CONVERSATIONS WITH AN EXPERT

TEXAS A&M UNIVERSITY
Private Enterprise Research Center

On October 14, 2021, Dr. Pia Orrenius and Dr. Roberto Salinas-León visited the Private Enterprise Research Center and that evening, they gave a presentation titled, "Immigration, Trade and the Future of the Mexican Economy." During their visit, they were interviewed by PERC's Dr. Andrew J. Rettenmaier.

To establish a few facts about Mexico's current economic situation, what are some of the distinguishing characteristics of Mexico's economy?

Salinas-León: From a broader perspective, or historical perspective, the distinguishing characteristic of the Mexican economy is that it has significantly diversified its economy and has become independent of a particular commodity. Before trade liberalization began in the mid-80s, Mexico's economy was too dependent on petroleum in the same way that you find in other countries like Ecuador, Brazil and definitely Venezuela. This diversification means that states, municipalities, and regions have basically changed their economic structures, becoming much more manufacturing oriented. This is a remarkable accomplishment of the Mexican economy over the past 25 years.

Another important characteristic is the transition to a climate of price stability. Despite the potential for rising inflation in the post-pandemic period, Mexico has not experienced serious bouts with inflation for two decades. Having lived through periods of high inflation in Mexico, I still wake up in the morning and check the exchange rate. Current younger Mexican citizens have grown up in a period where inflation has been more or less 3%. This transition has enormous implications for financial markets, capital markets, and for investment. Things as basic as calculating net present value, or internal rates of return, were impossible back in my day. The fact that you can have mortgages and develop all kinds of financial instruments in Mexico, though this area is still very underdeveloped, are important advances in the last 25 years. I think that diversification and a more stable price level are two very important characteristics that sometimes observers of the Mexican economy overlook.

What countries are Mexico's largest trading partners?

Orrenius: The largest trading partner by far is the United States but Mexico is a very open economy. It is highly export-oriented and certainly the United States is not their only major trading partner. Mexico has been very aggressive in pursuing open trade and has trade agreements with 50 countries. That said, about 80 percent of Mexico exports go to the U.S.

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Mexico has, over time, developed a very modern, highly productive manufacturing sector. This sector is obviously geared toward trade with the United States and with Canada, but also with Europe and other countries. This is in contrast to a very large domestic informal sector where we see a lot of poverty, especially in southern Mexico. There we see low productivity and low levels of schooling. There have been structural reforms attempting to address these issues, and they are still under way.

How large are the formal and informal remittances to Mexico?

Orrenius: Remittances to Mexico are currently hitting record levels. I think the latest update we have indicates that around $4.7 billion dollars were remitted to Mexico in a single month. This is almost twice what it was ten years ago in real terms on an annual basis. We unexpectedly saw remittances rise during the pandemic. I think this is interesting because it reflects how much stimulus there has been in the United States. It also indicates how well the economy has done in the United States, despite the pandemic, and how poorly the economy has done in Mexico. The money has flowed back to Mexico to sustain families there.

Mexico has the second largest economy among the Latin American countries, but on a per capita basis, using purchasing power parity, Mexico was ranked sixth among the Latin American countries in 2019 before the pandemic. What policies can be adopted to improve Mexico's per capita income relative to the per capita incomes in other Latin American countries?

Salinas-León: This is a very important question because it brings up the discussion of what many observers characterize as the 'two Mexicos', or really the 'many Mexicos.' You have states that are clearly characterized by their links to the North American Free Trade Agreement. And, it is not just trade with the United States and Canada. Mexico has signed 14 free-trade agreements with 50 countries throughout the world. Some states have clearly taken advantage of those opportunities with productive investments, especially the northern states. But it's not North versus South. There are some southern states that have done extraordinarily well in the wake of trade liberalization. If you measure the GDP per capita you'll find that it's very likely higher in Nuevo Leon, Sonora, and Chihuahua despite the horrendous effect that organized crime has had in Chihuahua or in Sonora or Tamaulipas.

It is also extremely important to try and decipher exactly what is measured in official GDP per capita estimates. What is not considered is the fact that the informal economy has become so sophisticated. It is not just 10% to 12% as estimated by some in the past. As it has become much more sophisticated and because almost everyone participates in certain aspects of the informal economy, the actual GDP is higher.

Orrenius: When we look at Mexico's economy and the last 30 to 40 years, the act of opening up to international trade and then ratifying NAFTA was huge. It was a game changer for Mexico, and it created a world class manufacturing sector. However, what we realized over time was that those reforms that were made in the manufacturing sector were never extended to other sectors of the economy. That was the problem, and that was what was limiting Mexico's success. We hoped with NAFTA that Mexico would begin to catch up in terms of GDP per capita to its North American neighbors. It has not caught up. It hasn't even narrowed the gap.

