***The Economist Special report on Mexico   
“Time to wake up”  
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**Introduction: Time to wake up**

**Mexico's new president, Felipe Calderón (right), must resume reforms and set the economy free—or risk backsliding, says Michael Reid**

“WAKE up, wake up, my dear, the dawn has broken, the birds are singing and the moon has set.” Thus go the lyrics of Las Mañanitas, the Mexican equivalent of Happy Birthday, belted out every day in restaurants and homes across the country, often by troupes of *mariachi* musicians in full regalia. The verse seemed particularly appropriate as Mexico celebrated its 196th birthday on September 15th—the anniversary of the day when Miguel Hidalgo, a parish priest, called for independence from Spanish colonial rule. Mexico gives every impression of sleeping while the world changes around it. Having seemed to embrace globalisation—favoured by its geography, on the doorstep of the world's largest consumer market—the country risks slipping back into internecine conflict and introversion.

Six years ago the election as president of Vicente Fox (pictured left) completed a long transition to democracy, ending 72 years of authoritarian rule under the Institutional Revolutionary Party (PRI). It also seemed to set the seal on the economic modernisation of the world's largest Spanish-speaking country, with a population of 106m. After Mexico went bankrupt in the debt crisis of 1982, the last three PRI presidents cast aside protectionism and state capitalism, most notably Carlos Salinas (in office 1988-94), who led his country into the North American Free-Trade Agreement (NAFTA) with the United States and Canada. Mr Fox, a former head of Coca-Cola's Mexican operations, pledged further economic liberalisation and reform.

Mr Fox's government can look back on a number of achievements for which his many domestic critics give him insufficient credit. In recent years the country has enjoyed greater political freedom than perhaps at any other time in its history. The government has maintained economic and financial stability, with inflation for this year estimated at 3.7%. Easier bank credit, together with a vast housebuilding programme promoted by the government, is slowly bringing tangible benefits to an expanding middle class. Social policies have helped to cut poverty.

**Asleep in a hammock of oil**

Even so, many of the hopes raised by Mr Fox were dashed. He lacked a majority in Congress and proved unable to win approval for any big reforms. Instead of the annual growth of 7% he had promised, the economy has limped along at an average of just 2.5% since 2000. The government's finances look better than they are, helped by extra oil revenues equal to 2% of GDP. “Fox has fallen asleep in a hammock of oil money,” says Liébano Sáenz, who was chief of staff to Ernesto Zedillo, the last of the PRI presidents (1994-2000).

Labour productivity is low and growing only slowly. Oil apart, Mexico's exports to the United States are losing market share to China's. Some of the social policies have reduced the incentive for millions of small businesses to put themselves on a proper legal footing. That is only one symptom of a wider absence of the rule of law. Another is mounting violence from drug gangs.

The president they did not get

As Mr Fox's term draws to its close, Mexico is starting to look like two different countries. Thanks in large part to NAFTA, much of the north is making visible progress. By contrast, the populous south remains locked in poverty, backwardness and neglect. Meanwhile, each year some 500,000 or so young Mexicans cross the country's northern border to the United States in search of a better life.

On top of all this, Mexico's politics have suddenly become much more complicated and confrontational. The campaign ahead of the presidential election on July 2nd was dominated by Andrés Manuel López Obrador. As mayor of Mexico City, he had made himself popular by providing pensions for the elderly and public works. Standing for a centre-left coalition, he took his fiery oratory to the public plaza in a country where politics has long been dominated by backroom deals. But he was pipped at the post by Felipe Calderón, the candidate of Mr Fox's conservative National Action Party (PAN). Mr Calderón won 35.9% of the vote against Mr López Obrador's 35.3%, a margin of just 233,831 votes out of almost 42m. The PRI's Roberto Madrazo polled a meagre 22.2%.

To many Mexicans, the election appeared to highlight their country's divisions and to call its growing globalisation into question. Mr López Obrador spent his formative years in the PRI. He left it in the late 1980s when the economic nationalists in the party lost out to the free-market technocrats. Though many of his economic policies were mild enough, he inveighed strongly against poverty and privilege. To his detractors, he seemed to stand for a return to the authoritarian populism practised by the PRI in the 1970s. Nothing in his life suggested any interest in or knowledge of the world beyond Mexico.

Apart from one brief wobble, in the run-up to the election Mr López Obrador was always ahead in the opinion polls. But he made mistakes, insulting Mr Fox and staying away from the first of two campaign debates. Some of the economic policies he proclaimed stirred fears of a return to financial instability. He was also the target of a smear campaign. Mr Calderón dubbed him “a danger to Mexico”, comparing him to Venezuela's populist president, Hugo Chávez. Mr Fox, along with Mexico's richest businessmen, weighed in on Mr Calderón's behalf.

So when the vote unexpectedly went against him, Mr López Obrador and his backers felt robbed. They cried fraud, though they never produced any convincing evidence, and called for “civil resistance” against the electoral authorities. For seven weeks the beaten candidate's supporters camped out in the centre of Mexico City, occupying the Zócalo, the great square that has been the heart of the city since Aztec times, and blocking Reforma, its grandest avenue. “To hell with your institutions,” declared Mr López Obrador.

Even the independence celebration on September 15th was overshadowed by the post-election conflict. Mr Fox chose to mark the occasion in his (and Hidalgo's) home state, leaving the traditional venue, the Zócalo, to Mr López Obrador's people for the evening. After a final rally of his supporters at which he vowed to proclaim himself the “legitimate president”, Mr López Obrador suspended his protests. But he said he would not recognise Mr Calderón when the new president formally takes over on December 1st.

