The Economist: Special Report on Mexico

From darkness, dawn

After years of underachievement and rising violence, Mexico is at last beginning to realise its potential, says Tom Wainwright

THE APOCALYPSE WAS on its way, and it would begin in Mexico. Where else? When archaeologists dug up Mayan calendars that ominously seemed to run out in the final days of 2012, some doomsayers predicted the end of the world. To many Mexicans it seemed like just another example of their country's unending run of bad luck. The steepest recession on the American mainland, a plague of H1N1 swine flu and a deepening war against organised crime had made the preceding few years fairly grim. In 2009 the Pentagon had given warning that Mexico could become a "failed state". Armageddon would be the icing on the cake.

But it turns out that the Mayan glyphs were misunderstood. The men with magnifying glasses now say that the world is not about to end—in fact, it seems that the Mayans were predicting something more like a renewal or a fresh start. Could the same be true of Mexico?

This special report will argue that there is a good chance of it. Some awful years are giving way to what, if managed properly, could be a prosperous period for Latin America's second-largest economy. Big, irreversible trends, from a falling birth rate at home to rising wages in China, are starting to move in Mexico's favour. At the same time the country's leaders are at last starting to tackle some of the home-grown problems that have held it back.

Many of the things that the world thinks it knows about Mexico are no longer true. A serially underachieving economy, repeatedly trumped by dynamic Brazil? Mexico outpaced Brazil last year and will grow twice as fast this year. Out-of-control population growth and an endless exodus to the north? Net emigration is down to zero, if not negative, and the fertility rate will soon be lower than that of the United States. Grinding poverty? Yes, but alleviated by services such as universal free health care. A raging drug war? The failure of rich countries' anti-drugs policies means that organised crime will not go away. But Mexico's murder rate is now falling, albeit slowly, for the first time in five years.

A vast country with deeply ingrained problems and unreformed corners, Mexico could yet squander the opportunities that are coming its way. But there are signs that it is beginning to realise its potential. With luck, the dire predictions made by the Pentagon and others may turn out to be as reliable as a misread Mayan calendar.

Preparing to lead Mexico into this brightening future is the party most associated with its past. The Institutional Revolutionary Party (PRI) ran Mexico without interruption for most of the 20th century, silencing opposition through a mixture of co-option, corruption and occasional violence. Only in 2000 did it give up its grip on power to the conservative National Action Party (PAN), which fielded two presidents in succession: Vicente Fox, a former executive at Coca-Cola, and Felipe Calderón, a lawyer whose father was a founding member of the party. On December 1st Mr Calderón will hand over the presidency to the PRI's Enrique Peña Nieto, who won a clear election victory on July 1st. A handsome 46-year-old with a gift for communication, Mr Peña claims to be the opposite of the crooked party men who ran the country in its pre-democratic days. But will the change be more than superficial?

Mr Peña says his priority is to make the economy grow faster in order to reduce poverty. Nearly half the population are poor, many of them in the south (see map). To achieve more rapid growth he will need to introduce a series of big economic reforms, some of which Mr Calderón attempted during his presidency, only to see them get stuck in Mexico's cantankerous Congress. The PRI had hoped to win a majority in the summer's elections, but it fell short by 11 in the 500-member Chamber of Deputies and by four in the 128-member Senate. In any case, some of the most important reforms will need changes to the constitution, which require a two-thirds majority in Congress.

However, Mr Peña has reason to be optimistic. The opposition PAN shares much of Mr Peña's agenda, and together the two parties have a two-thirds majority in both houses of Congress. A new power to fast-track two bills per congressional session will help. A lot will depend on who ends up leading the PAN, which is restive and rudderless after finishing third in the presidential election. The handover period between July's election and December's inauguration has been a model of presidential co-operation. Mr Calderón's crackdown on Mexico's vindictive criminals has given him a personal reason to stay on good terms with the new government, to make sure of the protection he and his family will need when he leaves office.

Fighting on two fronts

Mr Peña's main problem in Congress may well be his own party. As this special report went to press Congress was about to pass a labour-law reform, which among other things would make hiring and firing easier. But linked measures to make Mexico's over-mighty unions more transparent and democratic were voted down by congressmen from Mr Peña's own PRI, which has strong ties to unions. If the unions cannot be tamed, Mr Peña's other reforms—to open up the monopolised energy sector and overhaul the tax system—may be similarly diluted.

The runner-up in the election was the left-winger Andrés Manuel López Obrador, known as AMLO, who came a very close second to Mr Calderón in 2006 but lost to Mr Peña by 6.8%. After both defeats he claimed fraud. The evidence is thin. The left has about a quarter of the seats in Congress, but many of its congressmen have little patience with AMLO, whose magnetic personality repels as many voters as it attracts.

The government may also face opposition outside Congress. Though a majority of the political class now seems to be convinced of the need for economic reforms along the lines that Mr Peña proposes, the same may not yet be true on the street, in the public universities or in much of the press. "Mexico is a country where doctrine and principle matter more than practical considerations and results," says Enrique Krauze, a historian. The state-run oil monopoly is the sort of sacred cow that could emit a deafening, destabilising moo if Mr Peña tried to tether it. Mexico City already sees an average of 14 protests a day.

The internet is making politics more unpredictable. During the election campaign Mr Peña paid a disastrous visit to a university and fled after being heckled. This gave rise to an anti-Peña student movement calling itself YoSoy132, or "I am the 132nd" (the initial protest was led by 131 students). It is now capable of summoning large crowds via Twitter and Facebook to march against Mr Peña (and often, it seems, for AMLO). During Mexico's independence celebrations on September 16th anonymous hackers took down several government websites.

So it will not be an easy ride. Mr Krauze remembers that the optimism when the North American Free-Trade Agreement (NAFTA) came into force in 1994 was quickly punctured by the Zapatista uprising in Mexico's south on New Year's Day. "We thought we were there in the first world, on the final lap of our historic marathon. Then on January 1st we woke up to the astonishing news of a rebellion in Chiapas," he says.

Mexico has form in turning triumph to disaster, and could yet do so again. Its economy remains dependent on the fortunes of the United States, and financial crises in Europe make investors jittery. Promised reforms will depend on persuading entrenched interests to accept them. Corruption and bad government, especially at the local level, may cause good initiatives to fall at the last hurdle. And the drug war is by no means over. But Mexico deserves a fresh look—not least because its economy is revving up, as the next article explains.

Señores, start your engines

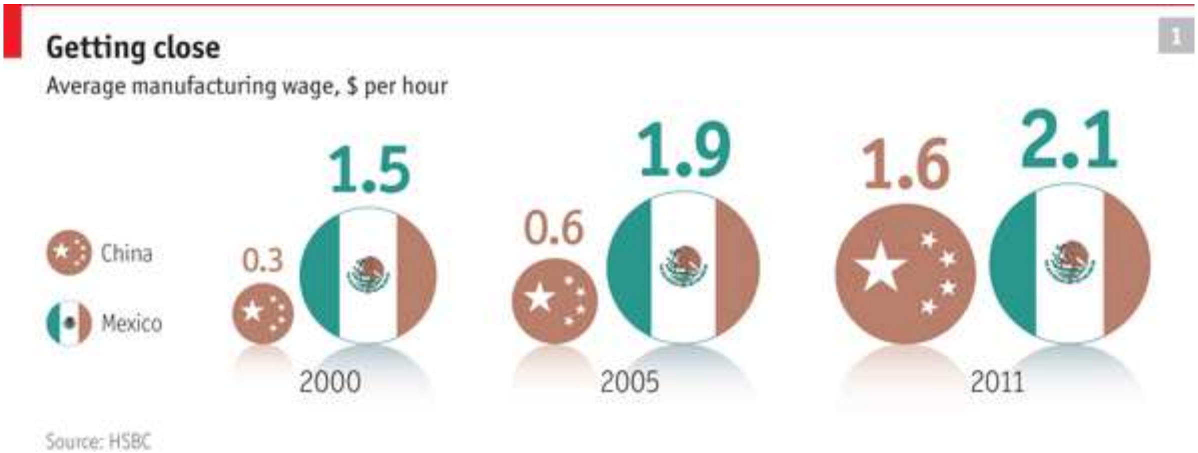
Cheaper than China and with credit and oil about to start flowing, Mexico is becoming a Brazil-beater

CUERNAVACA, A ONCE pretty, now sprawling city with volcano views just south of the capital, is a typical Mexican town. Hernán Cortés stopped off there after toppling the Aztec emperor Moctezuma in 1520; the conquistador's stables have since been converted into a smart hotel. Yet on the outskirts of the city, in an enormous industrial park, a visitor could forget he was in Latin America. Nissan, a Japanese car giant, has created a factory the size of a village where from next year it will begin turning out thousands of yellow and chessboard-chequered New York City taxis.

