It is an honor to speak before such an important group, the first national meeting of the legislators of the PAN.

High aspirations

The last time I was in Mexico was in October 1999, at an economics conference in San Miguel Allende. Vicente Fox, then an aspiring presidential candidate, came to the conference. I remember, at that point, that his bid to dislodge the PRI from the presidency seemed like an impossible dream. When I returned to the US, Felipe Calderon, who was attending my lectures at Harvard, showed me poll results. Eventually these polls reported Fox gaining on his opponents. I have to admit that I was somewhat skeptical at first. But then the impossible happened. The PRI was unseated. This peaceful and democratic change of party was an historic development in Mexican governance, and an inspiration to other countries around the world. I think there is also a broader lesson here: that it pays to have high aspirations.

I. The US economy

My main topic today is the performance of the US economy and implications for Mexico. I will begin with the good US economic performance of the 1990s, before turning to the current outlook. I have come with two lists. I have a list of possible explanations for the outstandingly good US economic performance, particularly in the late 1990s [the period I know the best, as I was in the Clinton Administration then]. I propose to compare that list to the list of policies that we urge on developing countries,
the so-called Washington consensus. Some say that the Washington consensus has been invalidated by recent financial crises in emerging markets, and point out that it involves some policies that we in the U.S. would never apply ourselves. But I find a greater overlap between the two lists than you would think.

**US Economic Performance in the 1990s**

Early in the year 2000, the US economic expansion surpassed in length that of the 1960s, and thus became the longest on record. Subsequently, the expansion reached the ten-year mark. It is all the more remarkable that this was accomplished with record budget surpluses, and low inflation. I say this not just because budget surpluses and low inflation are good, but also because previous long expansions had been fueled in large part by expansionary fiscal or monetary policies. The result in those episodes was that typically by the 6-year mark debt ratios and inflation rates were high, sowing the seeds for a subsequent contraction. The 1990s expansion, to the contrary, was led by private sector spending and private sector employment.

Even now, positive growth can continue, despite all the talk about recession.¹ So far, the last four quarters do not differ as much as you would think from what we were all forecasting a couple of years ago: a slowdown from the unsustainably rapid growth rates of 4-plus % that we experienced from 1996 to 2000. By 2000, the US economy was operating well beyond the capacity of its factories -- beyond the “full-employment” level of unemployment -- and the stock market was substantially overvalued. It was inevitable that there be a period of slower growth, before we got back on track.

There were many contributing factors behind the good US economic performance of the 1990s. I classify them into three categories: short-term, medium term and long-term. The short-term factors were luck, the medium term factors were skill, and the long-term factors were ongoing favorable structural trends in the US economy. I will elaborate briefly on each.

1. **Short-term factors: Temporary good luck on prices**

In the 1990s we had declining relative prices for computers, health care, oil, and US imports generally.² These factors put downward pressure on
inflation, and thus prevented overheating despite rapid growth in the economy. We knew all along that these trends were unlikely to continue for long; and indeed some of them did come to an end at the close of the decade. But even if one adjusted the inflation rate for such short-term factors, overall performance was still good.

2. Medium-term factors: Good macroeconomic policy

The 1990s also saw skillful exercise of macroeconomic policy, both fiscal and monetary.

In one of its greatest accomplishments, the Clinton Administration, which took office with seemingly intractable budget deficits, proceeded to eliminate them. In their place it left the largest surpluses in history. There was a new political economy trend in the 1990s that I found encouraging. The public learned from the experience of the 1980s to be skeptical of politicians selling snake-oil tax cuts, particularly those cuts inappropriately timed during the upswing phase of the business cycle, or that do little to advance the causes of either equity or efficiency. The Clinton Administration took advantage of the opportunity offered by the expansion to eliminate the deficit, exactly as we should have. As a consequence of our new budget surpluses, national saving rose. This in turn helped keep interest rates low and investment booming (especially investment in business equipment).