**Crying foul**

In “The Labyrinth of Solitude”, his classic study of the Mexican character, Octavio Paz noted that his countrymen habitually mask painful realities, hiding more than they reveal. Mr López Obrador's claim to be leading a mass social movement for democracy against a “usurper”, Mr Calderón, fits in with that tradition. Mr López Obrador recalled a long history of electoral fraud under the PRI. He drew a particular parallel with 1988, when Mr Salinas was declared president after the computers counting the votes had “crashed” while showing an early lead for his leftist challenger, Cuauhtémoc Cárdenas.

The parallel was askew. In 1988 the electoral authority was the Minister of the Interior. But a decade ago, with the agreement of all the parties, Mexico set up independent electoral institutions. According to those independent bodies, two counts of the ballots (and a partial recount of 9% of them) all showed the same narrow lead for Mr Calderón. The election produced the best-ever haul of congressmen for Mr López Obrador's centre-left Party of the Democratic Revolution (PRD). The electoral tribunal did find that the interventions of Mr Fox and the business groups were technical violations of the electoral law, but no other democracy would worry about such things.

Most of the people camped on Reforma, far from constituting an independent social movement, were cogs in the political machine built by the former mayor. The protest had the backing of the Mexico City government. “It's not the people v the powers that be. It is the powers that be,” quipped Jorge Castañeda, a political scientist who was the first foreign minister in Mr Fox's government.

The biggest irony of all is that as former members of the PRI, several of Mr López Obrador's closest collaborators were complicit in the fraudulent campaigns of the past. The protests were “the rebellion the PRI didn't do in 2000” when it lost power to Mr Fox, says Héctor Aguilar Camín, a historian. “Alternation in power had happened very cheaply for us. It's the first protest against this young democracy, done by the ex-Priistas of the PRD.”

Mr López Obrador's attempt to emulate Evo Morales, the Bolivian president who toppled two predecessors by organising street demonstrations, seems to have backfired. Polls show that if the election were held today, Mr Calderón would win by a comfortable margin. On October 15th the PRD lost a gubernatorial election in Mr López Obrador's home state of Tabasco even though he went to campaign for his party.

All that said, Mr López Obrador's campaign laid bare many Mexicans' deep sense of dissatisfaction with the status quo. And Mr Calderón, having won the narrowest of victories, has had to rearrange his priorities. He now lists these as job creation, the fight against poverty and public security; at the start of the campaign they came in the reverse order. “Pragmatically, I'm interested in winning over a part of the electorate that wasn't with me and whose concerns were much more centred on poverty,” he said in an interview for this survey.

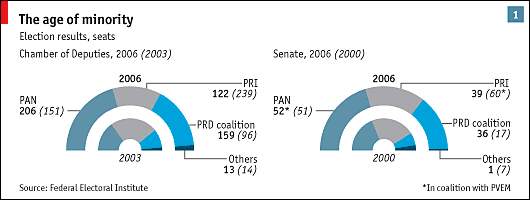
The first question raised by the election and its messy aftermath is whether Mr Calderón can govern Mexico. The second is whether he can restore it to a path of democratic progress and rapid economic growth. This survey will argue that, contrary to appearances, he has an extraordinary opportunity to do both—but only by being far bolder than his predecessor in tackling the many vestiges of the old order that are still holding the country back. Many of these involve monopoly power, public and private, political and economic. They cover a broad range: from the teachers' union to Pemex, the state oil monopoly, and Telmex, a private telecoms near-monopoly. It is these bastions of unaccountable power, rather than Mr López Obrador's antics, that are the real threat to Mr Calderón's government and to Mexico as a whole.

**Pregnant pause: The old political model has died; a new one has yet to be born**

DEMOCRACY did not come easily to Mexico. Whereas most South American countries nurtured a democratic tradition through their swings between dictatorship and civilian rule, Mexico over the past two centuries has seen long periods of authoritarian government punctuated by three civil wars. The one brief interlude of liberal government came in the mid-19th century, under Benito Juárez, a Zapotec Indian and elected president—a period known as *la reforma* and commemorated in the avenue of that name. The last and bloodiest of the civil wars was the Mexican revolution of 1910-17 (some historians argue that it did not end until 1940). It began as a crusade for liberal democracy, under the cry of “Effective Suffrage, No to Re-election”, but ended up with the corporate state run by the PRI.

The blocking of Reforma for seven long weeks was an apt metaphor for Mexico's condition over the past decade. Transforming an inward-looking corporate state into a liberal democracy with an outward-looking market economy was never going to be straightforward. Besides, Mr Salinas's bold economic reforms in the early 1990s were meant to give new life to the PRI system rather than end it—and some were less liberal than they looked. Just as NAFTA came into effect in 1994, the semblance of political order was shattered first by the short-lived uprising by the Zapatista rebels, led by Subcomandante Marcos, a ski-masked Marxist philosopher; and then by the (still unresolved) murder of Mr Salinas's hand-picked successor, Luis Donaldo Colosio. Shortly afterwards, just as Mr Zedillo took over from Mr Salinas, the peso collapsed and the banking system with it.

The subsequent deep recession undermined public support for market reforms, which had included privatisations as well as NAFTA membership. As a result, the PRI lost its majority in Congress in 1997. Mexican politics has seemed close to gridlock ever since. Where there was one dominant party there are now three, none of which can command a majority (see chart 1). The deeper reason for Mexico's political paralysis is that is has yet to replace many of the institutions of one-party rule.



One reason why the PRI regime was so durable was that it used coercion only as a last resort. Wherever possible it preferred to buy loyalty, be it of professors or peasants, with state largesse or the selective application of laws. Contrary to the revolution's rallying cry, suffrage was not effective and fraud was common. But by honouring the principle of no re-election the PRI ensured regular changes of leadership, and with it the flexibility to move left or right. On paper under the 1917 constitution the presidency was rather weak. In practice it was omnipotent.