Once shuttered off by tariffs and trade controls, Mexico has opened up to become a place where the world does business. The North American Free-Trade Agreement (NAFTA), which in 1994 eliminated most tariffs between Mexico, the United States and Canada, was only the beginning: Mexico now boasts free-trade deals with 44 countries, more than any other nation. In northern and central Mexico German companies turn out electrical components for Europe, Canadian firms assemble aircraft parts and factory after factory makes televisions, fridge-freezers and much else. Each year Mexico exports manufactured goods to about the same value as the rest of Latin America put together. Trade makes up a bigger chunk of its GDP than of any other large country's.

Normally that would be a good thing, but after the 2007-08 financial crisis it meant that Mexico got a terrible walloping. Thanks to its wide-open economy and high exposure to the United States it suffered the steepest recession on the American mainland: in 2009 its economy shrank by 6%. The country had already had a rocky decade. When China joined the World Trade Organisation in 2001, it started undercutting Mexico's export industry. In the ten years to 2010 Mexico's economy grew by an average of just 1.6% a year, less than half the rate of Brazil, which flourished in part by exporting commodities to China.

But now changes are under way, in Mexico's factories, its financial sector and even its oil and gas fields, that augur well for a very different decade. Latin America's perennial underachiever grew faster than Brazil last year and will repeat the trick this year, with a rate of about 4% against less than 2% in Brazil. Mr Peña is aiming to get annual growth up to 6% before his six-year presidency is over. By the end of this decade Mexico will probably be among the world's ten biggest economies; a few bullish forecasters think it might even become the largest in Latin America. How did Mexico achieve such a turnround?



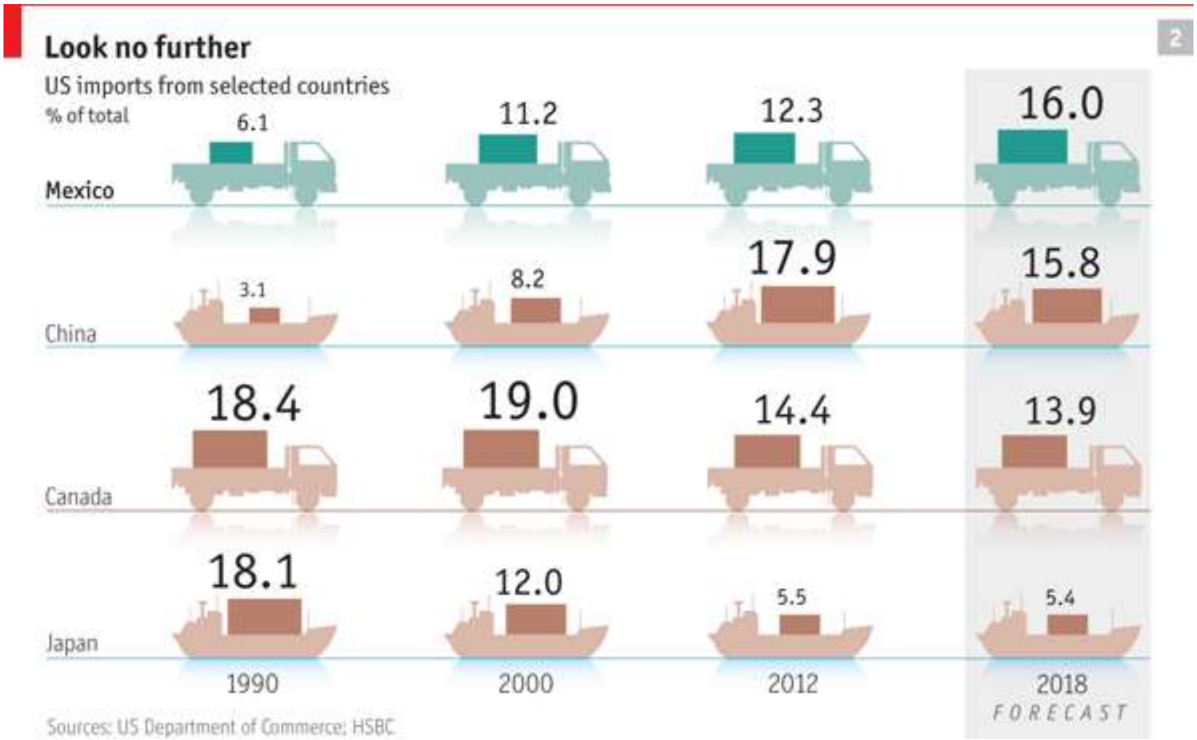
China's cut-price export machine sucked billions of dollars of business out of Mexico. But now Asian wages and transport costs are rising and companies are going west. "The China factor is changing big-time," says Jim O'Neill, the Goldman Sachs economist who in 2001 coined the "BRICs" acronym—Brazil, Russia, India and China—much to Mexico's irritation. China is no longer as cheap as it used to be. According to HSBC, a bank, in 2000 it cost just $0.32 an hour to employ a Chinese manufacturing worker, against $1.51 for a Mexican one. By last year Chinese wages had quintupled to $1.63, whereas Mexican ones had risen only to $2.10 (see chart 1). The minimum wage in Shanghai and Qingdao is now higher than in Mexico City and Monterrey, not least because of the rocketing renminbi.

Right next door

Hauling goods from Asia to America is costlier too. The price of oil has trebled since the start of the century, making it more attractive to manufacture close to markets. A container can take three months to travel from China to the United States, whereas products trucked in from Mexico can take just a couple of days. AlixPartners, a consultancy, said last year that the joint effect of pay, logistics and currency fluctuations had made Mexico the world's cheapest place to manufacture goods destined for the United States, undercutting China as well as countries such as India and Vietnam.

Companies have noticed. "When you wipe away the PR and look at the real numbers, Mexico is startlingly good," says Louise Goeser, the regional head of Siemens, a German multinational. Siemens employs 6,000 people at 13 factories and three research centres around Mexico. From its recently enlarged facility in Querétaro, in central Mexico, surge-arrestors and transformers trundle up to warehouses in the central United States in two days. Ms Goeser says that Mexican workers are well qualified as well as cheap: more engineers graduate in Mexico each year than in Germany, she points out.

In Aguascalientes, not far away, Nissan is building a $2 billion factory. Together with an existing facility it will turn out a car nearly every 30 seconds. About 80% of the parts in each car are made in Mexico. By using local suppliers, the company is "armoured" against currency fluctuations, says José Luis Valls, head of Nissan Mexico. "If you are localised, you can navigate through floods and storms. If you depend on imports of components, you are very fragile." In nearby Guanajuato Mazda and Honda are building factories; Audi is constructing a $1.3 billion plant in Puebla. This year Mexico will turn out roughly 3m vehicles, making it the world's fourth-biggest auto exporter. When the new factories are up and running, capacity will be 4m.