Under the Peña Nieto administration, there were important reforms that intended to extend the changes that had been made to the manufacturing sector to the other sectors of the economy. These reforms had the potential to raise productivity and experts were increasingly optimistic about Mexico's future. The reforms to the energy sector, labor market, banking industry, and tax system represented major changes. Everyone was hopeful as those were gradually implemented. Mexico seemed to finally be on the verge of its big step forward, and we saw was some progress for several years, but I think for the last 3 years or so, that progress has stalled.

Salinas-León: Yes, external free trade must be complemented with internal free trade. You cannot be competitive when you have mountains of rules and regulations. When the regulatory bureaucratic burdens actually become instruments of open rent-seeking, and when the internal structures lack contract enforcement and well-defined property rights, internal free trade is not realized. This requires stable institutions and predictable simple rules – in other words, laws that enable you to work and not hinder others. The main drag on productivity and why we haven't been able to capture that future that Pia was explaining is that the reforms have not been realized across all sectors.

In the United States the pandemic recession was very short. Is the same true in Mexico?

Orrenius: Mexico has had a much harder time than the U.S. in the pandemic in terms of the economic impact. The impact has been much larger there in terms of lost output and employment, but we also need to recognize that Mexico was already in recession before the pandemic started. The most recent recession started in 2019 when GDP started declining. When the pandemic hit, the situation got much worse in Mexico, although the economy turned around and began recovering as the U.S. economy began to recover.

The recovery in Mexico has been slower partly because there has not been any stimulus spending like we have had in the U.S. Mexico has still not recovered in terms of economic output although employment has almost recovered. The unfortunate development in employment is that most of the job gains have come in the informal sector. About two thirds of the jobs recovered are in the informal sector and only about a third are in the formal sector. This is not ideal since the informal sector is much lower paid and lacks fringe benefits.

Salinas-León: I would like to add that the situation in Mexico in terms of response to the pandemic was very different from the U.S. response. Pia mentioned the substantial stimulus in the U.S. If there was ever a time to take out the credit card and start creating fiscal deficits to do some sort of stimulus package, this was the occasion. Lopez Obrador said: absolutely not. In his mind, he did not want to repeat what happened during the Echeverria Administration from 1970 to 1976 and especially during the Lopez Portillo Administration from 1976 to 1982 which ended when the banks were nationalized and began the so called "Lost Decade" in Latin America. This was a very traumatic event for Mexico.

On the other hand, the restrictions on the Leisure and Hospitality sector in Mexico were far less severe than in other countries. Places like Cancun and Baja California have done incredibly well. So, you had a much more liberal approach to leisure and hospitality, and you had a much more conservative approach in the form of fiscal austerity.

What is Mexico's assessment of the United States-Mexico-Canada Agreement (USMCA)? How has it affected trade and has it hindered Mexico's ability to respond to the recession?

Salinas-León: At least from my vantage point, thank goodness it was signed. Our great fear was that Trump would get his way and cancel NAFTA. Not necessarily because of trade, but because of the straitjacket effect that NAFTA had on Mexico. NAFTA did provide regional rules of the game that are much harder to change than at a national level, let alone at the local level. NAFTA provided predictability.

I think the USMCA was a step backward. There are protectionist elements like the negotiated rules of origin of car parts and minimum salaries for those who work in the automobile industry. USMCA is not NAFTA 2.0, but maybe NAFTA 0.8.

At this stage of the game, thank goodness that there is an agreement, and that it hasn't hindered trade. Mexico is still the number one trading partner of the United States. But I think the agreement will eventually weigh on what happens, especially in the automobile sector.

Orrenius: The USMCA is a more restrictive trade agreement than NAFTA. The United States' own government report on the GDP effects of USMCA showed it would have a negative effect on the GDP of the three NAFTA partners. Of the USMCA partners, the largest negative effect is on Mexican GDP because of the restrictions on the auto sector. The agreement was designed to move more activity to the U.S. auto sector and away from the Mexican auto sector. The problem with that is that it negatively affects the U.S. as well because it drives up the prices of autos. As a result, it lowers production and hurts the consumer in all three countries. That is the unfortunate part of the USMCA.

There are other benefits, though. It does open up digital trade and has some other important changes. But, overall, it is a more restrictive agreement and less conducive to investment, trade and consumer welfare.

Returning to the reforms that invigorated the manufacturing sector, how could Mexico bring those reforms to other sectors of the economy?