But Mr Fox, the first non-PRI president for more than seven decades, had only his paper powers to rely on. He seemed an ideal candidate: thick-skinned, determined, bluffly charming and a natural media performer. But he has been a disappointing president. He “never understood the nature of presidential authority...he confused leadership with popularity as if he were a film actor, and he didn't know how to negotiate politically,” says Enrique Krauze, a historian.

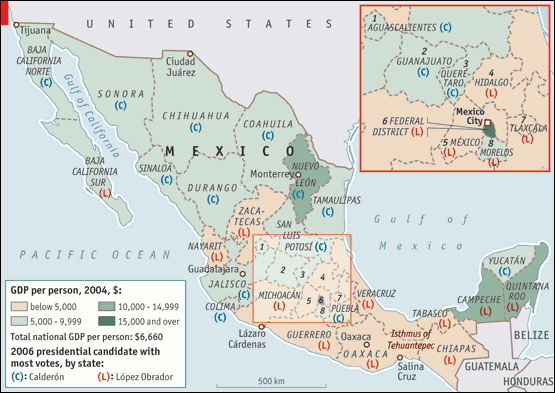
Certainly he was naive in allowing Marta Sahagún, his ambitious former press secretary and second wife, to give the appearance of sharing presidential power. And his approach to reform was far too laid-back: ignoring his party's congressional caucus, led for a time by Mr Calderón, he seemed to think his job was done merely by sending a bill to the legislature. Wags say he has a “Montessori cabinet” because each minister does his own thing.

He also shrank from applying the law where protests went beyond it. Early in his presidency his authority was terminally undermined when he permitted a few thousand machete-wielding far-left demonstrators to kill off a plan for a new airport for Mexico City. Mr Fox himself counters this last criticism by saying that it comes “from those who yearn for the old authoritarian presidentialism”. Maybe so. Yet whether in land-use planning or the policing of protests, Mexico finds itself in limbo. The old ways of presidential diktat no longer work, but new ways based on consultation, consensus and the exercise of democratic authority have yet to be created. Into this vacuum Mr López Obrador defiantly stepped in the weeks after July 2nd.

**Governing from the centre**

To all appearances, Mr Calderón faces a much more difficult task than his predecessor. His mandate is narrower, and his legitimacy is questioned by a substantial minority of Mexicans. Where Mr Fox could count on a “democracy dividend”, Mr Calderón is faced with demands that democracy deliver swift and tangible improvements, according to Miguel Székely, who has advised both men on social policy.

But Mr Calderón also has several advantages. Unlike Mr Fox, who came to politics late in life, he is a professional politician and a party man. He was born into the National Action Party, of which his father was a local official. He is a lawyer with technocratic know-how, having studied economics and, at Harvard, public administration. Aged only 44, he has had little administrative experience—he was Mr Fox's energy minister for just nine months before resigning to stand against the president's nominee to be his party's presidential candidate. But he has plenty of experience of Congress, which may count for more. A liberal on economics and a moderate conservative on social matters, he is a pragmatist and a skilled negotiator. “I must be a president who seeks the political centre,” he said in victory.



To secure a congressional majority, to which he is closer than Mr Fox, he has offered to lead a coalition government. But Mexico has no experience of formal coalitions. What Mr Calderón is working on, he says, is a “common agenda” with other parties. He is also likely to offer several ministries to people with ties to the PRI.

Much will depend on the PRI's attitude. Though Mr Madrazo, its presidential candidate, suffered a humiliating defeat, the party still governs 17 states (against nine held by the PAN and six by the PRD). These days most of its members are closer in their instincts to Mr López Obrador than to Mr Calderón. But the PRI is evolving into an alliance of powerful regional barons. Several important figures in the party stress that Mexico needs reforms. “There are very professional politicians in the PRI who understand that the country needs changes,” says Luis Téllez, who was energy minister under Mr Zedillo and is tipped for a job in Mr Calderón's cabinet.

Several pending structural reforms—for example in energy supply, trade unions, the labour market and the police—will require constitutional changes that call for a two-thirds majority (as well as the backing of a majority of state legislatures). This will be hard to muster without the support of at least part of the PRD. That is not out of the question. Even as Mr López Obrador was denouncing the country's institutions, many PRD leaders were quietly operating within them, in Congress and in the party's state governments. Several of those leaders, including Mr Cárdenas, have more or less openly distanced themselves from Mr López Obrador. Jésus Ortega, a senior figure in the PRD, talks of using Congress to introduce political reforms, a “change of economic model” to one of “stability with growth”, a tax reform and measures against corruption.

None of this is unbridgeably distant from the proposals put forward by Mr Calderón himself. Unlike Mr Fox, he speaks of the central place of Congress in making policy. That is to recognise reality. Jeffrey Weldon, a political scientist at ITAM, a Mexico City university, points out that more than 70% of the 824 measures approved in the legislature in the past three years were proposed by the legislators rather than by the government, against fewer than one-third under Mr Salinas.

Power has rapidly seeped away from the presidency—to governors, mayors, party leaders and the media as well as Congress. That may be a good thing, but there are no rules to encourage collaboration between these different actors. Many political scientists think that this new pluralism would be better served by a parliamentary system than a presidential one. But Mexico has been accustomed to a powerful figure at the top since Aztec days.

**More accountability**

A better option might be to help the president mobilise majorities and give him some tools to negotiate with Congress. For example, Congress could be required to deal with a bill proposed by the government within a given time limit. When no candidate in a presidential election wins outright, the introduction of a run-off ballot would strengthen the victor's mandate. That could be balanced by a shorter term of office. For its part, Congress would become more accountable if legislators were able to stand for immediate re-election. There is support in all three parties for a change that would allow senators two consecutive terms (12 years in all) and deputies three (nine years).

More needs to be done to bring accountability and openness to politics at all levels. Mr Fox, impelled by a media campaign, pushed through a freedom-of-information law. “It's very imperfect, but even so it's a leap forward of 50 years,” says Alejandro Junco, a newspaper publisher who led the campaign. Congress, however, remains a closed book: votes are secret, assets do not have to be declared and there are no rules for resolving conflicts of interest. “I can know what the president's towels cost but not what my congressman does,” Mr Sáenz says.

