEW ADMINISTRATION CONFRONTS A CHANGING WORLD: MEXICO'S ECONOMIC COMPETITIVENESS STRATEGY AT A GEOPOLITICAL INFLECTION POINT

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EXECUTIVE SUMMARY

Some three decades ago, Mexico made a bet on the global economy, and at a time when populism and protectionism are on the rise, the payoff is at risk. In response, Mexico must double down on its openness while addressing the critical structural problems, including corruption and inequality, that inhibit its domestic economy and led to the sweeping electoral victory of President Andrés Manuel López Obrador (AMLO) in 2018. This essay reviews Mexico's economic progress and the challenges ahead as a new administration takes office at a time of significant stress on regional and global economic institutions.

For more than a half-century following the Mexican Revolution, the country's foreign policy was based on the principal of noninterventionism, a not so subtle way of telling the United States and others not to meddle in Mexico's domestic affairs. The economic equivalent was Mexico's policy of import substitution, which raised tariffs and barriers to foreign investment designed to protect the country's domestic industries from international competition. The two combined to make Mexico an insular country, and despite the significant economic expansion achieved in the decades following World War II, by the 1970s, Mexico's economy and politics were showing signs of strain.

In the following decade, Mexico's relationship with the world was flipped on its head. Instead of raising barriers in an effort to protect Mexican sovereignty, the country's leaders made an audacious bet on the nation's integration into the global economy, especially in North America. In 1986, Mexico joined the General Agreement on Tariffs and Trade (GATT), the precursor to today's World Trade Organization, and then in 1994 took the dramatic step to join the United States and Canada to form the North American Free Trade Agreement (NAFTA). The results have been dramatic. In 1985, Mexico's trade-to-GDP ratio was 26 percent, but by 2017 it was up to 78 percent, belying its status as a modern manufacturing powerhouse building goods on the integrated North American production platform.[1] Yearly inflows of foreign direct investment increased from an average of just over 1 percent of GDP in the 1980s to approximately 2.5 percent during the past decade.[2] Today, Mexico regularly ranks among the most cost-effective places to locate manufacturing operations in the world.[3] In this sense, Mexico has become a model of successful integration into global value chains.

Mexico's export-oriented economy is highly efficient and has served as a motor of economic development, but the current economic model faces two significant and distinct challenges. The first is a direct result of Mexico's bet on its integration into the North American and global economy. At a time when U.S. (and some might say global) trade policy is shifting away from the open, rules-based system supported by the United States since the 1940s and toward a more mercantilist approach favoring protectionist tactics, Mexico's dependence on the U.S. market is proving to be a greater risk than most had assumed. In 2017, Mexico sent more than 80 percent of its exports to the United States, relying heavily on access to the market ensured by NAFTA and the World Trade Organization system of preferential tariffs, both of which are under significant stress.[4]

The second challenge is rooted not in what Mexico has done, but rather what it has failed to do. Implicit in Mexico's bet on economic openness was the idea that its advances in trade policy, coupled with the macroeconomic stability achieved through improvements in fiscal and monetary policy, would be sufficient to drive economic growth. Unfortunately, the export-fueled motor has not proven strong enough to overcome the significant drag created by multiple structural deficiencies and has instead propelled a part of Mexico forward while leaving much of the country behind. World Bank figures show that Mexico's average annual growth of GDP per capita has been just over 1 percent since 1990. Despite important improvements in access to health care, education, and housing, poverty as measured by income remains stubbornly high, at above 50 percent.[5] Weaknesses in the Mexican education system, insufficient energy and transportation infrastructure, a lack of access to credit, the still-limited rule of law, and a misalignment of incentives in the social insurance and tax regimes have combined to stifle growth and allow inequality to persist. Despite the fact that the near-term risks to the Mexican economy have quite a bit to do with U.S. trade policy and the global economic environment, the most important missing ingredient in Mexico's economic outlook is a stronger domestic economy.

As a result, Mexico's first priority must be a strategy for inclusive growth. At this point, it is quite clear that a small number of highly productive workers in a small number of highly competitive firms are not enough to bring broad-based prosperity to Mexico. Government programs can help address disparities through targeted infrastructure investments and a project to expand access to a high-quality education, but these must be accompanied by efforts to address market failures as a result of uneven contract enforcement, a problematic social insurance system design, and barriers that slow the growth of small and medium firms. To do so, the government must be judicious in deciding when to intervene and when to play the role of facilitator guaranteeing an even playing field and preventing market distortions. A pragmatic approach to economic management is required, along with a clear-headed view of both what has and has not worked.

One of the biggest benefits of NAFTA for Mexico was to lock in its domestic liberalizing reforms and to thereby give investors confidence that Mexico was a safe place to do business. As has been argued by one of Mexico's original NAFTA negotiators, Luis de la Calle, in the face of threats to NAFTA and the broader trading system, it is incumbent upon Mexico to once again show the world that it is committed to a path of modernization, economic stability, and openness.[6] Mexico's decision to move forward with the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) even as the United States withdrew was an important step in this direction. Recommitting itself to this economic path, even as new efforts are made to promote inclusive growth, is the best way to clear the cloud of uncertainty that has hung over the Mexican economy since 2017.

Principal policy recommendations

1. Mexico has benefitted greatly from its openness and commitment to prudent fiscal and monetary policy. At a time of rising nationalism and protectionism around the world, it is important both domestically and internationally that Mexico recommit itself to these policies and support the institutions that uphold them.

2. The availability of talent—trained and trainable workers—has replaced low labor costs as the principle driver of many major investment decisions for both production facilities and high value-add services work. Mexico stands at the threshold between an economy driven by efficient production and one powered by innovation. The country has made significant advances in improving the coverage of basic education, but much work remains to be done to improve the quality of all education, access to higher education, and worker training and retraining programs.

3. The Mexican economy is bifurcated, with a small, highly productive, globalized, and formal production system motoring the economy, while a larger, informal, and less productive sector drags down growth. To bridge the gap, investments are needed in poor and marginalized communities, but the Mexican system of social services must also be redesigned so that it stops subsidizing and incentivizing informality and the lack of productivity that tends to accompany it.

4. The availability of transportation and energy infrastructure have proven themselves key ingredients for economic development, especially in a country that depends on competitively manufacturing products that are often bound for the U.S. market. To promote inclusive development and incorporate the poorer southern states, the Mexican natural gas pipeline network and transportation infrastructure must overcome the challenging geography of the region to better connect southern Mexico to the North American and global markets.

5. The Mexican economy suffers greatly from the weak rule of law in the country. From preventing kidnappings to enforcing business contracts, weaknesses in law enforcement and the provision of justice allow for the misuse or outright theft of government and private resources, hinder the growth of (especially small) businesses, and raise the costs of securing business operations. A long-term approach to strengthening rule of law institutions is urgently needed.