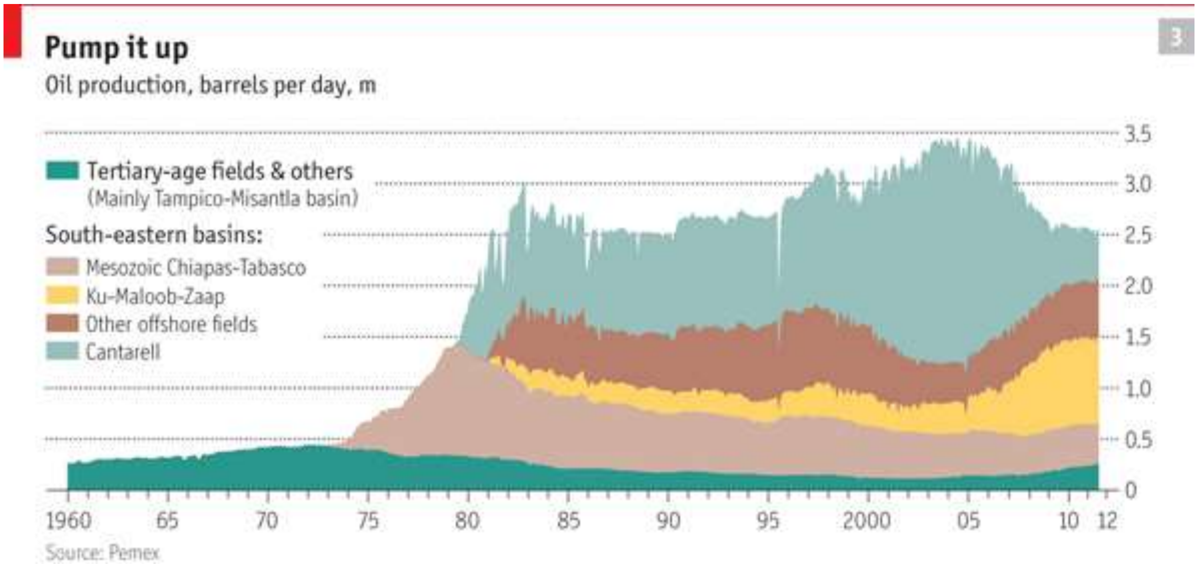


According to projections by HSBC, in six years' time the United States will be more dependent on imports from Mexico than from any other country (see chart 2). Soon "Hecho en México" will become more familiar to Americans than "Made in China".

On the opposite side of Cuernavaca from Nissan's gigantic factory, Antonio Sánchez plays a smaller role in Mexico's motor business. At his carwash customers queue to pay 46 pesos ($3.60) for their cars to gleam in the ever-present sun. Mr Sánchez seems to have enough business to open another branch, but credit is scarce and expensive. He explains that banks tend to charge interest rates of 25% or more and demand collateral worth three times the value of the loan. "It's complicated, expensive and the risk is too much," he says.

Mexican businesses have been fighting with one hand tied behind their backs, thanks to a chronic credit drought. Lending is equivalent to 26% of GDP, compared with 61% in Brazil and 71% in Chile. The drought started with the "tequila crisis" of 1994, when a currency devaluation triggered the collapse of the country's loosely regulated banking system. Banks spent the best part of a decade dealing with their dodgy legacy assets and were nervous about making new loans.

But things are looking up. Inflation, now running at 4.6%, has been well under control for ten years. The conservatively run Mexican subsidiaries of foreign banks such as BBVA, Citigroup and Santander are all rated higher than their American or European parent companies. Now they are starting to turn on the credit tap. Loans to companies are growing at 12% a year and to individuals at 23%. Given that many enterprises are informal, many of these "personal" loans probably go to businesses, according to David Olivares of Moody's, a ratings agency. "There are many financing opportunities in Mexico that are not tapped," says Agustín Carstens, the governor of the central bank. This gives Mexico an advantage over other Latin American countries that are deep in debt. Five to six consecutive years of loan growth, coupled with macroeconomic stability, would increase Mexico's annual growth rate by half a percentage point, the central bank estimates.



As credit starts flowing, so could oil. Since striking black gold in the 1970s, Mexico has been one of the world's ten biggest oil producers. The revenues of Pemex, the state-run oil and gas monopoly, provide about a third of the government's income. But that is part of the problem. The company is "horribly run", says Juan José Suárez Coppel, its director. He complains that successive governments have milked Pemex rather than let it invest in exploration and technology. It takes between six and eight years from discovering oil to pumping it, so "no president who invests is going to see the barrels," Mr Suárez points out. Each time a new field is discovered the company allows others to go into decline (see chart 3). Production has slipped from 3.4m barrels a day to 2.5m, and safety is wobbly: in September 30 people died in a gas explosion in Reynosa, near the Texan border.

Ten years ago a change in budgeting rules allowed more investment in exploration, and reserves have risen. This year production is expected to increase for the first time in eight years, but far more lies unexploited. Pemex reckons that there could be nearly 30 billion barrels under the Gulf of Mexico, more than half of the country's prospective reserves. But starved of money, the company has been slow off the mark to exploit it. Between 2006 and 2011 it drilled 18 wells in deep waters; Petrobras, its opposite number in Brazil, drilled 101. Shale oil and gas, and "tight" oil, are further opportunities waiting to be exploited.

Plenty of foreign companies are keen to start drilling in Mexico, but since the nationalisation of the oil industry in 1938 Mexico has been wary of dealing with gringos. That might now change. Mr Peña has promised an energy reform early in 2013. Many would like Pemex to do as Brazil did and allow competition. Petrobras lost its monopoly in 1997 and made the world's biggest share offering in 2010. Will Pemex follow suit? "I don't see it in the immediate future," says Luis Videgaray, Mr Peña's closest aide. However, Pemex "has to take steps in that direction," beginning with improving its corporate governance, he says.

There are some less radical options. Since 2008 Pemex has offered incentive-based contracts under which private firms are paid according to how much oil they extract. The next step would be contracts in which companies share the risk—and potential reward—of drilling in uncertain areas. "Incentive-based contracts have big limitations…We want a reform that allows the private sector to share more risk with Pemex in order to attract more capital and more technology," says Mr Videgaray. Such a reform would probably mean changing the constitution, which defines oil as the property of the nation. It would be “a signal that echoed around the world: a before-and-after in the history of Mexico,” says Héctor Aguilar Camín, a historian.

What could stop Mexico on its march to growth? One risk is a protracted slowdown in the United States, the destination of four-fifths of Mexico’s exports. Mr O’Neill points out that consumption in the United States amounts to about 70% of GDP; in the long run it will probably fall to around 65%. “That’s not good if you’re setting yourself up as an exporter next door,” he says.

Slimming the monopolies

But Mexico has created a few obstacles of its own which it urgently needs to remove. Goldman Sachs’s “growth environment score”, which measures the likelihood of sustainable growth, ranks Mexico below Brazil, partly because it scores badly on technology. Mobile-phone penetration is 85%, about the same as in Iraq. A fast broadband connection in Mexico costs nearly twice as much as in Chile. It does not help that telecommunications are a near-monopoly. Carlos Slim, the world’s richest man, controls companies that account for about 80% of fixed phone lines, 75% of broadband connections and 70% of mobiles.

Excessive concentration afflicts many other sectors, sometimes as a hangover from the pre-democratic days when political support was bought by granting informal monopolies. Nearly all of Mexico’s bread comes from Bimbo, cement from Cemex and television from Televisa. Nearly a third of household spending goes on products with monopoly or tight-oligopoly suppliers.