The same goes for many state governments. Some are models of reform, others are throwbacks to the old regime. Take Oaxaca, in the south, where the PRI has never lost power. In 2004 Ulises Ruiz, the PRI candidate, only narrowly won an election for state governor. His opponent's claim of fraud was better-founded than Mr López Obrador's, because in Oaxaca the PRI controls the local electoral authority. His opponents accuse Mr Ruiz of funnelling state money to his party's presidential campaign. In May, teachers in the state began an indefinite strike. This quickly turned into a quasi-insurrection in the state's capital, aimed at ousting Mr Ruiz. The city's tourist industry has collapsed. In late October, after a total of 17 people had been killed, Mr Fox sent the federal police to retake the city centre from the protestors.

This stand-off is a special case, but in many ways Oaxaca exemplifies the problems of southern Mexico, which voted heavily for Mr López Obrador.

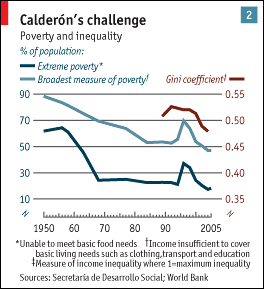
### Mexico's mezzogiorno: What is needed to bridge the gaping north-south divide

SANTIAGO TLAZOYALTEPEC is less than two hours' drive from the city of Oaxaca, up a precipitous dirt road flanked by cool forests of pine and evergreen oak. It is one of the 570 separate municipalities contained within the state of Oaxaca, a corrugated land of forested mountains and brown rivers. Like many of the settlements established by the Mixtec (meaning “people of the clouds”), Tlazoyaltepec straggles along the tops of sinuous mountain ridges: a clutch of separate ribbon villages with a total population of some 10,000 people. The world owes the domestication of the turkey to the Mixtecs. But today they scratch a living from small milpas (maize fields). Ask how things are going, and the answer is a repetitive lament: No hay trabajo (there's no work).

Even so, people are living a little better nowadays, concedes Panfilo Santiago, the municipal councillor in charge of education, his Spanish delivered in a thick Mixtec accent. The first reason is that many of them have gone north, to the United States or to work in the tomato fields of Baja California. They either return richer or send back money. The Inter-American Development Bank estimates that remittances from Mexicans abroad will total $24 billion this year, about a third more than the flow of foreign direct investment. The relative prosperity of such families is displayed in the status symbols of the Mixtec highlands: a big Ford or Chevrolet pick-up parked outside the door and, increasingly, a two-storey concrete house in place of a wooden shack.

The second reason why people are better off is a means-tested anti-poverty programme, pioneered by Mr Zedillo's government and expanded and renamed Oportunidades by Mr Fox. It pays mothers a monthly allowance provided they keep their children in school and take them for regular health checks. In Tlazoyaltepec, around 70% of families receive help from Oportunidades, says Mr Santiago.

Across Mexico Oportunidades helps some 5m families (or around a quarter of the total) at a cost of $2 billion a year. While alleviating poverty, the programme's main aim is to prevent it in the next generation. The idea is to expedite Mexico's transition to a labour force that has finished secondary school, says Santiago Levy, who as a finance official in Mr Zedillo's government invented the programme.

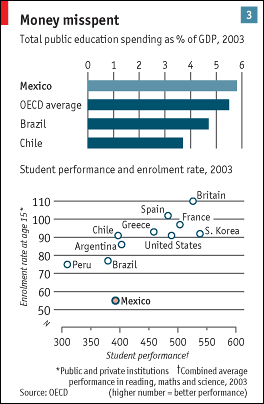


Thanks to remittances and Oportunidades, extreme poverty has declined under Mr Fox, despite mediocre economic growth (see chart 2). But as in many other Latin American countries, income distribution in Mexico has long been extremely unequal. “Perhaps nowhere is inequality more shocking,” noted Alexander von Humboldt, an aristocratic German scientist and traveller, in his essay on colonial Mexico published back in 1811. Despite the protestations of many critics of the economic reforms, income inequality now is no greater than it was 20 years ago, but regional differences are becoming increasingly marked. “There is one Mexico more like North America and another Mexico more like Central America,” is how Mr Calderón puts it. “It is a very clear challenge for me to make them more alike.”

Official figures show that one Mexican in two still lives in some degree of poverty; in much of the south that figure rises to three in four. For most of the past century southern Mexico has been worse off than the north, but NAFTA is helping to widen the gap. Average growth since 1995 in many northern states has been running at 4-5%; in most of the south and centre it has been more like 1-2%.

## Southern cross

The nine states of the south and south-east account for almost a quarter of Mexico's total area and population. They are more rural, more Indian and poorer than the rest of the country. Almost 45% of their population live in settlements of under 2,500 people, compared with 20% elsewhere. Twice as many people lack electricity and piped water, and half as many can read and write. Much of the south is afflicted by poor schooling, poor communications, lack of investment and, often, reactionary political leadership.



Successive governments have made a big effort to get children into education. Since 1960 the number of years the average Mexican child spends at school has gone up from 2.6 to nearly eight. But that still means some 35m adults have failed to complete the nine years of basic primary and lower secondary schooling. They find it hard to get decent jobs. Enrolment at upper-secondary level is lower than in many other Latin American countries (see chart 3). Moreover, the quality of schooling is poor and the education system fails to offer equality of opportunity.

Mr Zedillo's government bravely decided that Mexican children should sit international tests. Mexico came bottom of all the countries of the Organisation of Economic Co-operation and Development (OECD), the rich-country club it ambitiously joined when Mr Salinas was riding high, and did no better than Brazil and other Latin American countries, even though it spends proportionately a lot more on education.