PREFACE: ECONOMIC POLICY DURING THE OPENING MONTHS OF THE AMLO ADMINISTRATION

Since this report was initially drafted, we have had the opportunity to observe Andrés Manuel López Obrador acting as president-elect and now president for several months. His record on issues of economic importance has been mixed, at times demonstrating a willingness to have his agenda and social investments constrained by economic responsibility, while at others subordinating practical concerns to political ones. Each of his actions, however, can be understood as part of an effort to build his legacy as a reformer, bringing Mexico back to the left after what he views as more than three decades of neoliberal rule by the Institutional Revolutionary Party (PRI) and the National Action Party (PAN). López Obrador also seeks to construct an institutional legacy, transforming Morena, the political party he created to win the presidency, into a consolidated national party able to survive his transition out of office and able to sustain the reforms he seeks to implement. Given his aim to be seen as a successful president and a transformative figure in the history of Mexico, AMLO is pulled in opposing directions between radical reform and prudent economic management, and one should expect the mix of pragmatism and populist economic nationalism on display in recent months to continue throughout his tenure.

Even before winning the election, López Obrador began assembling an economic team more than capable of providing the president with sound policy guidance. This group, led by Finance Minister Carlos Urzúa, effectively communicated to markets in the immediate wake of the July 2018 election that the incoming AMLO administration would respect the autonomy of the Central Bank and maintain fiscal discipline. The strategy was successful, and the value of Mexico's currency actually rose in the early days after the election.

The first major bump in the road came when the president-elect called on his party to organize a national poll allowing voters to decide whether or not to cancel the construction of a new airport in Mexico City, which was already underway (only 1 million participated). Unsurprisingly, those who cast votes sided with the president-elect, who had campaigned for the project's annulment as a tool to critique the corruption and incompetence of the previous government. The move was populism in its purest form. It allowed AMLO to say that he was simply enacting the will of the people, but it came with a hefty price tag. Of the $13 billion expected total cost for the new airport, approximately $3-5 billion had already been spent on construction.[7] The state-owned company that was building the new airport and running the existing Mexico City airport had borrowed over $8 billion, and a decision to cancel the project set off a complex set of negotiations with bondholders who initially demanded immediate full payment. The Finance Ministry and the state-owned company successfully negotiated a deal to avoid technical default, but passengers using the existing airport will now be subject to increased fees on each ticket they purchase to pay for this decision. Of course, Mexico City will also not get a new airport. Instead, federal dollars will be spent to add runways at a nearby military base.[8]

In contrast to the airport, Mexico's 2019 budget, designed by AMLO's team at the Finance Ministry and passed by his party's majority in Congress, shows that it is possible to balance social spending and fiscal discipline. With reasonable macroeconomic assumptions, the budget projects a primary surplus of 1 percent of GDP in 2019, enough to keep Mexico's overall debt-to-GDP ratio from rising.[9] Nonetheless, significant space was carved out for signature social initiatives, including approximately $5.2 billion for an augmented public pension program, $3.2 billion for scholarships and worker training, and more than $1.8 billion for various agricultural programs, including subsidies and price guarantees.[10] To do this, monetary transfers to Mexico's 32 states were cut significantly, other social programs were canceled, and virtually all of the autonomous federal agencies, including those that safeguard Mexico's elections and promote government transparency experienced significant budget cuts. Though there is much to be applauded in the 2019 budget, this last point is of particular concern given the important role of several independent agencies in creating, deepening, and protecting the development of democracy in Mexico.

The last few months have been busy, and several other key decisions by the AMLO team have afforded opportunities to understand the trajectory of AMLO's six-year term. Mexico raised its minimum wage, and though few workers actually earn the minimum wage, it will provide an important improvement in their quality of life and potentially for the many more who earn wages indexed to the minimum wage. This move was made with the support of Coparmex, an important chamber of commerce for Mexico's employers, and is not expected to have significant inflationary effects.[11] In the U.S.-Mexico border region, the minimum wage was raised especially high, but that measure came in tandem with a series of tax cuts designed to boost the competitiveness of businesses, especially retailers that compete for shoppers with their counterparts across the border in the United States.[12] Though vulnerable to criticism as a tax cut for the wealthiest region of Mexico, it also shows an administration taking seriously the special concerns of border communities, which will help the president's party build political capital in the north, where until this past election Mexico's left has historically performed poorly. The Finance Ministry recently proposed a series of policy proposals to deepen capital markets, including lowering taxes on money collected by businesses through initial public offerings and allowing pension funds to allocate capital to a wider set of investments. These are generally very important and address a serious challenge, although there is some concern that this opens the door to the funding of politically motivated infrastructure projects.[13]

Finally, the government has launched a major effort to combat rampant fuel theft, which costs Pemex, the government oil company, more than $3 billion each year.[14] This is clearly an important effort, and the administration's seriousness must be commended. Implementation and communication, however, have been wanting, and the strategy of turning off pipelines left millions of Mexicans struggling to fill their gas tanks amidst massive shortages. The situation was aggravated by a simultaneous decision to stop buying U.S. light crude, which has in recent months been mixed with Mexico's heavier oil to produce gasoline due to a domestic shortage, in an effort to be closer to self-sufficiency in the politically sensitive energy sector.[15] The topic remains one of great debate in Mexico, but current evidence points toward a case of resource nationalism getting in the way of pragmatic economic decisionmaking. López Obrador seeks to strengthen Pemex so that Mexico becomes less dependent on private energy investments, but initial plans presented to investors left them unconvinced, and Fitch recently downgraded the company's debt. Importantly, just days later, AMLO announced an adjustment that would lessen Pemex's tax burden, suggesting the energy and finance teams, along with Mexico's political leadership, are willing to learn from their mistakes and adjust course.

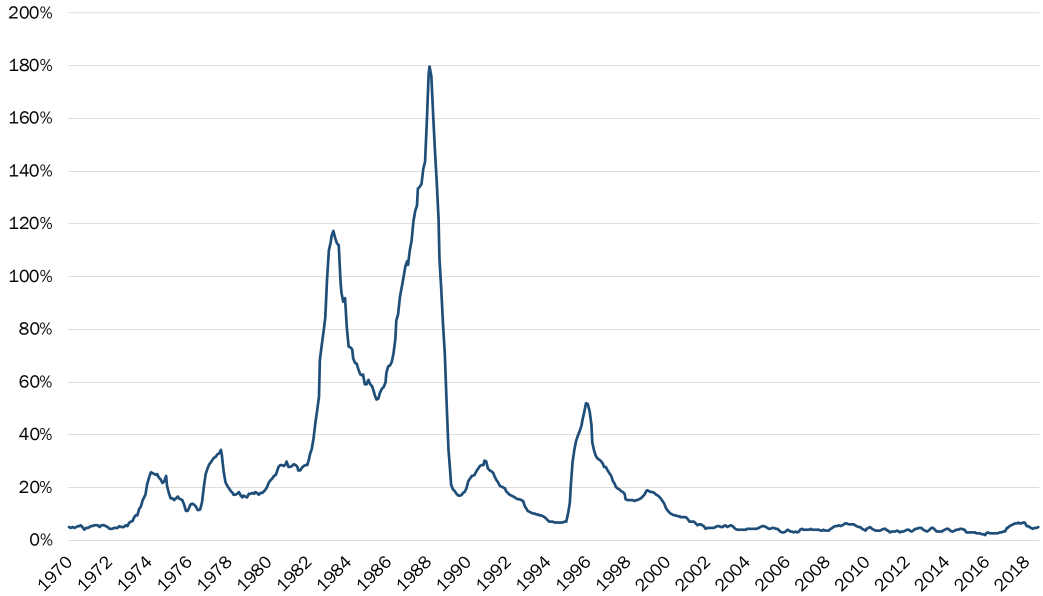
In his short time in office, President Andrés Manuel López Obrador has proven both his supporters and critics correct. Justifying detractors, he has revealed himself a foreign policy traditionalist (noninterventionist), an economic nationalist, and a left-wing populist. Importantly, though, he has in equal measure followed through on his promises to be a pro-poor reformer and clear-headed pragmatist, understanding that to be a successful president he must manage, rather than deconstruct, a Mexican economy deeply integrated into the global economy. The mixed messaging apparent in the above cases is not a case of a simple lack of coordination. Rather, it reveals a deeper tension present in the multiple dimensions of AMLO's approach to Mexico's economic development and his presidency that should be expected to continue to manifest itself throughout his time in office.