The competition authorities have recently been given teeth, with bigger fines and even prison sentences for offenders. Mr Slim’s phone companies are being forced to compete with Televisa’s television empire as technology joins up the two markets. Mr Peña has promised special courts to settle competition disputes. He may also remove the ban on foreign ownership of companies in some industries. “It’s a good moment to review whether Mexico needs these sorts of restrictions,” says Mr Videgaray, pointing to fixed-line telephones and airlines as examples. If Mr Peña can dynamite a few monopoly bottlenecks, there will be a better chance of the 6% growth he wants.

Bureaucrats and backhanders

The paperwork is dwindling, but bribes persist

A BUDDHIST MONK, some neatly dressed Mormon missionaries and a young Guatemalan reading Nietzsche are among those waiting in the offices of the National Institute of Migration for their visas to be issued. Clerks tell visitors to take a seat—a mischievous joke, since there are vastly more people than chairs in the cramped waiting room. The air is thick with boredom and barely stifled rage.

Doing business in Mexico can be a frustrating experience, thanks to the country’s affection for *trámites*, or red tape. Woe betide anyone who seeks a permit without the requisite number of photocopies or a notary’s stamp. Until recently foreigners of both sexes who wanted to live in Mexico had to fill in a form that included questions on their style of moustache (thin, trimmed or bushy?).

As well as raising the national blood pressure, *trámites* open the door to corruption. If you don't want to spend all day in the police station to pay a speeding fine, you can settle in cash by the roadside. An under-the-counter express service at the local council will quickly get you a permit for your restaurant to put tables on the pavement, for a small fee. Even Walmart, a multinational retailer, has been accused of paying backhanders to speed up the opening of new stores in Mexico.

Ending corruption will require cleaner public servants and a more indignant public. But the risk of graft can be lowered by removing the obstacles that tempt people to use illegal shortcuts. Registering a property in Mexico calls for seven separate *trámites* over ten weeks, whereas in America it involves four steps and takes a fortnight.

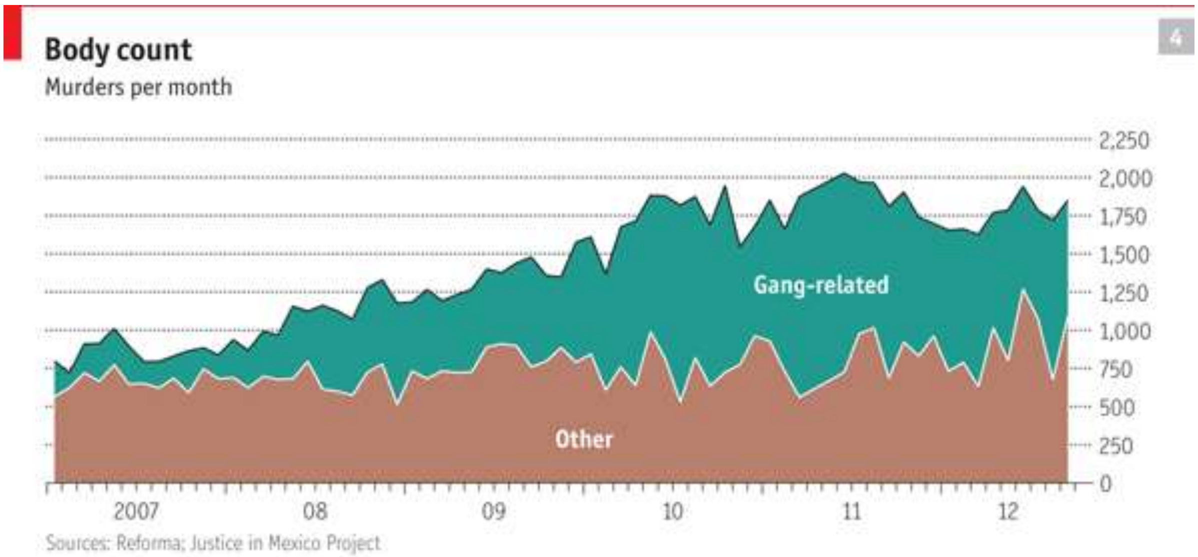
The queues are already shortening and the paperwork is thinning. Companies can file taxes online, which has cut the time it should take to about 340 hours a year. That sounds a lot, but in Brazil it takes 2,600 hours. Getting a construction permit in Mexico takes an annoying two-and-a-half months; in Argentina it takes a year. The World Bank ranks Mexico as one of the most straightforward places in Latin America to do business.

Petty corruption remains a gigantic problem. Transparency International, a graft watchdog, reckons that Mexican households spend about 32 billion pesos ($2.5 billion) a year on bribes, often to do things that ought to be free, such as having their rubbish collected or even sending their children to school. Worse, the burden falls disproportionately on the poor. The bonfire of the *trámites*must burn on.

Drugs and violence: A glimmer of hope

After five years of soaring murder rates, the killings have at last begun to level off

WHEN FEUDING BETWEEN drug traffickers was at its most brutal in Ciudad Juárez, a border city on the edge of the Chihuahua desert, the deadliest time to step into its mean streets was 4.45pm. The main television news bulletin is broadcast at 5pm, and Juárez's gangsters, experts in public relations, would time their murders to lead the evening headlines. "They would kill in the streets, by the highways, on the main avenues. They wanted to send a message to the authorities," says David García, head of the city's forensic service. Five years ago his team dealt with about 400 homicides a year, giving the city of 1.3m a murder rate roughly equal to that of New York in the early 1990s. By 2010 the small mortuary had to accommodate 300 murdered bodies a month, making Juárez by some reckonings the most violent city in the world.



The explosion of killing in Juárez is only the most extreme example of an appalling national trend. Five years ago Mexico was one of Latin America's gentlest countries, with a murder rate of nine per 100,000 people, not much higher than in the southern United States. But since then the numbers have more than doubled (see chart 4), in tandem with an increase in robbery, extortion and kidnapping. Sadistic killings have been beamed around the world over the internet.

Many parts of Mexico, including its gigantic capital, are relatively peaceful, so the country's overall murder rate is still no higher than Brazil's and much lower than much of Central America's. Yucatán, the quietest state, is statistically as safe as Finland. But very few places are unscathed by the trend: nearly all states saw more killings last year than five years earlier. Polls show that insecurity is Mexicans' biggest worry.