President Bush has made a tax cut the centerpiece of his program. He traveled around the country seeking to build popular support for it, with less success than one might expect: polls show that Americans would rather spend the money on paying off the debt and putting Social Security on a sound footing. He got most of his tax cut, thanks to a majority in the Congress. But it is a sign of the times that it is considered a political accomplishment when the President is able to convince people to accept a tax cut. In the past, presidents either responsibly resisted popular desires for tax cuts, explaining why the country’s future wellbeing required current abstinence, or else went along with the popular will. I can’t think of another time when a president went out among a public that was fiscally more mature than he was, and had to persuade them to take the free candy.

Let us turn now to monetary policy. The elimination of the budget deficit was a huge contribution to monetary policy, in that it allowed the Fed to
lower interest rates. Beyond that, the Clinton Administration’s monetary policy was simple to state: leave it to the Fed. This is more difficult than it sounds. First, the political temptation is always strong to nudge the central bank toward an easier monetary policy. Even if the monetary authorities don’t respond, it will give the government someone to blame if the economy slows down. The Reagan and first Bush Administrations did this in a heavy-handed way -- for example putting sufficient pressure on Chairman Paul Volcker that he eventually asked not to be reappointed. Such tactics often backfire, as the financial markets become alarmed and the central bank feels obliged to keep interest rates higher than it otherwise might, in order to demonstrate its independence. Second, even for a government that has wisely made a deliberate policy decision not to pressure the central bank, the human temptation is irresistible to respond to reporters’ inquiries with statements that, while not intended to be critical, are nevertheless inevitably interpreted as second-guessing the central bank. When I was in the Administration, we had an ironclad rule not to comment on the Fed or on monetary policy in any way.  

I think this strategy was a resounding success. Of course this worked well because the Fed was skillful. Greenspan’s record overall was quite good.  

Like Volcker before him, he followed a tight monetary policy early in his term, established a reputation for discipline, and was thereby able to take a more moderate stance during the remainder of his term. His forbearance during 1995-1998, even as growth and employment exceeded levels previously considered inflationary, was a gamble; but it turned out to be a wise gamble and an important component of the expansion’s longevity.

[ Perhaps the simplest overall conclusion one can draw from the 1990s is that it turns out that the US economy runs pretty well if the government avoids major macroeconomic policy mistakes. ]

3. Long-term factors

Many of the most important factors in explaining US economic performance stretch back over two decades or more. My list subdivides into three categories: deregulation, globalization, and innovation.

- Deregulation
The US economy has long been less highly regulated than most European economies. But the last 25 years has seen important further deregulation. Most people don’t realize it, but the deregulation trend began during the Carter Administration, in the sectors of trucking, airlines, natural gas, and banking. In the 1980s, during the Reagan Administration, deregulation was extended to the telecommunications sector. More recently, we have had electricity deregulation. Some of these deregulation efforts have faced bumps in the road, particularly banking and electricity. Nevertheless, I believe the overall effect has been to make the US economy more efficient in the long run.

**Globalization**

The United States has not always been an open market. During much of the 19th century, and again in the 1930s, tariff walls were high. And we are not angels on trade policy now. (Our treatment of Mexican truckers is one of the most embarrassing examples.) But the US has had a basic free trade orientation since World War II. The ratio of our trade to GDP has more than tripled since the middle of the 20th century.

Economic theory tells us that trade raises living standards. Perhaps more convincingly, the statistical evidence also tells us that openness contributes to growth. The increase in exports over 1993-2000 -- even including the period of the East Asia crisis -- constituted 20% of the growth in US GDP over this period. Imports increased even more rapidly. But imports too are beneficial. The increases in imports and in the trade deficit, though politically unpopular, were a useful safety valve during the strongest phase of the US expansion. They released pressure from very rapidly-growing domestic demand, pressure that would otherwise have shown up as higher inflation and interest rates.

**Innovation**

The third category of favorable long-run structural factors is innovation. I would in turn break down innovation into three types: technology, more competitive goods and labor markets, and the public sector.