INTRODUCTION: HARD EARNED TRADE COMPETITIVENESS AND MACROECONOMIC STABILITY

Mexico has achieved macroeconomic stability and has successfully integrated into regional and global supply chains, two extremely important achievements that provide the country with a strong and steady launch pad for growth.

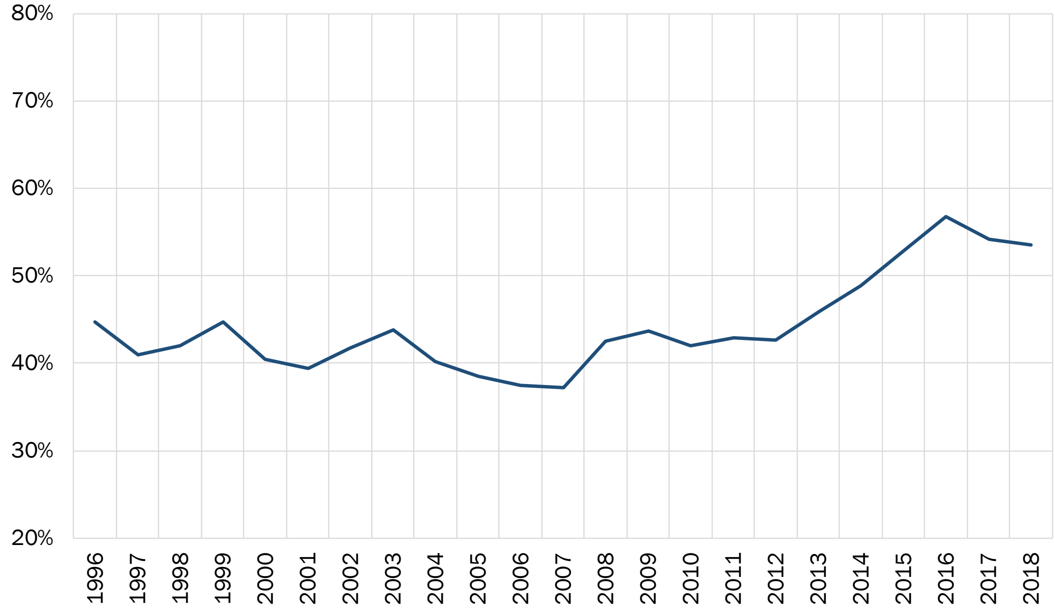
Figure 1 shows the stable level of inflation achieved over the past two decades, with the last Mexican debt/currency crisis taking place in the mid-1990s. The recent stability was earned through a series of reforms to the Mexican monetary policy framework and ongoing fiscal discipline to limit and manage public debt. Key steps include a constitutional change to grant the central bank autonomy in 1993, the adoption of a flexible exchange rate system in 1994, and the formal adoption of an inflation-targeting regime in 2001.[16] Figure 2 shows the relatively stable and safe level of debt owed by the Mexican government as a proportion of GDP. Though the level of debt rose during the administration of Enrique Peña Nieto (2012-18), the level of debt has been contained and declined over the past two years, leaving the new administration with a solid macroeconomic base and a limited but reasonable degree of fiscal space as they design their first budget.

FIGURE 1: MEXICAN INFLATION RATE, 1970-2018



Source: Banco de México.

FIGURE 2: MEXICAN DEBT-TO-GDP RATIO, 1996-2018



Source: International Monetary Fund.

Mexican trade policy over the last 35 years has been a major success story. In addition to joining the GATT (now the World Trade Organization) and NAFTA, described above, Mexico has developed a massive network of free trade and investment protection agreements, giving Mexican producers preferential access to markets representing over half of global GDP. When including the still to-be-implemented CPTPP, Mexico has negotiated free trade agreements with 53 countries around the world.

By opening to the world, Mexico has turned itself into a global manufacturing hub. Companies are able to produce goods in Mexico and, with very few barriers, serve markets around the world. Of course, Mexico's most important competitive advantage in this sense is its geography. As one of only two countries neighboring the largest consumer market on the planet, and as a signatory of NAFTA, Mexico has a special advantage in producing goods for export to North America. The results of Mexico's openness to the global economy are compelling. In current U.S. dollars, Mexico's exports have grown more than 20-fold since 1980, rising from $21 billion to $437 billion in 2017.[17] During the same time, the accumulated stock of foreign direct investment in Mexico has risen some 450-fold, from just over a billion U.S. dollars in 1981 to $489 billion in 2017.[18]

Trade and investment growth have helped develop Mexican firms and the Mexican workforce. Mexico's economic complexity, which is a measure of the relative knowledge intensity of an economy, has risen from 0.45 to 0.93 on the MIT Economic Complexity Index scale.[19] This means that Mexico, compared to countries around the world, has experienced greater than average increases in the skills and knowledge needed to produce a diverse range of products over the past several decades.

Furthermore, Mexican companies operating in the space that has been opened up to international competition have been forced to increase their productivity and competitiveness. To be sure, some failed during the process, but many of Mexico's largest companies have become globally competitive. Cemex, for example, has grown to become the world's largest cement maker, with more than 300 locations in the United States.[20] Telcel, the mobile phone and data network operator owned by Carlos Slim, has successful operations throughout Latin America and Europe, as well as operating the TracPhone pre-paid cellular company in the United States. Grupo Bimbo is now one of the world's largest baked goods companies, and Rassini and Grupo Alfa are major players in regional and global auto-parts markets. Companies operating in Mexico's export sectors and other sectors open and attractive to foreign investment have generally seen major increases in productivity. A study by the McKinsey Global Institute found that in the two decades between 1999 and 2009, large modern corporations raised productivity by 5.8 percent per year. Unfortunately, this powerful growth was countered by an even more powerful decline in the productivity of smaller, often informal firms, in what could be described as the more traditional sector of the Mexican economy, which experienced productivity declines of 6.5 percent per year, even as a growing percentage of Mexican workers were employed in this portion of the Mexican economy.[21]

Looking at these numbers, many have noted that there are in fact two Mexican economies, one modern, formal, and growing, and a second that employs more workers and capital than the formal sector, but that has failed to generate productivity and wage growth.