Orrenius: The good thing about the reforms that were implemented, even though they have stalled out in many cases, is that we know what needs to be done. What it entails in almost every one of these sectors, whether it's energy, or banking, or legal reforms, is confronting the vested interests. This is true whether it is Pemex, other monopolists or powerful and politically influential individuals and institutions. They must be changed to allow for the entry of private investment, the opening up of credit markets, and the entry of new businesses. This will fuel capital infusion, raise wages, and raise productivity. What has happened in the manufacturing sector, which has done so well in Mexico, can be replicated across the service sector, the education sector, the energy sector, and the financial sector. The sky is the limit, but difficult changes must be made, and the vested interests must be confronted.

Salinas-León: It is also very important to see the setbacks that Lopez Obrador has implemented in the public policy framework precisely in that light because there was hope that Mexico could go forward and could reach much greater prosperity. However, it is not something that affects only Mexico. It also affects the United States. It also affects citizens in Indiana and in Michigan and in Oregon and in California, not just in Texas or Arizona. That is why in the U.S., and especially in Texas, we should all remain very watchful not just about issues concerning immigration or issues that are hot, but also about the broader perspective of how Mexico's economy is going to be fare in the next 10, 15, 20 years.

How have the patterns of immigration changed in recent years?

Orrenius: In terms of the flow of all foreign-born coming into the United States, we have seen a drop since 2016. Some say this decline is correlated with the policies of the Trump administration which were unfriendly toward immigrants. We saw a particularly big decline in the number of foreign students, especially foreign students from China, perhaps due to some of the geo-political tension at the time.

In the pandemic, the immigration decline that was already ongoing became much more severe. Immigration policy makers who favored fewer immigrants, realized that they could use public health related tools to stem more inflows. As a result, we saw further declines in immigration during the pandemic and those declines have not been fully reversed yet.

Turning to the dynamics on the Southwest border, they are very different from what used to be considered 'normal' years ago. We no longer have the large undocumented immigration flows from Mexico that were typical 20 to 30 years ago. Undocumented immigration from Mexico dried up during and after the Great Recession. But those flows were replaced by surges of Central Americans who were trying to apply for asylum. This is obviously not illegal, but it's still controversial. Under the Trump administration, there were stringent conditions put on the asylum seekers. Things like the Migration Protection Protocols which compelled asylum seekers to wait in Mexico. This was a real hardship, so many chose not to wait.

With the Biden administration, some of these restrictions have been repealed and there are more open and humane policies being implemented on the border. What we have seen partly as a result, combined with other crises ongoing in the western hemisphere and elsewhere, are more surges of not just Central American migrants, but also African migrants and others from different countries like Haiti. With greater migrant flows, Border Patrol apprehensions of migrants reached their highest level ever in 2021. The situation on the border is commanding substantial resources and political attention and may be preventing further reforms.

What are the necessary components of immigration policy that address the current unauthorized immigrant population in the United States?

Orrenius: I think that there's only one solution to the 11 million unauthorized immigrant population, and that is to legalize them. One path is to legalize them by granting them green cards, and then they eventually become US citizens. Alternatively, they can be given work permits and some other kind of temporary status.

Legalizing the undocumented immigrants is the only way we can begin to address future flows of unauthorized immigrants. The starting point is to legalize those who are already here. This will get them on the books, and then we can implement electronic verification of worker authorization. I have proposed, with my coauthor, a plan where we would have universal employment authorization requiring all employers in the U.S. to verify that their workers are here legally and have permission to work in the United States.

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This is how you address the jobs magnet, which is why most people come. Between those two things, first legalization, and then an E-Verify mandate that covers all employment, the problems at the border can be mostly solved. A third step is to make legal work-based immigration easier so that labor demand in the future will be filled by legal immigrants.

The next step is to address asylum seekers. The system for asylum is backlogged and excruciatingly slow. After many years, most of the asylum seekers get their claims denied, are not granted asylum, and are asked to return to their home countries. The system needs to work faster and smarter. For example, asylum seekers could be allowed to apply in their homelands. In any case, I think we have all of the tools and appropriate answers to solve these problems. What we lack is the political will.

Let me ask this question, how do you deal with the argument that these policies would cost millions of US jobs? (question by Salinas-León)

Orrenius: Legalization will not take jobs from Americans because they (the immigrants) are already here and working. Legalizing them will create an even playing field and hold employers accountable. In the context of the labor shortages that we're seeing now, and the medium to long term demographic challenges that we're facing in the US labor market—the retirement of the baby boomers, the falling birth rate, and the aging workforce—immigration has to be part of the answer. We can manage immigration, but we have to start by addressing undocumented immigrants.

Salinas-León: Many years ago, Alan Greenspan made precisely that point by suggesting that perhaps a way to address future challenges of labor shortages associated with the retirement of the baby boomers is a more relaxed immigration policy.

The views expressed here are solely those of the interviewee(s) and do not reflect those of the Federal Reserve Bank of Dallas or the Federal Reserve System.

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