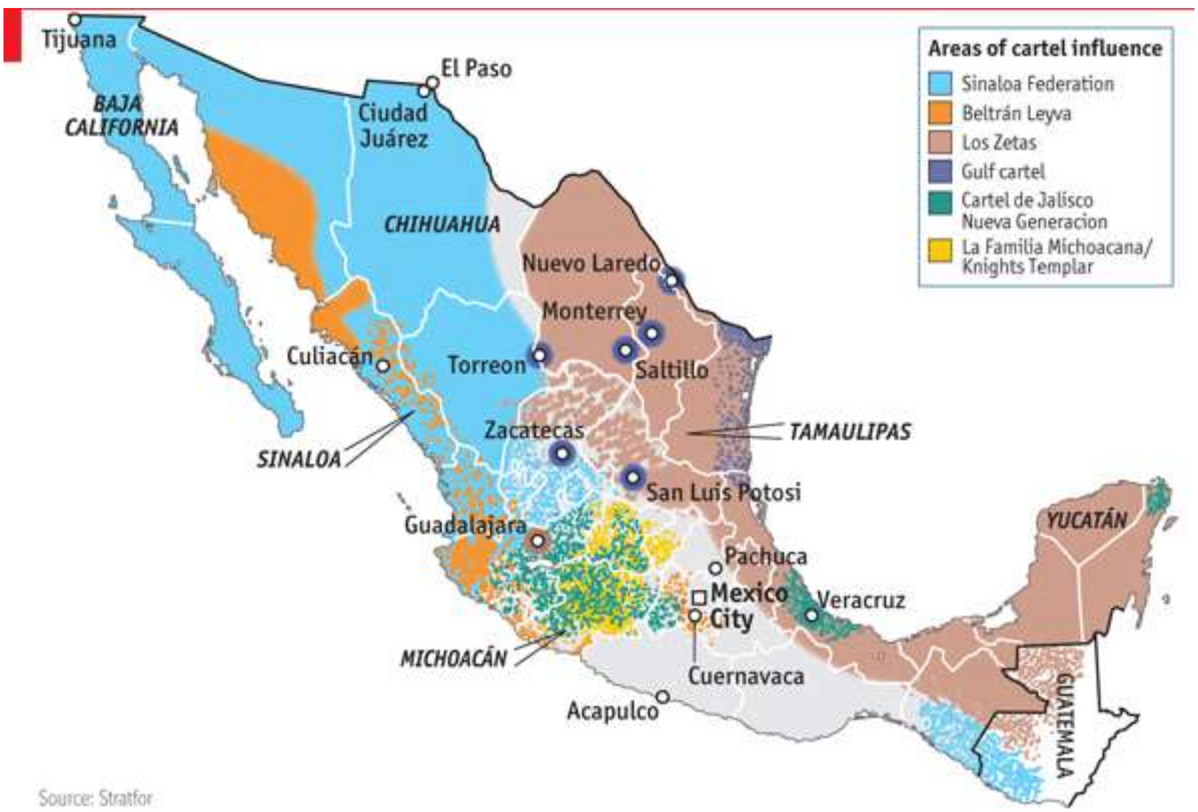
Now, for the first time since murders began to soar in 2008, the rate is subsiding. In the first nine months of this year killings were 7% down on the same period in 2011. Twenty of Mexico's 31 states recorded a decline. In Juárez Mr García's mortuary is back to handling about 40 bodies a month, little more than during what *juarenses* still know as the "pre-war" years. Mr Calderón describes the past year as a "turning point" for the country, but cautions that it took Colombia many years to bring its murder rate under control. In Juárez people once again drive with their windows rolled down and eat their burritos on the pavement, but achieving the same results elsewhere will not be easy.

After the Caribbean cocaine-smuggling route was shut down in the 1980s, Colombia's drug lords turned to Mexico, whose 2,000-mile border with the United States, the world's biggest drug market, made it a convenient stepping-stone. As the net closed around Colombian *capos* in the 1990s they ceded more of their operations to their Mexican partners, whom they began to pay in cocaine rather than cash. Shortly after the turn of the century Mexico's gangs became more powerful than Colombia's, reckons Antonio Mazzitelli, the regional head of the UN's Office on Drugs and Crime.

A brief history of horror

The dates engraved in gold on the gaudy narco-tombs of cities such as Culiacán, in Sinaloa, show how gangsters have been blasting away at each other for decades. Some trace the recent spike in killing to 2003, when Osiel Cárdenas, the leader of the east-coast Gulf cartel, was captured by the army in the state of Tamaulipas and eventually sent to a Colorado "supermax" prison. This sparked a takeover bid by the Sinaloa mob, which terrorised the Gulf-controlled city of Nuevo Laredo. In 2006 La Familia, a gang thought to be allied to the Gulf clan, rolled five human heads onto a Michoacán dance floor.

When Mr Calderón donned the presidential sash a few months later he vowed to crush the cartels. "The moment would arrive when one day they were going to take control of the state itself," he says. After he deployed thousands of troops, the cartels seemed to reach a truce of sorts in 2007. But then violence erupted in the north-west as the Sinaloans fell out with their allies in Juárez, Tijuana and Culiacán. Murders linked to organised crime, previously about 2,000 a year, more than tripled. In 2010, when the Gulf cartel fell out with the Zetas, its former enforcers, such killings rose to more than 15,000. The following year the government stopped counting. Newspapers' tallies suggest that gang murders continued to rise.



Source: Stratfor

Many leading *mafiosi* have been captured or killed. Of 37 kingpins named in a wanted list in 2009, only 12 remain at large. On October 7th marines shot dead Heriberto "the Executioner" Lazcano, supposedly the leader of one branch of the Zetas. Three weeks earlier they had nabbed the head of the Gulf clan, Jorge Eduardo Costilla. Such captures have altered the borders of Mexico's underworld (see map). But they have sometimes made things worse as fallen *capos'* underlings fight for the throne. In cities such as Acapulco, powerful but relatively peaceful criminal monopolies have been replaced by volatile small gangs.

The local police are not up to dealing with them. Mexico has more officers per head of population than many rich countries, but most are members of ill-paid municipal forces. Seven out of ten Mexicans say they paid a bribe last time they dealt with a traffic policeman. Several of the baddies on the most-wanted list are themselves former officers. The federal police is more widely trusted but remains too small to do the job on its own. Mr Peña has promised to draft 40,000 soldiers into the police and increase spending on security from 1.5% of GDP now to nearer Colombian levels of 5%. Plans to bring the disparate local forces under a single command, as in Colombia, have faltered in the face of opposition from mayors who do not want to lose control of their local muscle.

Small businesses are at their wits' end. In downtown Juárez, on an avenue leading to El Paso, the windows of discos and shops are smashed and boarded up. Arnulfo Gómez, sporting a Stetson and a wispy silver ponytail, has run the Don Félix bar for 38 years. His neighbours used to include more than 100 souvenir shops; now there are fewer than five, he reckons. One nearby business says that the going rate for extortion is about $100 a week. Dotted around the city are the burnt shells of shops that refused to pay. Big multinationals, which have their own security forces and keep their managers and cash off-site, seem unfazed, which may explain why overall economic growth has weathered the storm.

Some citizens have taken matters into their own hands. In an apartment in Mexico City where she works as a cleaner, a tiny round 70-year-old great-grandmother explains why she is saving up to hire a contract killer. Three men and a woman are terrorising her village. They recently robbed her granddaughter and broke her husband's arm with an axe-handle to stop him from snitching. The neighbours dragged one of the robbers to the police but he paid his way out. "So we have to do something ourselves, the *pueblo* united," explains the old lady. She knows of a former soldier with a gun in nearby Pachuca who carries out what she calls "revenges". "If the authorities don't do anything, what are we left with?" she asks.

In a tough neighbourhood of breezeblock homes on the sandy south-eastern edge of Juárez, two groups of teenagers are squaring off for a fight. It may not look like it, but the scene helps to explain the turnaround in Juárez's murder rate. The teenagers are taking part in a *taekwondo* lesson in the Manuel Valdez Community Centre, a tidy new facility for sport, arts and education. Every month nearly 100,000 people drop in to the network of 42 centres, built mostly in the poor neighbourhoods where gangs flourish. Next door to the *taekwondo*session a computer course is under way; on a roof terrace children dance to Rock Around the Clock, belted out on an electric keyboard.

To turn the failing city around, the federal government spent 5 billion pesos ($390m) on security and social development in Juárez in 2010 and 2011. Héctor "Teto" Murguía, the mayor, says this has resulted in a remarkable drop in murders. "In cities like Medellín, Palermo, Chicago or New York it took them ten years to reduce their indices in this way," he notes. October saw 30 murders, barely a tenth of the number during the worst months of 2010. Murders across the state of Chihuahua halved over the same period. Mr Murguía says jobs are the key. "A young man recently said to me: 'Teto, young people would rather die on their feet in a year than spend 50 years on their knees.' That is pathetic. We have to offer young people a future."