## Reclaiming the classroom

In the past much education spending was lavished on public universities because the PRI saw students and academics as an important constituency. Recent governments have spent more on schools, but nearly all of the money has gone on teachers' salaries. That is a tribute to the stranglehold the Educational Workers' Union, Latin America's largest trade union, has on Mexican education. In effect, it is the provider; the federal government merely hands out the money. Its 1.4m members include not just classroom teachers but head teachers and school inspectors too.

In practice it is the union, not head teachers, parents or state governments, that decides on the hiring and (very rarely) firing or redeployment of teachers. It resists outside evaluation of teachers, many of whom are untrained. Enrique Rueda, the leader of the Oaxaca teachers, concedes that the union has been better at pursuing salary demands than at improving schooling. “Control of bad teachers is very limited,” he says.

As education minister in Mr Salinas's government, Mr Zedillo devolved formal responsibility for schooling to the states and modernised teacher-training and textbooks. But in practice the system remains centralised: the union negotiates salaries with the federal government each year, and then its regional branches try to extract a bit extra from the states. Few decisions are taken at school level.

John Scott of CIDE, a Mexico City university, points out that only 1% of students in higher education are from the poorest 20% of the population. As things stand, echoes Miguel Limón, who was Mr Zedillo's education minister, education reproduces regional inequalities. Although coverage in the south is catching up, quality lags, partly because richer northern states top up federal funds.

Across the south other factors conspire against good schooling. Poverty is itself one reason why children drop out of school early, as the Oportunidades programme recognises. The region is home to many Mexicans of indigenous descent. At primary level 1.2m pupils receive bilingual teaching in 54 different tongues, but there are few competent bilingual teachers. And where the population is thinly scattered, as in the Mixteca, primary-school classes take in children of widely differing ages.

In Tlazoyaltepec the Velascos, a peasant family, provide an illustration of educational progress—and of the obstacles that still remain. María Elena Velasco's father had only two years of schooling and her mother none. She and her brother dropped out of secondary school after a year. She is determined that her children will do better. “I'll have to take them to the valley. Who knows how I'll do it, but I have to.” Mr Santiago, the education councillor, says the town council has asked the state government for an upper secondary school “so that the young people don't have to migrate to the United States.”

Technology may be the only way to improve rural schooling. Mr Fox speaks proudly of having put a computer into every school, opening it up to Enciclomedia, a pioneering programme of digital textbooks. The Tecnológico, a not-for-profit university based in Monterrey, is working with the government on a scheme to deliver upper-secondary schooling via the internet in 1,000 communities in the south. But in Tlazoyaltepec, as in many rural towns in the south, there is no internet connection. Rafael Rangel, the Tecnológico's rector, says the scheme's success depends on government investment in a wireless internet network.

## Lessons for teachers

That leaves the question of what to do about the teachers. At present 95% of education spending goes to the producers and only 5% to the consumers in the form of scholarships. A really bold president might try to break the union's grip on the classroom by giving the money to parents in the form of vouchers. But Elba Esther Gordillo, the union's general secretary, has transferred her political support from the PRI to Mr Calderón, for whom she was an important electoral ally.

Mr Calderón insists that the only way to change education is with the union rather than against it. “The key is to introduce the right incentives,” he says. He has proposed to the union that instead of “paying more to those who press hardest, as in Oaxaca...let us pay more to those who teach better, who raise the level of their class, who prepare more and who meet required standards.” If he can get this idea past Ms Gordillo, it would be a big step forward.

**Plodding on: Economic stability is all very well, but where's the growth?**

MR FOX had barely installed himself in Los Pinos, Mexico City's modernist presidential complex, in December 2000 when his country was dealt two blows that stopped economic growth in its tracks. The dotcom bubble burst, triggering a slowdown in industrial production on both sides of the border. And China joined the World Trade Organisation, marking the arrival of a powerful competitor to Mexico for footloose manufacturers hoping to export to the United States. Those twin blows caused three years of economic stagnation in Mexico and the loss of some 700,000 formal jobs, most of them in the *maquiladora* plants producing goods for export. Some of those jobs moved to China.

In the second half of Mr Fox's term growth has picked up. This year it is heading for 4.5%, the highest figure since 2000. In the first nine months of this year some 900,000 formal jobs were created, almost keeping pace with the growth in the labour force. That is thanks in part to higher oil prices. But it is also because the private sector has made a big effort to cut costs and regain its competitive edge, as Alfredo Thorne of JPMorgan, an investment bank, points out.

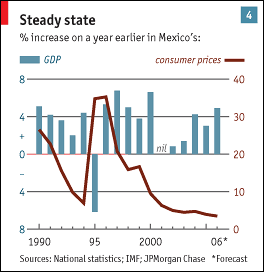
The car industry is doing especially well, with output in the first half of this year up 36% on the same period in 2005. Detroit's troubled carmakers may be closing factories in the United States, but they are quietly expanding in Mexico. So are Nissan, Toyota and Volkswagen. Mexican suppliers of car parts account for a much higher portion of the finished cars than in the past. Mexico cannot match China's cheap labour, but it can compete in higher-value goods and where transport costs are important. Many of the jobs it lost were in textiles; some of the new ones are in electronics, which now accounts for around one-fifth of the country's total exports.

There is a familiar cloud on the horizon: the economy north of the border is once again threatening to slow down. But Mexico is much better placed to weather an American recession than it was in 2000. That is because inflation is low, the public-sector deficit is close to zero and the current-account deficit is much smaller than it was six years ago. Nor is growth coming only from exports. Mexican banks are lending again.