Technological innovation, especially information technology, has received so much attention that I will say little more about it. Clearly the
Nasdaq rise as of a year ago was far overdone. And the IT revolution was not the sole reason for good US economic performance in the 1990s. But it certainly was a positive factor.\textsuperscript{10}

The United States has always had relatively competitive goods and labor markets, compared with Europe for example. But the last two decades have seen a further movement in this direction, including the initially unpopular corporate restructuring of the 1980s and the initially popular dot-com start-up firms of the 1990s.\textsuperscript{11, 12}

The last category of factors on my list is innovation in the public sector. I particularly have in mind here two examples: welfare reform, which was more successful in moving people off of public assistance and into jobs than anybody could have hoped; and defense reconversion, where we actually managed to shut down some unneeded bases.\textsuperscript{13}

Each of the many factors I have mentioned has contributed a bit to the flexibility and strength of the economy, and to the good economic performance of the 1990s. The favorable long run structural factors are still in place, even if some of the short run and medium run favorable factors have disappeared.

\textit{Qualifications}

Of course things were far from perfect in the United States, even at the peak of economic performance. Examples of the negatives are the related problems of guns, crime, drugs and the size of the prison population. Also, inequality is greater than we would like. Our system of primary and secondary education is not what it should be. After the last election, we no longer have a claim to special expertise in electoral democracy.\textsuperscript{14} Overall, however, things looked pretty good when I left Washington in 1999. (I will return to the subject of the recent US slowdown later.)

\textbf{II. Emerging markets}

Does the American record of success in the 1990s translate into a model for growth in Mexico and other developing countries? High aspirations in the 1960s – that developing countries would before long join the ranks of the industrialized countries -- for awhile seemed unfounded. Then East Asia in the 1980s showed it could be done.
The usual view in Washington is that the key to economic development is sound macroeconomic and microeconomic policies – not unlike the positive structural factors that I listed for the United States. “Sound” refers to discipline and market-orientation. But the Mexican peso crisis of December 1994 and subsequent crises in other emerging markets raised a number of questions regarding this advice.

**Mexico**

Mexico should, and I think does, aspire to join the ranks of the industrialized countries. It has had several false starts. In the late 1970s, oil and loans seemed a possible route to wealth; but that ended in the debt crisis of 1982, and the decade of lost growth. In the early 1990s, capital inflows returned, apparently responding to improved economic policies, along the lines of the famous Washington consensus, aided by NAFTA [and joining WTO and OECD]. But then this boom ended too, in the crisis of December 1994. The question is, did that event, and the East Asia crises of 1997-98, disprove the wisdom of the Washington consensus?

I think there is some truth in the claim that market discipline is a medicine that Washington prescribes for others and would not take itself. In the 1980s, we lectured Latin America on fiscal discipline, while we ran up record deficits. Even today, when the Mexican or Argentine economy goes into stagnation, the international financial community requires it to tighten fiscal policy. When the US economy slows down, we get a tax cut.

International financial markets do have a double standard. Perhaps investors are rationally remembering past excesses, or are simply learning too slowly about genuine changes, or are subject to their own fickle fads that are unrelated to economic fundamentals. In a sense it does not matter. When investors lose confidence, an explicit renewed commitment to policy reform seems to be the only way to keep them in. Otherwise, currency and securities prices fall, and interest rates suffer a more prolonged rise that they would otherwise. It may not be fair. But unless you are prepared to live without international capital markets altogether, which is not an attractive prospect, there is not a whole lot of choice.
The Washington consensus

I would distinguish between two different questions
1. Have we learned from recent crises in emerging markets that the Washington consensus is not to be recommended after all?
2. Does the US practice what it preaches?

My answer to the second question, is “usually, but not always.” As I have indicated, different rules sometimes apply to emerging markets and industrialized countries. But my answer to the first question is that the Washington consensus holds up better as policy advice, ten years later, than most people seem to think.

Let us go back and check the original list of recommended policies that were pronounced “the Washington consensus” in 1990, by John Williamson of the Institute for International Economics.

1. Fiscal discipline: deficits should be small. [I would add monetary discipline.]

2. Within public spending: education, health and public infrastructure investment are priorities, while subsidies (e.g., to energy) should be eliminated.

3. Tax system: the tax base should be broad and marginal rates moderate

4. Interest rates: should be market-determined, and positive in real terms

5. Exchange rate: should be at a competitive level (whether fixed or flexible), as an essential element of an outward-oriented trade policy (and “there is relatively little support for the notion that liberalization of international capital [portfolio] flows is a priority objective”).

6. Trade policy: imports should be liberalized; import licenses are the worst (they give rise to corruption), uniform tariffs are preferable if necessary.