THE ROCKY ROAD FROM NAFTA TO THE U.S.-MEXICO-CANADA AGREEMENT (USMCA)

In recent years, a wave of backlash against globalization has risen in several Western countries, provoking a series of nationalist policies affecting trade and immigration. In the United States, the 2016 presidential election saw both the Democratic and Republican candidates expressing a degree of trade skepticism, but the Trump campaign was particularly forceful in its repudiation of NAFTA and the broader U.S.-Mexico economic relationship. Then-candidate Donald Trump promised to renegotiate NAFTA or withdraw from the agreement, alongside harsh rhetoric regarding immigration and border control that offended many Mexicans.

After President Trump won the election, Mexico and Canada sought to limit the possibility of U.S. withdrawal from NAFTA by agreeing to renegotiate the accord. With approximately 80 percent of all Mexican exports being sold to the United States each year, maintaining preferential access to the U.S. market is a first-order national interest. Mexico therefore quickly engaged senior U.S. officials, especially senior advisor and son-in-law of the president, Jared Kushner, in an attempt to negotiate a quick solution to the threat of NAFTA withdrawal as well as challenges on issues of migration and drug trafficking. Through this process, Mexican officials developed strong relationships with their U.S. counterparts, but the unwillingness of the U.S. president to stop using rhetoric that offended Mexicans—that Mexico would pay for the construction of a wall along the border, for example—made it impossible to conclude a deal. With tensions high, President Trump came very close to sending notification of his intention to withdraw from NAFTA on at least one occasion,[22] but the vast and deep economic interconnections between the two countries provided Mexico with important allies inside the United States. The potential for strong negative economic effects on U.S. businesses, especially farmers, caused President Trump to walk back from the precipice.

Instead, the strategy of finding a quick, comprehensive solution gave way to a slower, formal process to renegotiate NAFTA beginning in August 2017. Over the next several months, under the leadership of U.S. Trade Representative Robert Lighthizer, the U.S. team developed a series of tough, nationalistic, and many would say protectionist proposals that became known as the "poison pills" due to the fact that they were virtually impossible for Mexico and Canada to accept, at least in their original form. These included stringent rules for the automotive sector that would substantially raise requirements for North American parts and include a stipulation that half of the parts (by value) in any car would need to be made in the United States; the elimination of binding dispute settlement procedures for anti-dumping cases and investor-state conflicts; the imposition of a "sunset clause" that would cause NAFTA to automatically expire every five years unless all parties agreed to renew the accord; new mechanisms that could be used to limit Mexican seasonal produce exports to the United States; a greater opening of Canada's dairy market; and limits on Canadian and Mexican access to compete for U.S. government contracts. With these proposals on the table by the fall of 2017, the negotiations moved to a two-track process.

The negotiations stalled in those tough areas, with Mexico and Canada rejecting the U.S. proposals as unworkable, but another portion of the process continued right along. The original NAFTA was negotiated in the early 1990s, before the era of smart phones, e-commerce, and a host of other technological advances that have reshaped global trade policy. As such, it was in need of modernization. Many of these issues had been addressed in the context of the Trans-Pacific Partnership negotiations undertaken during the Obama administration, but since the Trump White House decided it would no longer seek approval of that agreement, an effort was needed to add 21st century disciplines and trade policy advances to the aging NAFTA. Barring a handful of conflicts on issues such as intellectual property, the modernization components of the negotiations moved forward throughout the fall of 2017 and the spring of 2018, creating a sense of momentum that bought the three countries time to begin developing creative responses and new approaches to the U.S. "poison pill" proposals, even as they missed several deadlines to conclude the process.

In a push to finish negotiations before the Mexican presidential election on July 1, 2018, and to give the Republican-controlled U.S. Congress the opportunity to follow the timeline dictated by Trade Promotion Authority legislation to vote on the agreement before new members took office in 2019, negotiating teams entered an extended and intense negotiating round in April and May. This round saw advances in important areas, including movement toward resolution on automotive sector rules, but in the end, none of the key issues were fully resolved and the talks were put on hold until after the Mexican election. Worse still, the United States imposed tariffs on steel and aluminum imports from several countries, including Mexico and Canada, claiming they were needed to protect U.S. national security interests.

There had been serious concern in Washington and throughout North America that the election of Andrés Manuel López Obrador in Mexico could throw a wrench in the already complicated negotiations, given his nationalistic rhetoric and the political imperative for all presidential candidates in Mexico to be seen as defenders of the nation in the face of aggressive rhetoric and challenging policy shifts coming from the United States. AMLO's team of advisors, however, worked hard to explain to foreign and domestic audiences that he supported NAFTA and maintained positions very close to those that had been articulated by the Peña Nieto government regarding the renegotiation of the agreement. They astutely understood that the ongoing uncertainty caused by the NAFTA negotiations hung like a cloud over the Mexican economy they were about to inherit. After winning the election in July, AMLO appointed Jesús Seade as his representative to work with the Peña Nieto team to conclude the negotiations.

When negotiations restarted in late July 2018, a new dynamic emerged. The United States invited the Mexican team, but not the Canadians, to continue talks on so-called "bilateral" issues. Canada, which did not feel the same political pressures as the United States or Mexico (hoping to finish the deal before a change of government), had been more willing to hold firm on the contentious issues as pressure mounted on President Trump to fulfill his campaign promises on NAFTA before the mid-term elections, so the United States sought to increase pressure on the Canadians by dealing bilaterally with Mexico. Talks continued in this way through August, and by the end of the month the United States and Mexico announced that they had reached a deal. Mexico gave ground on the automotive sector rules, agreeing to increase North American component requirements from 62.5 percent to 75 percent of the total value of the vehicle, with 40-45 percent of value needing to be produced by workers earning at least $16 per hour, more than double prevailing rates of pay for Mexican production line workers. In return, the United States dropped its demands on Mexican seasonal produce and agreed to a much extended sunset clause in which the agreement would be reviewed every six years, at which point the parties could either extend the agreement for an additional 16 years or, if consensus cannot be reached, let the agreement expire after an additional 10 years. This change to the sunset clause helped preserve the certainty sought by investors by not allowing a single administration to make the agreement expire. Investor-state dispute settlement was weakened somewhat across the board, but preserved for key industries doing business with governments, including energy, telecommunications, and transportation infrastructure.

After the announcement of a U.S.-Mexico deal, the pressure was on Canada to reach a final agreement with the United States, and by the end of September 2018, they had done so. Canada managed to preserve Chapter 19, which allowed for arbitration on matters of anti-dumping and countervailing duties, while giving a bit of ground in terms of access to its dairy sector.

In the end, Mexico achieved its most important goal: the preservation of NAFTA and its preferential access to the U.S. market, which receives some 80 percent of Mexico's exports. Mexico renewed its commitment to open markets and its participation in global and regional supply chains. By doing so amidst a complicated transition of power, this statement has earned the country and the new government important credibility in international markets that will pay dividends in the long term. Though Mexico had to make concessions that many would have preferred to avoid, and international agreements in general offer less certainty in this new context of nationalistic movements across the world, Mexico has, at least judged through the lens of its management of the NAFTA renegotiations, proven itself a safe haven during this moment of geopolitical uncertainty.