**The end of original sin**

“A few years of single-digit inflation have transformed the financial markets,” says Guillermo Ortiz, governor of the Bank of Mexico, the central bank. “What's surprising is that this has happened so quickly.” Mexico's government debt began to achieve investment-grade status in 2000 with dramatic effects. In 1999 the maximum term of government bonds was one year; most were denominated in dollars or linked to inflation. In 2003 the government issued a 20-year bond in pesos; last month it launched a 30-year peso bond not indexed to the inflation rate.

So Mexico has overcome what Ricardo Hausmann, a Venezuelan economist at Harvard, dubbed “original sin”—emerging-market countries' traditional inability to borrow long-term in their own currency. Because of its relatively conservative fiscal policy, the government now absorbs only 16% of national savings, down from 80% in 2000. That has helped everyone else to borrow more cheaply. Big companies are now issuing ten-year peso bonds at a fixed rate of around 8%, according to Damian Fraser of UBS, a Swiss investment bank.



The banking system seems poised for growth, after a turbulent quarter-century that began with its nationalisation in 1982. Mr Salinas privatised it but unwisely barred foreign banks from bidding. Having lent recklessly, sometimes to insiders and/or in dollars, the banks got into difficulties when the peso plunged and interest rates leapt in 1994-95.

But just as the bankers had benefited from lax regulation under Mr Salinas, so they received generous treatment from Mr Zedillo when they got into trouble. In effect they were allowed to pass their non-performing loans to the government, which also offered unlimited deposit insurance. In all, the bank bail-out cost the taxpayer around 20% of GDP. The Zedillo government did belatedly tighten supervision and accounting standards and lifted the ban on foreign commercial banks. Now foreign banks make up more than four-fifths of the system.

Until recently the banks did very little lending, but credit is now expanding. Mexicans are able to take out mortgages again and loan interest rates are coming down fast. Such is the boom in house construction that Cemex, Mexico's biggest cement company, in September announced its largest capacity expansion in a decade.

Consumer credit too is growing rapidly. But small and medium-sized businesses have been slower to take advantage of lower interest rates. Jaime Guardiola of Bancomer, the Mexican affiliate of Spain's BBVA, notes that although his bank has a smaller market share in its home country than it does in Mexico, in Spain it lends ten times as much to such businesses. To boost such lending in Mexico, new rules are needed to make it easier for banks to call in loan guarantees.

Mr Ortiz reckons that excessive interest-rate spreads and fees dampen demand for credit. Bankers reject the criticisms. Competition is fierce and is driving down margins, says Sandy Flockhart, HSBC's managing director for Latin America.

Mr Fox's government has been markedly more effective at reforming the financial system than at dealing with its own finances. Since 1999 the public-sector borrowing requirement has fallen from 6.3% of GDP to around 2%, despite a modest increase in public spending. But the government has been helped by falling debt payments and bumper oil revenues. Oil accounts for more than a third of total government revenue. There are two problems with that. The first is that it bleeds Pemex, the national oil company, of investment funds. The second is that oil revenues are likely to fall in the coming years.

**The taxman cometh**

Mr Calderón will need to spend more—on infrastructure, education, health and probably on job-creation measures—if Mexico is to make the most of NAFTA, and indeed if it is to remain governable. Yet Mexico is notoriously bad at collecting taxes. Total tax revenues in 2004 (excluding oil income) amounted to only 11.4% of GDP. That is not only much less than the average for the OECD countries (36%), but also below the average for Latin America (13.7%). One reason is that large chunks of the economy—food, medicines, agriculture, fisheries and land transport—are either exempt from value-added tax or zero-rated. The OECD estimated that the exemptions cost up to 2% of GDP in lost revenue—and also make evasion easier.

But Congress twice rejected the efforts of Mr Fox's government to broaden VAT. Mr Calderón says he wants to simplify tax rates and increase the number of taxpayers, on which Mr Fox's government has already made some progress. He names fiscal reform as one of his top two legislative priorities because it will allow him a greater margin for manoeuvre. The other priority is energy policy, one of a raft of structural reforms that Mexico's economy needs if it is to become more competitive and grow faster.

Even without reforms, the economy is not about to collapse. Growth averaging around 3.5-4% a year for the next few years may still be possible. Indeed, Francisco Gil, the finance minister, argues that Mexico could follow Spain's example. Like Mexico, Spain opened up its economy and cast off authoritarian rule. Like Mexico, Spain suffers from weak productivity but has achieved sustained economic growth by combining manufacturing exports to a large and rich neighbour with dynamic construction and tourist industries and a strong banking system.

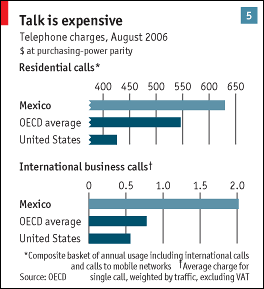
The trouble is that Mexico needs to do better than Spain if it is to reduce poverty and raise its living standards by enough to stop its young people from leaving for the United States. Mr Ortiz says bluntly that growth is “completely insufficient. With better public policies, we could grow at 5.5-6% a year. That is the challenge. The answer is basically to make the economy more flexible.” But that will mean tackling some powerful vested interests.

**Monopoly money: Competition is not Mexico's strongest point**

THE most powerful man in Mexico is not Mr Calderón, nor Mr López Obrador. It is Carlos Slim, the world's third-richest individual, with a net worth put by *Forbes* magazine at $30 billion (the equivalent of 3.7% of Mexico's GDP). His tentacles extend across large swathes of the economy. At their head is Telmex, the telecoms company privatised by Mr Salinas in 1990, of which Mr Slim's family holds 48% of the capital and 71% of the voting shares. The cash from Telmex has financed relentless diversification. Mr Slim's América Móvil is the largest mobile-phone operator in Latin America. His family also holds a string of industrial and retailing businesses, including the Mexican operations of Sears. He is the biggest tenant in the country's shopping centres. His latest venture is Ideal, an infrastructure company working mainly in the oil industry. He is also the second-largest shareholder in Televisa, Mexico's dominant media business. What distinguishes him from Bill Gates and Warren Buffet, the only two men richer than him, is the parsimony of his philanthropy.

