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Leader of the Free World!

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The World Bank in early March said that the world economy could fall in 2009 by as much as 2 percent, the first decline since World War II. The Bank also predicted that world trade will contract this year by the largest amount in 80 years. The Asian Development Bank concluded that global assets may already have declined by more than $50 trillion. I confess that I find it hard to grasp how large this figure is. Spending at a rate of $1 million day, it would take more than 125 years to go through $50 trillion.

The United States often describes itself as the "leader of the free world." We certainly are right now—leading the world economy down. In his speech before the Council on Foreign Relations on March 10, Ben Bernanke, the chairman of the Federal Reserve Board, traced the current crisis to imbalances in world trade and capital flows that began in the latter half of the 1990s—stemming from a chronic lack of saving relative to investment in the United States combined with an extraordinary increase in saving in East Asian countries and oil and other commodity exporters. The combination led to an inrush of capital from these developing countries to more developed countries, particularly the United States, where it was not invested wisely.

Providing subprime mortgages that clearly could not be repaid was one use of the capital inflows into the United States. These questionable mortgages were then packaged by financial institutions into bonds that were sold across the globe garnering high profits. The financial institutions must have concluded that the packaging somehow obliterated the inherent dangers of the worthless paper that secured the bonds. The blame for this carelessness is widespread: congressional action to reduce oversight of financial institutions based on the premise that the private sector knows best; the rapacious greed of executives of financial institutions in both the United States and elsewhere; the use of credit default swaps by AIG, the world's largest insurance company, to insure against nonpayment of the bonds that had been sold, which led to losses so massive (almost $62 billion in the final quarter of 2008) that it surely will lead to the dismemberment of AIG. Each step in the process was approved by highly paid financial executives. Why didn't simple prudence warn them that actions that cannot long endure will not endure?

Because it is hard to grasp the enormity of the global damage, I will focus on Mexico, a country important to the United States. Mexico has an inglorious history of thoughtless financial policy. This led to economic collapse in 1982, when Mexico led the way to widespread debt defaults in Latin America and a lost economic decade in the region; and again in 1994, when Mexico exhausted its foreign reserves protecting its exchange rate and was unable to meet its dollar obligations to creditors. Mexico was given an international line of credit of $50 billion, the largest bailout ever at that time. However, starting with the administration of Ernesto Zedillo, president from end-1994 to end-2000, Mexico put its financial situation in order. The fact that Zedillo was a trained economist (Ph.D. from Yale) surely made a difference. Mexican banks had collapsed in the 1990s, but changes under Zedillo and his successor, Vicente Fox, led to a strong banking structure—one that was praised for its solidity by the International Monetary Fund. Almost all of Mexico's large banks are now foreign owned, something that was generally not permitted before the 1994 financial collapse. Banco Nacional de México (Banamex), one of these large banks (its assets account for about 20 percent of Mexico's banking system), is owned by Citicorp, but there has been some question whether, under Mexican law, banks partially owned by the U.S. or any other foreign government could remain in foreign hands.

Mexico's inflation was largely brought under control over the past decade. Inflation was a bit high last year at an annual rate of 5 percent in mid-2008, before the U.S. financial collapse. Mexico's fiscal accounts had moderate surpluses well into 2008. The deficit in Mexico's current account of the balance of payments was 6 percent of gross domestic product in 1995 and then was brought down to less than 1 percent of GDP in later years. The country's exports increased substantially after NAFTA came into

effect in 1994. Inflows of direct investment (FDI) also benefited from NAFTA—and from Mexico's sound financial position; FDI reached US$25 billion in 2007. The peso was quite stable at between 8 and 11 pesos per dollar from 1995 until 2008.

Mexico is fortunate that it entered 2008 in good financial shape because the fallout from what happened in the U.S. economy might otherwise have been worse. Mexican GDP will decline this year—my estimate is by 2.5 percent. The Mexican currency has depreciated to almost 16 pesos per dollar at this writing; and in order to stem the fall, the central bank has been selling dollars from its foreign reserves to buy pesos. Mexico had earlier built up these reserves to more than $80 billion, and the central bank is trying to attract new foreign reserves even as it sells dollars. The Mexican automotive sector thrived under NAFTA—but is now in deep trouble. In February 2009 domestic auto sales fell by 29 percent, automotive exports fell by 44 percent, and production declined by 39 percent, all from the same month of 2008. Industrial production fell by 7 percent in December 2008, year-on-year (yoy), the largest decline in almost seven years. Remittances from Mexicans living in foreign countries (mostly the United States) fell by 11.9 percent in January, yoy. Unemployment is rising in the formal market; the informal segment of the labor force, about 40 to 50 percent of the total, is undoubtedly growing as workers lose formal jobs. In order to protect consumers, the Mexican treasury has frozen gasoline prices, cut the price of liquid gas used by households, and reduced electricity tariffs for small and medium enterprises. It would have been less expensive for Mexico to use targeted subsidies for gasoline and household liquid gas to help those who most need relief.

About 80 percent of Mexico's exports normally go to the United States. The leading exports are automotive (cars, trucks, auto parts), oil, and television and other video equipment. Mexico's share of the U.S. market has been holding up remarkably well; it was 10.8 percent in 2007 and fell slightly to 10.3 percent in 2008. However, total U.S. imports have been falling since late 2008.

Given that the economic and financial problems Mexico faces this time are not of its own making, it is proper to ask what the United States is doing to help its neighbor. The answer is that the United States is not always a caring neighbor in this time of economic and political stress in Mexico. Perhaps the best example of this is in cross-border trucking.

Under NAFTA, access to the four U.S. border states by Mexican trucks was to be allowed three years after signature on December 17, 1992. On December 18, 1995, the U.S. secretary of transportation announced that there would be a delay on implementation of this provision, allegedly because of truck and driver safety concerns. The U.S. Teamsters Union had campaigned hard for this "delay." Mexico, in turn, halted access of U.S. trucks into its territory. In addition, under NAFTA, Mexican trucks were scheduled to be able to carry cargo to customers throughout U.S. territory six years after NAFTA started. This provision was not honored by the United States in 2000. Mexican trucks carrying cargo to U.S. destinations must stop at designated commercial areas at or near the border where the trailer carrying the goods is removed. The trailer is then picked up by a drayage truck and transferred to the U.S. side of the border. From there the load is picked up by a long-haul U.S. truck for transport to its destination.

In order to ameliorate this burdensome procedure, a cross-border trucking demonstration program was put into effect during the Bush administration; the U.S. Congress earlier sought unsuccessfully to cut off funding for this. During the 18 months of this program, 103 Mexican trucks crossed the border more than 45,000 times without a significant accident. The $410 billion spending bill signed earlier this month by President Obama will terminate funding for this program.

I agree with the comment made by an economic officer of the Mexican embassy that this congressional action was "protectionism, plain and simple." The U.S. decisions on trucking were never about safety. A NAFTA panel, following a Mexican challenge, ruled in 2001 that the United States should fulfill its NAFTA obligations. Under this ruling, Mexico has the right to retaliate against imports from the United States. There has been no retaliation because Mexico clearly has not wanted to get into a tit-for-tat trade restriction fight with its stronger neighbor. Such retaliation may yet come if the Mexican authorities conclude there is no other way to resolve the trucking problem—especially now that the special program has been terminated.

It is worth noting that Barack Obama and Joe Biden voted in favor of terminating the funding for the special program when they were in the Senate.

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