Still, as an open economy deeply integrated with the U.S. and global economies, Mexico remains vulnerable during this period of rising economic nationalism. Given this context, trade diversification sounds like an appealing course of action, but the reality is that Mexico's key comparative advantage in the global economy is its proximity to U.S. consumers and industry, which makes any serious effort to reduce dependence on the U.S. market a difficult and risky proposition. Instead, Mexico must accomplish three important tasks.

- First, Mexico should continue its strategy of engaging U.S. subnational governments, the business community, and civil society in an effort to ensure the ratification of the USMCA in the U.S. Congress (ratification in Mexico is not expected to be difficult given the broad support for the agreement across political parties).
- At the same time, Mexico should engage partners both within and outside of North America to defend and modernize the World Trade Organization, which offers Mexico important protections should the USMCA/NAFTA face renewed crisis.
- Finally, and in the end most importantly, Mexico needs to, through its domestic economic policy, prove to investors and trading partners around the world that it has not itself fallen prey to the temptations of populist economic nationalism afflicting so many countries around the world.

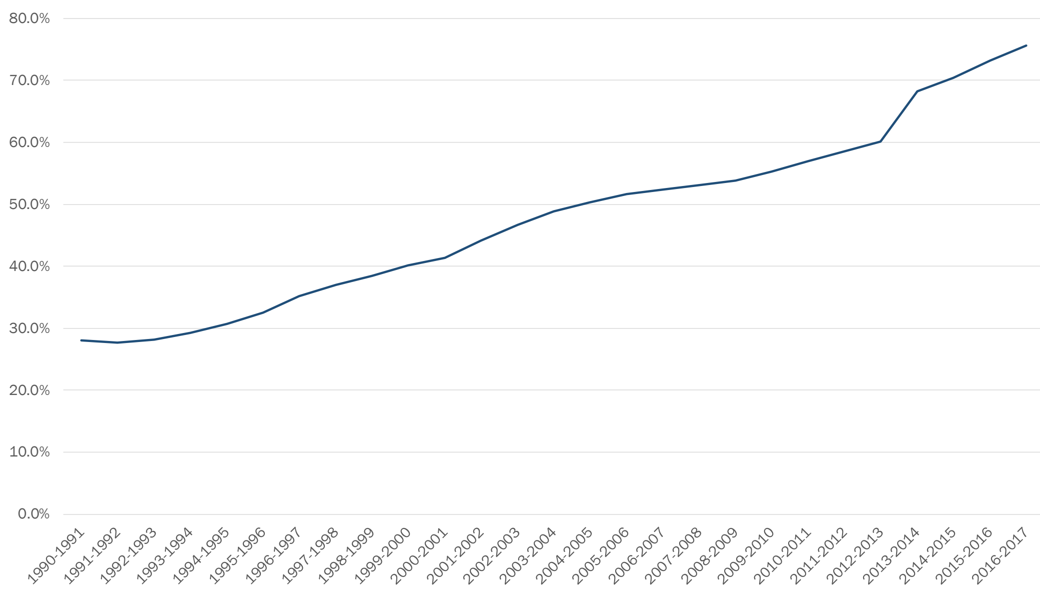
SOCIAL WELFARE IMPROVEMENTS

Despite the inability to stimulate economic development in a way that brings broad and inclusive economic opportunity, Mexico has nonetheless been able to deliver some important welfare gains. A part of this is the result of trade policy and Mexico's economic opening, which brought a much wider variety of consumer goods and better prices to the shelves of Mexican retailers, but a large portion is also due to targeted social programs that have effectively delivered improvements in housing quality, health care, and education. Policies to improve health and education must continue to be a focus of the Mexican government, as developing human capital is fundamental to driving growth, but unless the structural issues that incentivize informality and allow weak contract enforcement and insecurity are addressed (these issues are each addressed below), Mexico's human capital will continue to be underutilized and economic growth will remain slow.

Education

Education is an area of both significant advance and ongoing challenges. On the positive side, high school coverage has had a steadily increased since 1990. As shown in Figure 3, in 1990, only 28 percent of students had access to high school education while for the 2016-17 academic term, coverage was 76 percent. For most of recent history, Mexico spent too little on education, but it has recently rectified this problem, at least in terms of educational investment compared to the size of the economy. In 1990, Mexico spent 2.3 percent of GDP on education compared to the 4.5 percent average among members of the Organization for Economic Cooperation and Development (OECD), but by 2014, Mexico had reversed this trend, spending 5.3 percent of GDP versus the 5.2 percent OECD average.[23]

FIGURE 3: HIGH SCHOOL COVERAGE IN MEXICO



Source: According to the Mexican Education Ministry (SEP), coverage is the proportion of the total enrollment of a given educational level, with respect to the population at the official age of attending the level.

Though coverage and spending are up, educational quality still lags behind the levels needed to fuel Mexico's transition to a knowledge- and innovation-driven economy. Table 1 shows that Mexican students place last among all OECD countries in evaluations of math, reading, and science skills. Most of the OECD countries are advanced economies, so that may be a somewhat unfair point of comparison, but Mexican students still place in the bottom quarter of the expanded pool of 70 countries participating in the Programme for International Student Assessment (PISA) tests across all subject areas. Only among Latin American countries do Mexican students score at an average level, indicating that the educational challenges faced by Mexico are shared by many countries in the region. Similarly troubling is the fact that across subject areas, less than 1 percent of students are top performers.[24] Mexico's educational challenges are quite pervasive, and only a small fraction of Mexican students are being effectively prepared to lead the country into its next stage of development.

TABLE 1: MEXICO'S RANKING IN PISA EVALUATIONS, 2015

	Science	Reading	Mathematics
Overall (70)	57	55	56
OECD countries (35)	35	35	35
Latin America & Caribbean (10)	6	7	5

Source: Organization for Economic Cooperation and Development.

In order to increase the quality of the education provided by the federal government, new policy guidelines and evaluation mechanisms were created through the 2012 education reform. The reform created a system of teacher evaluations; created a merit-based system of promotions (taking away some power from the unions, which have traditionally offered political support to candidates willing to protect their dominance over the education system); gave schools more independence; and created new opportunities to boost teachers' professional development.[25] Though on paper the reform took measures to address many pending challenges in the national education system, it has yet to be fully implemented. Worse still, it appears to be at risk under the López Obrador administration.[26] According to a 2016 government evaluation of the reform, much work was left to be done. Only 13.5 percent of high school teachers and 4.8 percent of elementary school teachers had received training; new high school curricula had yet to be developed; many schools had not met minimum infrastructure and equipment needs; the system for teacher professional development remained a work in progress; and the process of implementing teacher evaluations had been challenged by teacher unions in some states.[27]

Health services

In 2003, Mexico created the Seguro Popular program with the goal of providing universal health care coverage, addressing the needs of the approximately half of Mexicans that previously lacked insurance, which was primarily a benefit offered to workers in the formal sector (and their families).[28] By 2013, some 56 million Mexicans were enrolled as beneficiaries of the Seguro Popular, and by 2016 the number of people without access to health insurance had declined to 15.7 million, or less than 15 percent of the population.[29] While the growth in coverage was impressive, the Seguro Popular offers treatment for only a limited number of ailments, and the fragmented nature of Mexico's health system remains a challenge. To address these issues, President López Obrador has announced a plan to end the Seguro Popular and allow members of the program to access other public health care institutions. This is a worthy goal, but reorganizing Mexico's sprawling health bureaucracy will prove a complex and costly task requiring careful planning and execution.