There is no doubting the business acumen of Mr Slim. His defenders portray him as a national champion and a bulwark against foreign (probably American) control of the economy. But he has had a lot of help from the government.

As with the banks, Mr Salinas privatised Telmex badly: the new owners were granted an outright monopoly for six years. Since then the market has been open. Several competitors have poured billions of dollars into rival networks. So why does Telmex still have 94% of landlines, 78% of mobile services and 70% of the broadband internet market? That question is all the more pertinent because telecoms costs in Mexico, though falling, remain above the international average (see chart 5). Mexico also has fewer phones per person than any other OECD country or Brazil, which privatised eight years later but encouraged competition.



The answer is that Telmex still exercises significant monopoly power. Its competitors tell a Kafkaesque tale of regulatory capture. Pedro Cerisola, the minister of transport and communications, was a Telmex manager of long standing, and one of his deputies is a former manager of Televisa. In breach of its legal duties, the ministry has dragged its feet in approving licences for would-be competitors and shown Telmex their business plans. Telmex has repeatedly used the courts to block or delay regulatory rulings telling it to cut its prices. If Mexico were the United States, Telmex would have been broken up years ago.

But Mexico is Mexico. Telmex is merely one of the more egregious examples of the widespread rule of oligopoly. An ordinary citizen who wants to import and distribute beer, cement, textiles or bread will soon find that he cannot do so. In the midst of the election campaign, Congress approved a law giving free wireless spectrum to Televisa and its only rival, TV Azteca. Only in the airline industry has there been timid progress: Mexicana and Aéromexico have been de-merged, and two tiny low-cost ventures have started up.

“Mexico lacks a competition culture,” says the OECD. The Federal Competition Commission is fairly toothless, though a new law is supposed to give it more bite. Some analysts are hoping that technological innovation will undermine Telmex's monopoly. But it is seeking to expand into new businesses, such as cable television.

By common consent, any increase in competition depends on the president's willingness to use the legal instruments available. Mr Ortiz has denounced the costs Telmex imposes on Mexico. Mr Gil says he pressed Mr Fox in vain to open the telecoms market. Mr Calderón can afford to be bolder. “The political monopoly of the PRI has ended but all other monopolies remain. There's a public demand to change that, because it carries a high cost for consumers,” notes Mr Aguilar Camín.

But private monopolies pale in comparison with the state monopoly of energy. Pemex's stranglehold on the oil industry, from exploratory drilling to refining to deliveries to petrol stations, goes back to 1938, when President Lázaro Cárdenas expropriated British and American oil companies, asserting that “*El petróleo es nuestro* (the oil is ours).” But rather than working for the Mexican people, Pemex works for the government treasury and for its own union. With almost 140,000 workers, it is wildly overmanned. Its pre-tax earnings last year were around $50 billion, but it invested only $13 billion. As a result, oil production is already falling and will decline rapidly unless new discoveries are made. Pemex is replacing only a fifth of the reserves it is depleting, and Mexico already imports 30% of the petrol and 23% of the natural gas it consumes.

Mr Zedillo's government made a first attempt at loosening Pemex's monopoly by allowing others to import natural gas, which required a change in the constitution. But in practice Pemex is still the sole importer. Mr Téllez, who as energy minister introduced that reform, says that the need for change is much more widely accepted now. He recommends gradual reform, starting with private investment in refining. Next, he would require Pemex to operate along more commercial lines, and then allow private investment in exploration. But the first thing that is needed is to give Pemex greater financial autonomy.

The electricity industry is dominated by two state-owned monopoly distributors, the Comisión Federal de Electricidad and, in Mexico City, Luz y Fuerza. Mr Zedillo changed the constitution to allow private investment in generation; Mr Fox has secured further investment through public-private partnerships. But electricity is expensive, despite subsidies equivalent to around 1% of GDP (which benefit the rich more than the poor). Luz y Fuerza is in thrall to its powerful trade union.

The PAN used to be suspicious of the PRI-dominated trade unions. But Mr Fox's government has appeased the most powerful unions, such as the teachers, the employees of the Social Security Institute, the Pemex workers and the electricians. Some economists argue for constitutional amendments to reform the unions and the labour market. In practice labour in many industries is quite flexible already. A better way of taking on the over-mighty unions would be to tackle the monopoly power that sustains a number of them.

In view of all these economic rigidities, and of the poor quality of the judicial system, it is little wonder that Mexico does not do well in league tables of international competitiveness. Mexican workers are only a third as productive as those in the United States. Foreign direct investment, apart from a couple of big bank takeovers, has fallen from 3.5% of GDP in 1994 to less than 2% a decade later.

Mexico does have a handful of big world-class firms. Cemex has grown to become the world's third-biggest cement company, with factories in 50 countries, thanks to professional management, a highly efficient production system and a string of acquisitions. Mexican beer has become a big export industry: Corona and Sol are two of the country's few international brands. Grupo Maseca, a tortilla maker, has opened a factory in China and is planning others. But most Mexican firms seem to lack ambition. Between January 2004 and June 2006 there were just 19 share offerings in Mexico, with a total value of $5.7 billion. Mr Fraser of UBS points out that the equivalent figures for Brazil are more than three times higher.

North of Mexico City there are outposts of innovation. On a patch of shrubland next to Monterrey's airport, the Tecnológico, with government partners, is building a technology park. Since 2003 it has set up 30 campuses across Mexico that are offering degrees in engineering and computing, linked to small business incubators. Mr Rangel, the Tecnológico's rector, points out that Mexico trains more engineers each year than the United States, China or India. He sees great potential for Mexico in industries such as aerospace, white goods, food, biotechnology and pharmaceuticals.