7. Foreign Direct Investment: is good

8. Privatization: private industry tends to be managed more efficiently
9. Deregulation: as in the U.S.

10. Property rights: they matter. They are taken for granted in the US. But one of the things we have learned in the 1990s, especially from the difficult transition of the formerly communist countries, is how hard it in fact is to establish the rule of law and property rights for the first time.

One thing striking about this list is how little it needs to be revised ten years later. Hardly at all, I would say. [A major lesson to come out of the East Asian crises is that one should try to eliminate “crony capitalism” before opening a country to short-term capital inflows. But Williamson already had some of that on his list -- that liberalizing portfolio inflows should be low priority and that property rights and corruption were serious problems.]

To be sure, some other factors are also important to long-term growth; but they tend to be not always amenable to policy. High saving and investment are (along with human capital and openness both natural geographical openness and outward-oriented policies) the most important determinants. An equal initial distribution of income helps, but forcible redistribution is divisive and disruptive and undermines incentives and property rights. Political stability and economic freedom are both important, but are sometimes thought to conflict with each other. Finally, conditional on the right fundamentals, countries that start out farther behind will have a tendency to catch up, to grow faster than the front-runners. But, again, though these factors are important in the sense that they help explain growth in statistical studies, most of them are not necessarily policy levers that national governments can use.

III. Current Outlook

Mexico’s growth has been relatively strong for the last few years, and it has held the confidence of investors. When financial crisis hit Brazil 3 years ago, or Argentina subsequently, and when contagion threatened to spread throughout Latin America, Mexico seemed much less affected financially than in the past. Also, while some other countries in South America have threatened to move backwards in their political evolution, Mexico has continued to evolve in the democratic direction. It has been said recently that Mexico has moved from Latin America to North America. I am optimistic that this is indeed the case.
As of the most recent quarter, however, growth has disappeared in Mexico. Your current slowdown inevitably poses the question whether the last few years might be yet another “false start.” At the moment, I think your economic preoccupation lies with the US economy, our slowdown, the effect on Mexico, and the outlook. I will briefly devote the remainder of my remarks to these questions.

My view is that it was inevitable that the rapid growth rate experienced by the US during 1996-1999 (the years I was in the Clinton Administration) would not be sustained. By 2000 the economy was operating above its long-run potential. People were working longer total hours than they wanted to. Firms had trouble finding workers. A speculative bubble had carried prices of technology stocks to excessive highs. The business community had unrealistic expectations about ever-higher rates of profit. Last year, the long spell of good luck on prices and good macroeconomic policy finally came to an end.

Why did it happen in 2000? It is tempting for a former Clinton official to blame it on the change in Administration. But there are other plausible culprits. The unwinding of a Y2K boom in IT spending. A spike in energy prices. And the familiar pattern that ends many expansions: fear of inflation led the Fed to raise interest rates, perhaps a bit too far in 2000.15

A slowdown from 4 ½% growth to 1% growth in many ways feels like a recession. I would like to stress that I don’t think that the US economy has gone into recession. I happen to sit on something called the Business Cycle Dating Committee of the National Bureau of Economic Research, which is the official arbiter of when US recessions start and end. This committee has not yet found it necessary to meet in person to discuss the current slow-down, and indeed its rule is that it doesn’t meet until a turning point in the business cycle has become obvious and well-established. Nevertheless, we keep track of what is going on. Speaking for myself, I do not think we are necessarily going into a recession. Nor, on the other hand, do I think that we will return soon to the 4 ½% growth rates of the late 1990s, or even the 3.2 % growth rate that the Bush Administration has found it convenient to forecast for 2002. My best guess is that we will remain for awhile somewhere in between, perhaps at 1% this year and 2% next.
One reason I do not expect an outright US recession is that monetary policy has eased so much (300 basis points so far this year, as of Tuesday). It is true that clear effects have not yet been felt -- not even in long-term interest rates or the value of the dollar, let alone in the higher levels of spending that low interest rates and a low dollar should stimulate. There are some who say monetary policy has lost the ability to stimulate the economy. But monetary policy has always worked with a lag of a year or more. I expect the same to be true this time.