Juárez is now held up as a model by the federal government. Alejandro Poiré, the interior minister, says that the city has "undoubtedly" got through the worst of it. Enforcement has helped. Last year federal police arrested José Antonio "El Diego" Acosta, the head of the "executions" department of the Juárez cartel. He has confessed to organising more than 1,500 murders, including those of three people linked to the American consulate who were shot dead in 2010 for reasons that remain murky. His fall has not yet sparked the kind of instability seen in Acapulco. "Weakening criminal structures begins with removing the contract-killing capacity that they have," says Óscar Naranjo, a former head of the Colombian police who recently moved to Mexico to advise Mr Peña.

Chihuahua is one of four states to have brought in oral trials, which are due to replace the old written justice system across the country by 2016. The new trials rely more on evidence than on confessions, which police sometimes used to obtain with the help of car batteries and wet towels. Now "a case is very weak if it relies only on witnesses," says Mr García, whose forensic scientists routinely give evidence. They are also speedier, taking an average of 160 days, down from 560 under the old system. This will help to free up space in prisons, where four out of ten inmates are awaiting trial. But the jails may soon fill up again: Chihuahua has stiffened its penalties. For example, it now punishes extortionists with life imprisonment.

Miracles and mirages

Cities such as Juárez show that Mexico's violence could subside as quickly as it erupted. The speed of improvement has made some people wonder if a deal has been struck within the criminal underworld. Stratfor, an American consultancy, says that Sinaloa has battered the Juárez cartel into submission and done something similar to the Tijuana cartel, a few hundred miles west in Baja California. There, murders are about a third down on 2010. "There was an informal agreement [among the cartels] to reduce violence, because it attracts the attention of the media, the military and the [US] Drug Enforcement Agency," says Víctor Clark Alfaro, who runs the Binational Centre for Human Rights, a Tijuana NGO.

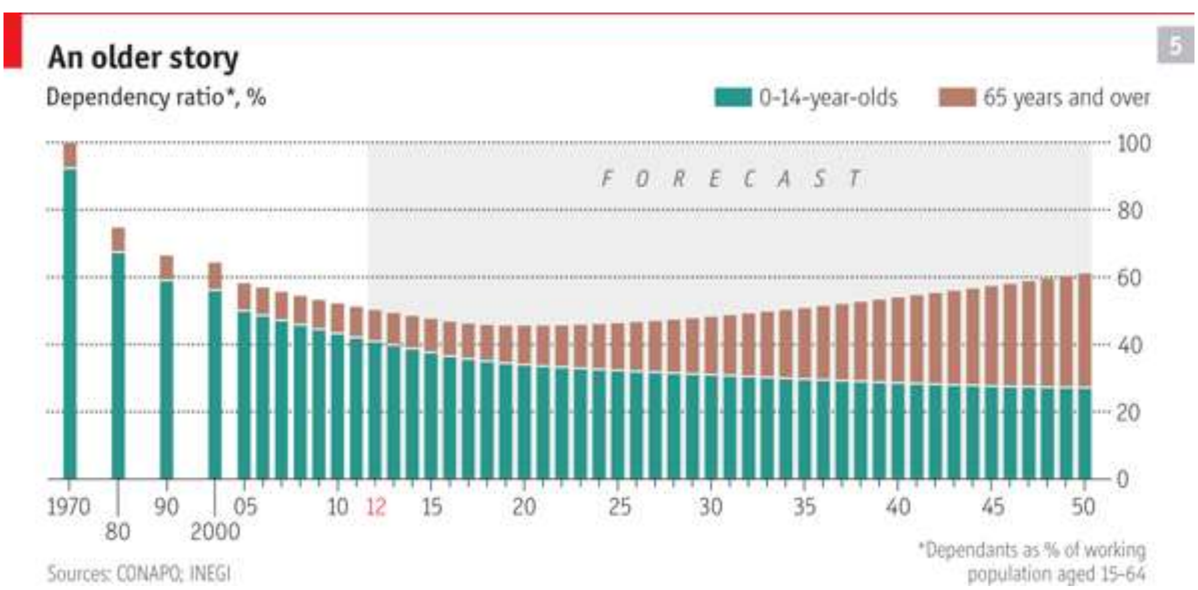
The government rejects talk of negotiation, but there are legitimate ways of pushing the villains into less destructive types of business. Mr Poiré acknowledges that the drop in violence "has a lot to do with business dynamics and competition between the cartels…To the extent that you cannot make the demand for drugs disappear, what you can do is significantly increase the costs of some of the crimes that hurt society the most." The priority is to reduce murder, extortion and kidnapping, he says. The next government is likely to take the same line. "Security policy can become an end in itself. The most important thing is the life of the citizens," says Mr Naranjo.

Mr Calderón is convinced that it is "impossible" to end drug trafficking. Instead, Mexico's target should be to end "the caprice and freedom of these criminals, strolling around the streets with their SUVs and weapons and no one saying a word to them," he says. Some parts of Mexico are getting closer to that. Juárez's kingpins now live in hiding rather than in narco-mansions. Carlos Bustamante, the mayor of Tijuana, says that thanks to government pressure criminals are "being more selective about whom they deal with," by which he means whom they murder. In Tijuana the dismemberments have stopped and convoys of black SUVs no longer rumble through town in broad daylight. This does not mean that crime has gone away. "We have a new generation of traffickers in Tijuana, with a very entrepreneurial vision of the business," says Mr Clark.

The next government must prevent those entrepreneurs from getting too big for their cowboy boots and corrupting the institutions of the state. At the same time it must try to avoid the all-out warfare that Mr Calderón's crackdown seems to have provoked. It is a delicate and dangerous balancing act. As long as America imports billions of dollars-worth of drugs that it simultaneously insists must remain illegal, Mexico's gigantic criminal economy is unlikely to disappear.

The gain before the pain: Mexico's demographic dividend will be short-lived

IN PINK COWBOY boots and a bright red Disney hat, Ángeles Zermeño is surely one of Mexico City's most stylish three-year-olds. Her parents, Ricardo and Blanca, are thinking of having another child, perhaps in a year or so. But they have already decided that two will be enough. "The small family lives better," says Mr Zermeño, a mechanic. The couple know this all too well: in rural Hidalgo they grew up with 29 aunts and uncles between them.



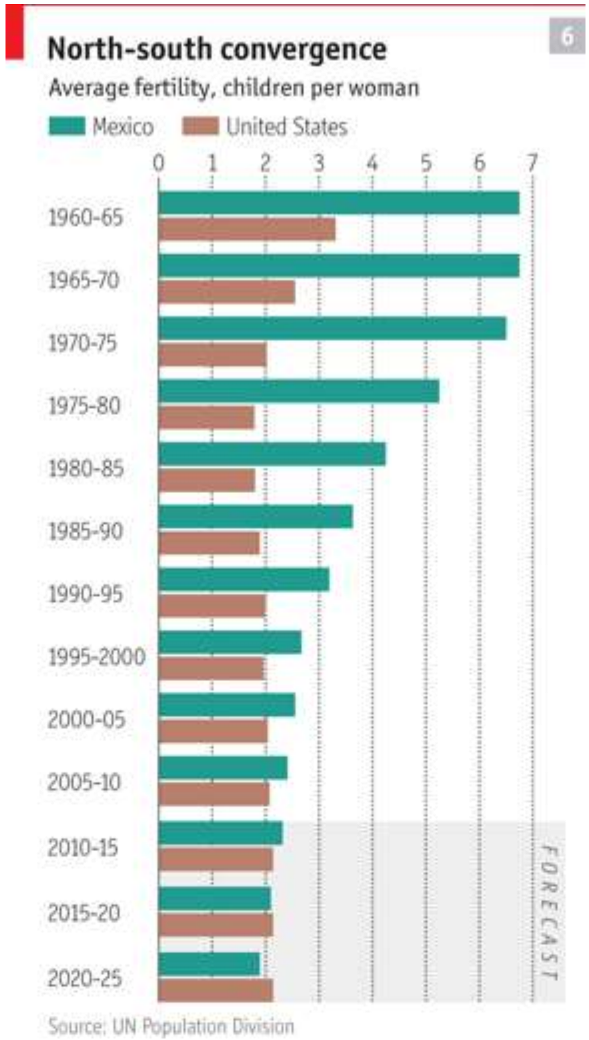
The changing shape of families such as the Zermeños has created a dramatic baby bust. Fifty years ago Mexico was one of the world's great producers of people. In the 1960s Mexican women had an average of seven children each; now they have only 2.4, and before 2020 the number is expected to drop below two (see chart 6). That would give Mexico a lower fertility rate than the United States, which is expected to maintain its current rate of about 2.1.