Mexican health authorities also face new challenges as a result of their own success and the rise of Mexico's middle class. Life expectancy is up and access to basic food and medicine has improved, but noncommunicable diseases such as obesity and diabetes have emerged as major health risks. At just over 33 percent, the rate of adult obesity in Mexico is the second-highest in the OECD and much higher than the OECD average of 19 percent. Further, 35 percent of those aged 12 to 19 are overweight or obese, and the OECD projects that by 2030, 40 percent of the population will be obese.[30] In order to combat these challenges, Mexico has implemented several public health policies, such as taxation on sugar-sweetened beverages, expanded nutritional labeling standards for food products, and regulation of food advertising for children, but much more work is needed to reverse these worrying trends.

Housing

The federal government has undertaken a series of social welfare programs to improve household conditions for those who live under the poverty line. Thanks to these programs, the number of households with dirt floors has been decreased from 3.1 million in 1990 to 1.7 million in 2010. Access to housing has also improved. In 2016, there were 122.3 million people living in Mexico and 32.9 million houses in the country, twice as many houses as in 2000. This increase in housing stock has been enough to lower the average number of people living in each house by one person per house since 1995, down to 3.7 people per house in 2015.[31]

This was made possible in part by the work of INFONAVIT (Federal Institute for Workers' Housing), which acts as a housing fund for private-sector workers and is responsible for about two-thirds of all mortgages in Mexico.[32] Since its creation in 1972, the institute has provided more than 10 million mortgages. Despite the important advances, the growth of housing development fueled by government-facilitated loans has often spurred urban sprawl, at times even pushing people to live in areas without basic services.[33] In 46 of Mexico's 59 metropolitan areas, more than 70 percent of homes registered between 2006 and 2013 were built on the outskirts or periphery of the city. Moreover, roughly 90 percent of the housing stock consists of individual homes, which continue to make up the majority of all new development.

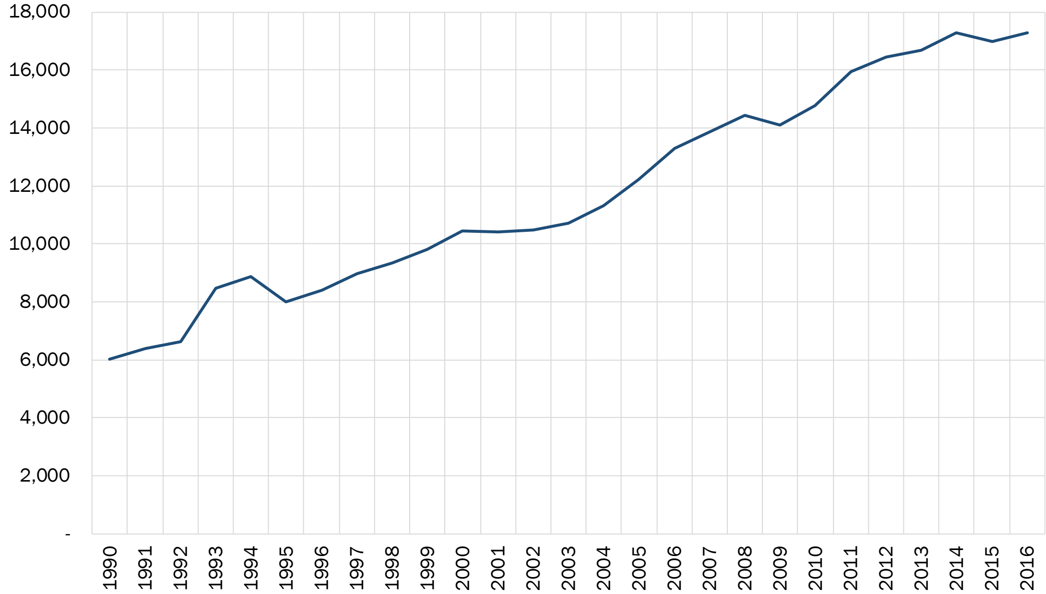
Structural incentives for informality

Ironically, the expansion of poverty alleviation and social welfare programs has served to entrench, rather than alleviate, Mexico's two-track economy. Santiago Levy provides extensive documentation of this phenomenon in his new book, Under-Rewarded Efforts: The Elusive Quest for Prosperity in Mexico, explaining that by increasingly delivering to all Mexicans the benefits that were once associated with only formal employment, the government has effectively decreased the incentive for firms to join the formal sector.[34] In 2013, 90 percent of all firms in Mexico were informal, meaning that their employees are either non-salaried and thereby not a part of the traditional, high-quality benefits system, or that they are salaried but illegally hired and generally also excluded from the traditional benefits system.[35] By staying in the informal sector, firms let the government subsidize benefits like health care (through the free Seguro Popular) that they would have to pay for themselves if they formalized. This of course limits the opportunities for these businesses to access credit and grow, thereby locking them into the slow track. A reconfiguration of Mexico's diverse system of social security and health care institutions is required to correct the misalignment of incentives that has deepened as a negative side effect of otherwise highly beneficial social program improvements.

POVERTY AND FLAT WAGES

Opening Mexico to the world and building a world-class manufacturing sector have without a doubt resulted in the creation of a functioning motor for economic development, but the motor has proven too small to generate significant reductions in poverty and wage improvements. A quick review of income, wage, and poverty numbers reveals the complicated tale of real but inadequate economic development that has characterized Mexico in recent decades.

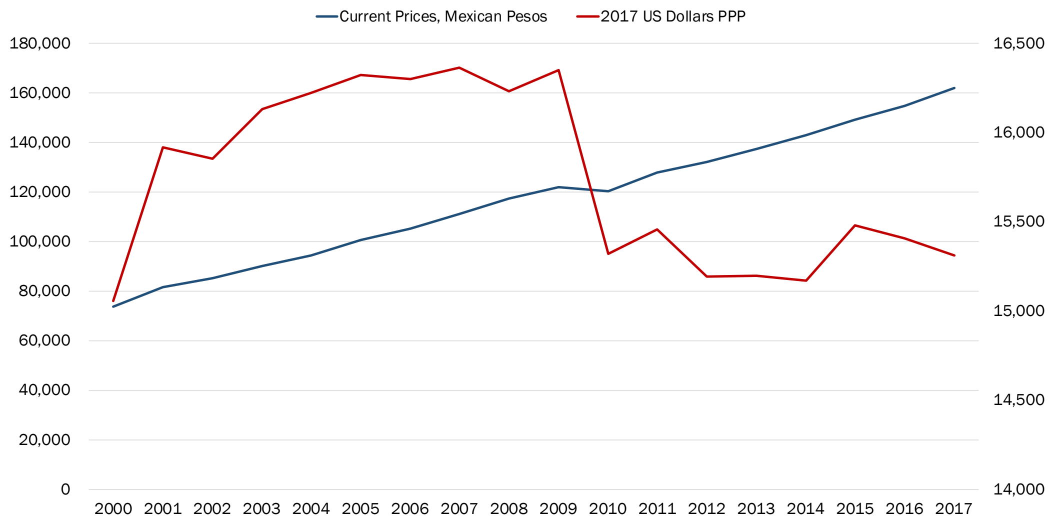
FIGURE 4: GDP PER CAPITA, 1999-2016 (PPP, CURRENT INTERNATIONAL DOLLARS)



Source: World Bank.