That may be tomorrow. But today the vast majority of Mexican companies are small businesses, many of them operating in the informal economy.

**The joy of informality: Working in the official economy has its drawbacks**

IN THE afternoon, try walking past the stately headquarters of the Bank of Mexico, across the Alameda from the massive new foreign ministry tower in the heart of Mexico City. Your progress along the pavement is slowed by a thick mesh of street vendors. Throughout the centre of Mexico City they hawk Chinese clothes and electronics, or pirated DVDs produced closer to home. They are just the most visible segment of a huge informal economy of unregistered businesses.

No Stalinist monopolies here

According to a recent estimate by the World Bank, this sector accounts for slightly more than half of total employment in Mexico. That is about par for the course in Latin America. Contrary to some claims, informal work has not expanded in the dozen years since NAFTA came into effect, but nor has it shrunk, says Bill Maloney at the World Bank, who is preparing a book on the subject. And perhaps there is no reason why it should have done: NAFTA is just a trade agreement, albeit a sophisticated one. Unlike the European Union, it does not require the wholesale import of regulatory regimes and legal institutions.

The size of the informal sector goes a long way to explaining why Mexican productivity is so low: small businesses in this sector find it hard to expand or to innovate. It is also one of the reasons why the tax take is so meagre. But there is no simple recipe for change. Mr Maloney finds that many people consciously choose to work in the informal sector, not least because it is hard for those who never completed their basic education to get a well-paying job in the formal sector.

Tangles of red tape have made it unnecessarily hard for informal businesses to go legal. That is starting to change. A reform last year cut the average time it takes to set up a new business in Mexico City from 58 to 27 days. Together with cuts in federal corporate income tax and a new capital-markets law that improved corporate-governance standards, this lifted Mexico 19 places to 43rd (out of 175 countries) in the World Bank's latest annual survey on the ease of doing business around the world.

Even so, recent innovations in social policy may be making it more attractive to remain in the informal economy. Formal private-sector workers are obliged to contribute to the Mexican Institute of Social Security (IMSS), which provides pensions and health care, as well as to a housing fund. Between them, workers' and employers' contributions add up to a hefty 35% of wages.

The institute is yet another of Mexico's union-driven Stalinist monopolies. It administers the state pension scheme and is perhaps the largest single provider of health care in North America. Its trade union is the second-biggest after the teachers', with 380,000 members. Mr Zedillo reformed pensions, switching from a pay-as-you-go system to Chilean-style individual capitalised accounts for new workers, but with one embellishment. The government makes a contribution to each account (at a total cost of $1.5 billion a year) because otherwise many pensions would be too low to live on. The Afores, as the new pension funds are called, now manage $61 billion in assets and have provided a natural market for the government's long-term peso bonds.

But the reform did not apply to the Social Security Institute's own employees (nor to other public-sector workers who have a separate social-security institute). So of each peso of contributions, 17 centavos go to the institute's own pensioners. In ten years' time this figure will rise to 30 centavos, says Mr Levy, who was Mr Fox's first IMSS director. He piloted a bill through Congress that would have switched new employees at the institute to a pension scheme similar to the one used in the private sector. But the union went on strike in protest, and Mr Fox caved in. So the health system for formal-sector workers continues to be short-changed. Moreover, thanks to the union, there are too many cleaners and clerks and not enough doctors and nurses.

Meanwhile, Mr Fox's government, with the best of intentions, has launched or expanded a range of non-contributory social-protection schemes for workers outside the IMSS. The IMSS covers only 13m workers, or 30% of the workforce. The schemes include Oportunidades, the anti-poverty programme that replaced a series of less effective transfers and subsidies. This year the government added a pension scheme to Oportunidades under which it contributes slightly more generously than it does to formal-sector pensions. Mr Székely, a former official at the social-development ministry, says that more than 95% of those who get Oportunidades have never worked in the formal sector. Mr Levy fears that if more benefits are added to the scheme, they never will.

Mr Fox's government also launched a health-care programme called Seguro Popular for those outside the social-security system. In practice, this is non-contributory. All told this year public spending on health for workers in the informal sector will total 131 billion pesos ($12.1 billion), against 107 billion pesos for those in the IMSS. Since 1998 public spending on social protection for informal workers has expanded by 110%; the figure for the social-security system is only 21%. Meanwhile, general public investment in infrastructure and the like has risen by just 0.8%.

**Better at the bottom**

Thanks to Oportunidades and the expansion of social protection, the poor are getting much more out of social spending than they did in the past. But rather than a minimum safety net, social protection is becoming a powerful competitor to the official social-security system—and one that will increasingly provide better health care for informal than for formal workers. It thus amounts to a tax on formality. As Mr Levy puts it, “we tax unskilled labour through the social-security system. Workers prefer to wash cars if they get free benefits.” Mr Calderón has promised that the government will pay the first year of contributions for every new job registered with the IMSS. But that will not solve the problem: many low-income workers registered with the IMSS drift into the informal sector later on.

The solution is not to dismantle social protection but to merge it with a reformed social-security system. A first step would be to separate the pension and health-care functions of the IMSS. A second step would create a universal non-contributory basic pension, supplemented by a freely negotiated contributory scheme. This would recognise that in Mexico, unlike in Brazil, the elderly tend to be poorer than the population as a whole, notes Mr Scott of CIDE. A third step would be to create a universal health-care system financed out of taxes (and/or by means-tested social insurance). This would replace the present rival systems, one contributory and the other in effect paid for from oil revenues. A fourth step would reform the labour market, reducing payroll taxes and severance pay. That would still offer to those who work in the informal sector more rights if they were to go legal.

Given that state governments are increasingly involved in the delivery of social policy, all this would involve complex negotiations. But the prize would be worth having: to provide incentives for formalising work, thus boosting tax revenues; and perhaps even to increase productivity and economic growth. “Social policy is economic policy,” concludes Mr Levy.