At the same time life expectancy has grown. In 1960 most Mexicans did not live beyond their 50s, and the average age was 17. Today the country has a wrinklier face. On average people live to 77, only a couple of years less than in the United States. Mexico's shift from a big baby-producer to a fast-ageing nation will provide an enormous demographic dividend. It also harbours an almighty time-bomb.

Lie back and think of Mexico

The explosive population growth during much of the 20th century was encouraged by the government. Mexico lost nearly half its territory to the United States in 1848. It put this down partly to a failure to populate lonely wastelands such as California. Cranking out babies thus became a form of national security policy. "The idea was that to govern was to populate," says Rodolfo Tuirán, a demographer who is now minister for higher education.

Everything changed in the 1970s. The nascent middle class noticed the opportunity cost of having large families, and as infant mortality dropped there was no longer a need to produce so many spares. The government made a U-turn: the right to a "free, responsible and informed" decision on how many children to have was enshrined in the constitution, and family-planning services were rolled out in spite of opposition from the Catholic church. Abortion remains illegal in most of the country, but contraception is widely accepted. Four out of ten married women are sterilised. On the desk of Salomón Chertorivski, the health secretary, is an enormous bowl of what look like business cards but turn out to be condoms, handed out to visitors with the compliments of the federal government.



The crash in the birth rate has brought a steady improvement in the dependency ratio. Forty years ago there was one dependent (usually a child) for every toiling worker. Now, and for the next 20 years, the ratio of workers to dependants will be more than two to one (see chart 5), easing the burden on the state in the same way that having fewer children has eased the burden on families. At the same time the large generation of workers getting ready to retire is expected to boost saving and investment.

Mexico’s dependency ratio will be further helped by the drastic cut in migration of young workers to the United States (see article). Moreover, the country is maintaining fairly strong population growth. By 2025 the number of inhabitants is projected to grow by about 15%; in Brazil it will expand by around 10%. The UN expects Mexico’s population in 2050 to be 65% of Brazil’s, up from 57% in 2000. That won’t make its citizens any richer, but it will make its economy bigger. However, the demographic fillip needs to be worked at. “It’s a bonus if they prepare for it. It’s a problem if they don’t,” says Wendy Cunningham of the World Bank’s human-development department. “They must invest in education and training to make this big group of people more productive. If the assumption is that just having more labour will do it, it won’t work.”

Don’t squander it
So far Mexico has been worryingly complacent. The Asian tigers made the most of their demographic dividend by creating some of the world’s best schools. Mexico’s, by contrast, are

pretty bad. In tests set by the OECD, nine out of ten South Korean teenagers meet basic requirements in maths but only half of Mexican ones do. Much poorer countries such as Azerbaijan and Thailand achieve better results on smaller budgets. Higher education also needs beefing up: only 22% of 25- to 34-year-olds in Mexico have a tertiary qualification, against 37% in Chile. “There is a risk that Mexico will squander its demographic bonus,” says Mr Tuirán. Financial crises in the 1980s meant that less was invested in education, he adds. As if to illustrate his point, students denied university places this summer staged a noisy demonstration outside his office on Mexico City’s Plaza de Santo Domingo.

Still, education spending has been growing and now amounts to 6.2% of GDP, the same as the OECD average. But the money is spent badly. In primary schools 83% of non-capital expenditure goes on teachers’ pay, a bigger proportion than in any other OECD country. Teachers’ salaries are set and paid by their union, which publishes no accounts. Some “teachers” are union officials who do no teaching. Others are imaginary. A rare audit in 2008 found that one, in Chihuahua, was being paid 700,000 pesos (then $66,000) a month. There is now some testing of teachers, but apparently no consequences for the many who fail those tests. Elba Esther Gordillo, the union’s leader since 1988, confirmed in a recent interview that teaching positions could be bought for 50,000-100,000 pesos, a practice she said she found outrageous.

For now, the increase in the number of pensioners is more than compensated for by the fall in the birth rate, so the number of dependants is still falling. But starting in about a decade the dependency ratio will get steadily worse. The state will have to support a larger population of pensioners, just as families will have to help out ageing parents and grandparents.

The welfare net will thus need a serious revamp. At the moment many Mexicans are not even covered by it. The 5m or so who work in the public sector get a health and pension package, and so do salaried workers who pay into the state welfare system. But probably no more than 15m of the 40m who work in the private sector have this insurance, estimates Santiago Levy, a former head of Mexico’s Social Security Institute who is now at the Inter-American Development Bank. The uncovered include the self-employed as well as those who duck under the taxman’s radar or work in the informal sector.

On average, low earners spend about half their careers in the formal sector and half outside it. People who alternated between working in a textile factory and selling clothes door-to-door, for instance, would pay into the system only half the time. They would thus have to toil for 50 years to build up the 25 years of contributions required to get a basic pension. Because low earners are the most likely to work in the informal sector, “those who need pensions the most will get the least,” says Mr Levy.

A parallel system has slowly been growing to help the uninsured. The biggest example is in the health service (see box). Similar programmes to support informal workers have been set up in housing and child care. A universal pension, begun in left-leaning Mexico City, has been adopted by about half the states. A federal pension programme called “70 and up” has been expanded from small communities to bigger ones.

Millions have benefited, but there is a snag. If social services are available to all comers, there is little reason to work in the formal sector and pay taxes. Partly for that reason, informal employment has been growing faster than the formal sort. Some companies offer employees a choice: work formally for a given wage or informally for a slightly higher one. With health care and pensions available either way, workers are quite sensibly taking the informal route, but this will cause a further drop in fiscal revenues.

One solution would be to eliminate the difference between formal and informal employment by financing health care and social security through consumption rather than payroll taxes. Not everybody is a salaried employee, but everybody is a consumer, reasons Mr Levy, an advocate of this plan. “Instead of collecting taxes at the door of the factory, you would collect them at the door of the store,” he says. Consumption taxes are easier to enforce than payroll taxes. But they are also regressive, and would require subsidies to ensure that Mexico’s yawning inequalities do not widen further.

Mr Peña has trailed fiscal reform as one of his big legislative projects, not least to increase revenues sufficiently to allow Pemex, the state oil monopoly (which provides about a third of the government’s income), to invest more in exploration and technology. He has also promised a new “universal social-security system” to provide health and unemployment insurance and pensions, financed by general taxation. Congress already has a lot on its plate, but it would do better to overhaul the system now than wait until the demographic time bomb goes off.

Stretching the safety net: Falling ill is no longer an economic disaster

IN SOME RICH countries it remains a distant hope, but in Mexico free universal health care became more or less a reality this year. Having insurance used to be contingent on having a salaried job, which left about half of Mexico’s population with only the most basic care. But since 2004 a programme called Seguro Popular (Popular Insurance) has been gradually rolled out all over the country to provide better services to those without employment-linked insurance. The overwhelming majority of Mexicans are now covered—“a remarkable feat”, according to the *Lancet*, a British medical journal.

To cover the uninsured, the government has increased its spending on health from 5% of GDP at the turn of the century to nearly 6.5%, which is still lower than in most of the rich world. More than 200 new hospitals and 2,000 clinics have been built and thousands more renovated. The ratio of doctors to patients is up by more than half.