GDP per capita has indeed grown, with the most impressive advances revealing themselves when taking into account the improved purchasing power Mexicans have achieved through economic opening and prudent macroeconomic management to limit inflation. Figure 4 shows that GDP per capita, controlling for purchasing power, has nearly tripled since 1990. Other measures, however, present a more sobering story, especially for the half of the Mexican population living in poverty. In nominal terms, wages are up, but in real terms, the 2009 recession wiped away all gains since 2000 for the average Mexican worker (see Figure 5).

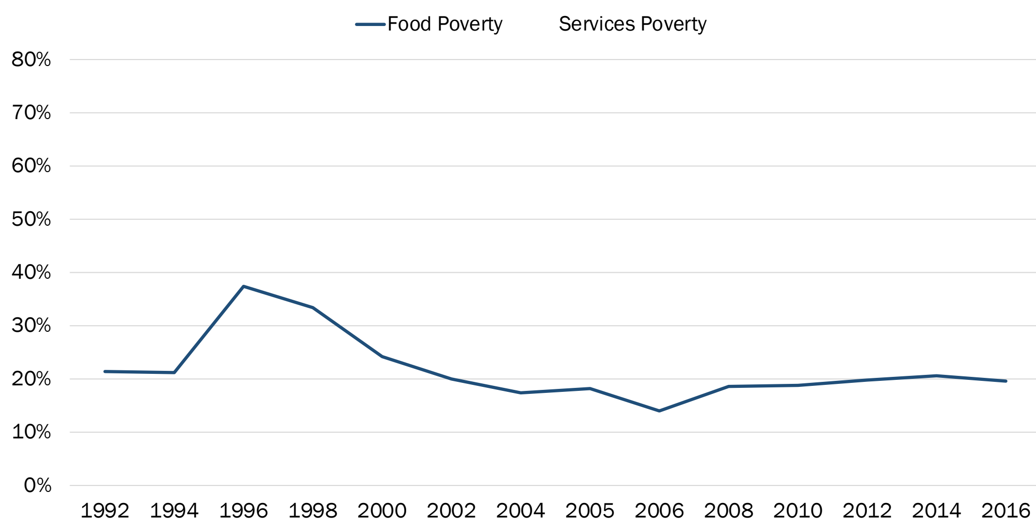
FIGURE 5: AVERAGE ANNUAL WAGES IN MEXICO, 2000-17



Source: Organization for Economic Cooperation and Development.

Income-based poverty has remained relatively constant since 1992. Figure 6, which includes two of the classifications made by CONEVAL (the Mexican program evaluation agency), shows that approximately 20 percent of the population brings in insufficient income to purchase a basic basket of food goods, while some 53 percent of the population lacks resources to buy both food and a broader basket of goods that includes health care, education, clothing, housing, and transport (services poverty).[36] Mexico's current poverty measures are multidimensional, incorporating non-income based components related to access to housing, health care, and education, but only the income-based dimension has sufficient data to allow for long-term comparisons.

FIGURE 6: INCOME-BASED POVERTY LEVELS IN MEXICO, 1992-2016



Source: CONEVAL and México ¿Cómo vamos?

STRENGTHENING COMPETITION, COMPETITIVENESS, AND PRODUCTIVITY

To strengthen its competitiveness and stimulate inclusive development, Mexico must employ a multifaceted strategy that reaffirms its commitment to global engagement, as well as fiscal and monetary responsibility; break down barriers to competitive internal markets; address misaligned incentives related to its social programs and tax policy; make investments in human capital and workforce development, implementing an energy policy capable of spurring investment in infrastructure and production; and work to strengthen the rule of law in order to ensure contract enforcement and reduce violence, each of which hinder economic development.

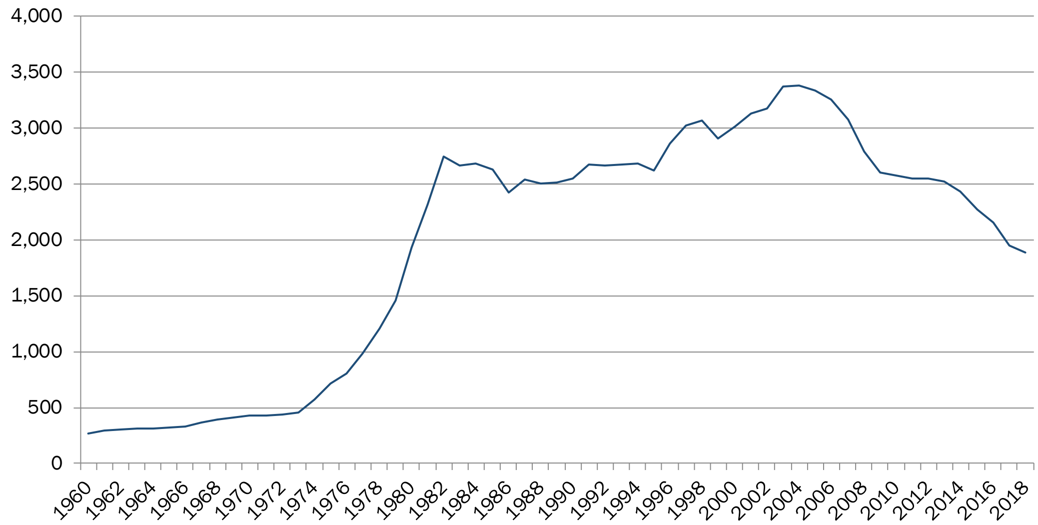
When Mexico began its economic transition toward being an open, market-oriented economy three decades ago, the focus was on dismantling barriers to international trade and investment, as well as the privatization of state-owned enterprises. As discussed above, the opening of the Mexican economy to the world enhanced competitiveness by opening markets and increasing the level of competition faced by local firms. Privatization was more of a mixed bag, at times replacing government monopolies and oligopolies with similarly concentrated and uncompetitive markets comprised of private firms. A series of reforms since then have been focused on better regulation of various sectors of the economy, including important steps to add competition and attract investment to the telecommunications and energy industries, and a strengthening of the institutions that guarantee competitive markets, such as the Federal Competition Commission (COFECE), the Federal Commission of Regulatory Improvement (COFEMER), the Federal Telecommunications Institute (IFT), and the Energy Regulatory Commission (CRE). Despite advances, there is much work still to be done to strengthen competition in Mexico's markets and to invest in key drivers of economic development, including infrastructure and human capital.