Mexicans’ health has perked up dramatically in some areas. Since 2008, when Seguro Popular began providing a vaccine against rotavirus, a common cause of diarrhoea, deaths from the illness have fallen by 60%. When the programme started to pay for treatment of acute leukaemia in children, the survival rate improved from three in ten to seven in ten. Nearly a third of women with breast cancer used to abandon treatment because they could not afford it. Since 2008, when treatment became free, the drop-out rate has come down almost to zero.

Insurance has saved many people from another affliction: poverty. When the poorer half of the population had to pay for medicines or procedures not covered by state hospitals, millions of families were bankrupted by illness. Julio Frenk, a former health secretary who oversaw the beginning of Seguro Popular and is now dean of Harvard’s School of Public Health, recalls meeting a family in which the mother had needed a Caesarean section and the baby had spent a couple of weeks in intensive care. The child survived, but the medical bill cost his father his animals and tools and meant that his brother had to be taken out of school. “People liquidated their productive assets and their poverty was transmitted to the next generation,” says Mr Frenk. Until the late 1990s nearly 7% of families were dragged below the poverty line each year by medical emergencies. By 2010 the figure had fallen to less than 3%.

Seguro Popular is still a work in progress. Quality is patchy and people in remote regions have to trek a long way to see a doctor. Mr Frenk estimates that about 5% of the population are still not covered. Some conditions are not yet being paid for. There is a shortage of specialist doctors, and some rural clinics are manned by students.

There are also big regional disparities. Nine out of ten pesos going on Seguro Popular are spent by state governments, and the results are mixed. “We need to work on accountability,” acknowledges Salomón Chertorivski, the health secretary. When some states inexplicably paid far more than the market value for certain drugs, the federal government set maximum prices for medicines. There have been reports of bent doctors tricking people into paying for their supposedly free care. The government has introduced a system of certification for clinics. But in rural areas it is still hit-and-miss—one reason why Mexico’s infant-mortality rate remains stubbornly high.

Success in treating communicable diseases has brought new problems. The biggest killer now is diabetes, brought on by sugary diets and sedentary lifestyles. Mexicans are among the world’s fattest people: 70% are overweight, more than in the United States. A third of women are obese, double the OECD average. On a per-head basis, Mexico has the world’s highest consumption of Coca-Cola. In rural areas seven out of ten children have a fizzy drink with their breakfast, according to Consumer Power, a civil organisation. Public sports facilities are scarce, which may help to explain why Mexico came only 39th in this year’s Olympics, level with Georgia, which has only a small fraction of its population. Health care may be expanding rapidly, but so are waistlines.

Mexico’s states: The 31 banana republics

Unreformed government could hinder Mexico’s march forward

SUNBATHERS LOUNGING BY a lagoon near Acapulco last spring rubbed their eyes in disbelief. Skimming daringly close to the water, an AgustaWestland helicopter roared over the lagoon at 150mph with a whooping, wetsuited figure clinging on to a trailing tow-rope. The helicopter had been bought by the state health department to ferry doctors to indigenous communities in the mountains of Guerrero, where the maternal-mortality rate is among Mexico’s highest. But on several days last year the aircraft was borrowed by the president of the Acapulco city environment commission to practise for, and eventually break, a world speed record in barefoot helicopter waterskiing.

Mexico suffered from deeply corrupt and often incompetent government for much of the 20th century because voters had very little say about who ran the show. Only in the 1990s was real political competition allowed to blossom, and not until 2000 did an opposition party win the presidency. Government has got better since then. But many Mexicans ask why, after more than a dozen years of fairly clean elections, some corners of their country are still as badly governed as the worst Latin American banana republics.

In theory, democracy forces politicians to act in the interests of the voters: if they don't, they get kicked out of office. But Mexico denies its citizens this right. The first part of the democratic process, electing politicians, it does pretty well. The Organisation of American States, a regional body, says that no Latin American country has stronger electoral institutions. But the second half—deciding whether politicians get to stay or have to go—is barred by Mexico's constitution. Almost alone in the world, the country has a total ban on consecutive re-election that applies to anyone from the president to local mayors.

Perverse incentives

The idea is to discourage dictatorial ambitions. But it means that once elected, Mexican politicians have little reason to maintain the support of the public. It makes more sense to please party bosses, who nominate candidates for their next position, or other interests such as unions, business or the media, which provide campaign funds or support. Acapulco's waterskiing champion was so unconcerned about the voters' reaction that he uploaded a video of his slippery exploits to YouTube, where it attracted dozens of scathing comments. It didn't matter: no charges were brought, and his party later nominated him as a candidate for federal deputy, a more senior post (he lost).

The ban on re-election is a problem at all levels of government, but the worst cases of corruption tend to emerge at the level of the states, which account for a large and growing proportion of government spending. Between 1989 and 2007 their share of the total national budget increased from about a fifth to nearly half, according to IMCO, a Mexico City think-tank. It wasn't because they got better at raising revenues—in fact, during the same period they slipped from generating about a third of their income to just a tenth, with most of the rest coming from the federal government.

In spending this handout, governors are accountable only to their own state congresses. Since the congresses' single-term members exist to serve the interests of their parties, not of voters, their scrutiny of the governor—usually their party boss—is not exactly forensic. And failure is rewarded with federal help. "If you have a very serious problem in your state, the federal government is going to come and help you, and massively so," says Mr Calderón. "One of my conclusions as president is that our federal system does not have the incentives correctly aligned." The result is not federalism but "feuderalism", a term coined in a recent essay by Héctor Aguilar Camín, a historian, and Jorge Castañeda, a former foreign secretary.

This could yet undermine Mexico's budding success. Business is expanding, but is being held back by local red tape and corruption. Progress in health care and education is marred by vast regional inequalities. The fight against crime is hampered by bent police and mayors. Following a mass jailbreak in Coahuila in September Mr Calderón sent a telling tweet: "In the past six years more than 1,000 inmates have escaped from state prisons. From federal prisons, not a single one."

One answer is to beef up the federal government's role. Mr Calderón hopes to have 50,000 inmates in federal prisons by December, up from fewer than 5,000 at the beginning of his term in 2006. Some federal security funding is now contingent on states vetting their staff for corruption. State health clinics are certified by federal assessors. Schools' exam results are published online so that parents in Chiapas can ask teachers why children are so far behind those in Nuevo Leon.

A better answer is to force states to do their jobs. In October Congress passed a law to make state and local governments publish their financial records and to toughen penalties for account-fiddling. The next step should be to grant Mexicans the missing part of their democracy by allowing them to choose whether politicians stay or go. Mr Calderón introduced a bill to allow re-election (except for the president), but it was blocked in Congress. Mr Peña opposes it. Some in his party reason that governors and mayors, the majority of whom belong to the PRI, will be more co-operative with the new president than they were with Mr Calderón, and that PRI congressmen will obey presidential orders. Mr Peña's aides hint that the PRI's historic ties to interest groups such as unions and the media make it the best party to keep them in line.

It is here that the new president is least convincing. Using the old corporatist network to force change is unlikely to work as long as politicians have so little incentive to respond to voters' concerns. PRI congressmen have already proved reluctant to vote for curbs on union power in an impending labour reform. Mr Peña may yet show that he can bring Mexico's mighty interests to heel. But without political reform there is a risk that he could be the one who ends up taking orders.

To take advantage of the economic opportunities ahead, Mexico will need effective government across the board. That will come only with deeper democracy. "For most of the country's life it has been a federal republic that in reality is a centralist monarchy," says Enrique Krauze, the historian. Mr Peña must decide whether he wants to be the frustrated king of an old, unreformed country or the president who set its vast potential free.