A study by Mexican Central Bank economists Daniel Chiquiar and Manuel Ramos-Francia describes the underlying issue as the "presence of rigid and non-competitive market structures," which are found by the Central Bank to cost the country 1 percent of GDP growth each year.[37] At a national level, there are still restrictions on foreign investment in the domestic transportation market, but after a series of federal-level reforms, many of the market failures that need to be addressed are at the subnational level. These include restrictions on the production of corn flour and tortillas, local bus operations, and poor state and local government procurement, among others.[38] The OECD has found many sectors of the Mexican economy to be among the most over-regulated within its member group. A recent report by the OECD analyzed competition policy for the pharmaceutical and meat markets in detail, offering more than 100 policy recommendations designed to improve competition and competitiveness. The authors calculated that if implemented, the recommendations to improve just these two markets could grow the Mexican economy by up to $2 billion.[39] In an academic paper published in 2013, Carlos Urzúa, now the finance minister for President López Obrador, found that monopolistic behavior by firms in Mexico negatively impacts consumers across the country, but with the greatest costs imposed on poor individuals and the poorer states in southern Mexico.[40]

Addressing monopolistic and other non-competitive behaviors in the market will go a long way to allow for innovative small- and medium-sized firms to challenge dominant players, but these businesses also need access to financing and a regulatory framework that allows for experimentation in order to bring new ideas and practices to the Mexican economy. Mexico has a small but burgeoning venture capital market that is helping successful startups grow, especially financial technology companies. This is important because financial technology may be the most effective vehicle to expand access to banking in Mexico—only 69 percent of Mexican municipalities have at least one bank at which withdrawals and deposits can be made, leaving nearly a third of the country without access to banks and the tools for saving and credit that they offer.[41] A well-functioning innovation ecosystem requires a full cycle of funding tools, from angel investors and competitive rates on commercial bank loans to a stock exchange ready to take growing companies public. Corporate venture and corporate investment in research and development in particular are in need of expansion and are areas that public policy should seek to promote.[42] Significant advances have been made in promoting the funding of innovation and entrepreneurship over the last several years, and in 2018, a new stock exchange, the Bolsa Institucional de Valores (BIVA), opened in Mexico with the goal of allowing smaller and newer companies to go public.

The Mexican energy sector, which for years was able to fill in the fiscal gap created by weak tax collection, has now become a drag on the country's competitiveness. As shown in Figure 7, oil production has been falling for the past 15 years, the result of a lack of investment in Pemex, inefficient management of Pemex, and, until recently, an unwillingness to seek out investment and know-how from the private sector. The 2013 energy reform changed the Mexican constitution to allow private participation in exploration and extraction, allowing the development of transparent bidding procedures (that should serve as an example for other government procurement processes), which have begun to bring new investment into the sector. The management of this very important and politically sensitive reform by the new government will provide important signals regarding the willingness of the administration to honor existing government commitments and favor pragmatic policies that promote growth.[43]

FIGURE 7: MEXICAN OIL PRODUCTION, 1960-2018 (THOUSANDS OF BARRELS PER DAY)



Source: Comisión Nacional de Hidrocarburos.

Given the importance of the industrial base of the Mexican economy, the availability of natural gas has proven an important facilitator of growth. The Mexican states with natural gas pipeline infrastructure have, on average, a GDP per capita 50 percent higher than those without it. The most competitive states in the country, including Mexico City, Aguascalientes, Nuevo León, and Querétaro all have access to natural gas, while less developed states such as Michoacán, Chiapas, Oaxaca, and Guerrero are all off the network, disincentivizing local investments in manufacturing.[44] In 2012, there were 12,000 km of gas pipelines in Mexico, and in 2013, recognizing the need to expand access to the rest of the country, the Ministry of Energy, working with Pemex and the Federal Electricity Commission (CFE), initiated a plan to build 12,000 km more of gas pipelines.[45] Implementation has been slower than anticipated, due largely to political and security challenges, but significant construction is underway.[46] Completing and extending the pipeline network, especially to southern Mexico, could provide an important development boost for the region.

In addition to the need to improve educational quality and access to higher education described above, Mexico is beginning to face the pressures that automation and artificial intelligence have been placing on lower-skilled workers doing repetitive tasks around the world. This creates a need for both up-skilling (factory floor and back office jobs are more likely to require programming, running, and maintaining software, robots, and machines than manually performing the now-automated tasks) and re-skilling (as employees replaced by technology must transition to new types of work).[47] Mexico has a wide network of technical post-secondary schools that are well-positioned to help fulfill this role, but many additional efforts will be needed, especially those that involve and incentivize collaboration between the private sector and academic institutions to ensure the applicability of curricula and to create pipelines to employment of those receiving training.

Finally, and in light of the organized crime and public security crises of the past decade, Mexico clearly must work to strengthen the rule of law. In 2018, the number of homicides registered in Mexico was the highest it has been in recent decades.[48] The World Economic Forum 2017 survey of executives found that the top constraints on doing business in Mexico are corruption, crime and theft, and inefficient government bureaucracy.[49] All the best-designed laws and government programs are rendered worthless if corruption, a lack of professionalization, and problems with institutional design block their effective implementation. This challenge is too large and multifaceted to offer much of a useful diagnostic or policy prescriptions in this short space, but a wide range of literature is available on the topic, including the excellent work by my colleagues María Amparo Casar (2015), Luis Rubio (2015), Viridiana Rios and Duncan Wood (2018), Vanda Felbab Brown (2017 and forthcoming), and Eric Olson (2018).[50] These works demonstrate significant economic and budgetary losses, in addition to the social costs, of corruption and violent criminality. Unfortunately, there are no shortcuts on the long road to institutionalize the rule of law. Rather, the best thing Mexico can do to improve business and investor confidence in the face of corruption and insecurity in the short term is to articulate and generate social support for a convincing long-term strategy. At the same time, the participation of business leaders, particularly at the local level, has proven a key and necessary ingredient in efforts to establish the rule of law.[51] The Mexican government must resist the temptation, especially strong in a once-corporatist state, to centralize security operations and political control, and instead find ways to channel the energy of businesses and civil society while engaging and persuading local governments to be active and accountable participants in the implementation of the rule of law.

CONCLUSION

The Mexican economy and Mexican economic management have made great advances over the past 25 years. Mexico's integration in global and regional value chains has facilitated the development of a world-class manufacturing sector that attracts investment, creates jobs, and increasingly includes a degree of design and engineering work alongside skilled production processes. This has been possible due to the opening of the Mexican economy, a trade policy that has earned Mexico preferential access to major markets around the world, and an institutionalization of the country's commitment to prudent macroeconomic management. These advances must be protected at both the international and domestic levels.

Nonetheless, Mexico has failed to extend the benefits of this thriving globalized sector of the economy to all Mexicans. To do so, it must grow faster and more inclusively by improving efficiency in the provision of government services, including making major advances in guaranteeing the rule of law, extending competition to oligopolistic and protected sectors, improve the design of social tax policy and social programs, and both make (as a government) and incentivize investments in human capital and infrastructure. The rise of the left in Mexico and the electoral victory of Andrés Manuel López Obrador present an opportunity to pursue significant reforms to promote inclusive development. Though López Obrador was elected with a mandate to bring dramatic change to Mexico, to succeed, his government must recognize and protect the hard-won achievements of the past decades even as it leverages its significant political capital to overcome deeply entrenched barriers to faster and more broad-based growth.

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