But I do not expect the economy soon to go back to 4 1/2% growth because I think the long-run potential growth rate is more like 3%. And it may take another year or so to get back even to that. We have yet to see the long-awaited downward adjustment of household consumption, for example.

The Mexican economy has its own mixture of policy and luck, and part of the luck is what happens in the United States. The slowdown in the US has both positive and negative effects on emerging countries. The negative effect, of course, is the loss in exports to the US. The positive effect is that US interest rates have come down sharply this year, which eases the debt burden in emerging markets. In most countries today, financial factors are more important in determining swings in the balance of payments than trade. In the case of Mexico, however, the close proximity and heightened integration with the United States mean that the export factor is more important than in, say, Argentina. So a slowdown in Mexico is the readily-explained consequence of the slowdown in the United States.

**Exchange rates**

I will conclude with a few words about exchange rates. If there was a bubble component to the US expansion of the last five years, then that bubble has persisted in the dollar longer than anywhere else. Even after the stock market peaked, the real economy slowed, and interest rates fell, the dollar continued to appreciate. In my view the dollar has been overvalued against the euro. But regardless whether one views the appreciation of the dollar as fully justified by fundamentals or not, it has created trouble for emerging markets whose currencies are tied to the dollar. Here I see a favorable outlook. I think the dollar may have finally reversed trend, which would make things easier for Latin America.
Argentina is the clearest example. A big part of its problem in recent years has been a loss of competitiveness stemming from the tight link between the Argentine peso and the dollar. The currency board is looking far less attractive than it did seven or eight years ago. Nor do I think that, for a country as large and independent as Argentina, that going all the way to formal dollarization would solve its problems. In some ways, Mexico is better suited to such links to the dollar. The conference I mentioned in San Miguel Allende two years ago was chaired by Robert Mundell (the week before he was awarded the Nobel Prize in Economics). A number of the key participants were urging Mexico to consider a currency board or dollarization. But my own perception is that Mexico values its monetary independence too highly for that. The floating peso has served Mexico well during the stormy crossing of the last six years; a peg probably would not have survived. On the other hand, the recent appreciation of the peso reminds us that floating currencies can become overvalued as much as pegged currencies, and can be subject to speculative bubbles as easily as pegged currencies are subject to speculative attacks. The conventional wisdom in recent years has been the “corners hypothesis” – that countries need to adopt either institutionally-fixed pegs, like Argentina’s currency board, or freely floating currencies, like Mexico and Brazil. But it seems to me that the intermediate regimes are starting to look better than the corner regimes. For Mexico this would mean managed floating, allowing capital inflows to increase the level of foreign exchange reserve flows rather than primarily to appreciate the currency.

Notes

1 including from the White House, in a ill-advised attempt simultaneously to lower expectations and to pass its proposed tax cut.
2 due both to the appreciation of the dollar in the second half of the 1990s, and to deflation in some partner countries, particularly in East Asia.
3 A decade ago it looked like the country was doomed to a pro-cyclical fiscal policy of pursuing fiscal expansion when times were good and finding discipline only in time of recession, the one point in the business cycle when raising taxes was least appropriate. Counter-cyclical fiscal policy may not be an option available to emerging market countries; but there is no need for the United States to run a pro-cyclical fiscal policy.
subsequent collapse of LTCM. In September 1998 President Clinton gave a key speech on the international financial crisis. In it, he opined that inflation was no longer the biggest fear for monetary policy. [The speech included other steps to address the financial situation as well. The President escalated the rhetoric urging the Congress to vote the US share of a quota increase for the IMF and the New Arrangements to Borrow. Michael Waldman, POTUS Speaks, (Simon and Shuster, New York, 2000); and J. Frankel and N. Roubini, “The Role of Industrial Country Policies in Emerging Market Crises,” in Economic and Financial Crises in Emerging Market Economies, edited by Martin Feldstein; forthcoming (University of Chicago Press, Chicago).] Soon thereafter, the Fed lowered interest rates, and the world’s other central banks followed. This turned out to be the critical point for turning the corner on the year-old financial crisis in the world’s emerging markets.

5 Even if, in retrospect, the tightening of 1999-2000 may have gone one step too far.

6 Incidentally, the pattern of central bankers who seek to establish a reputation for monetary discipline early on in their career fits the new ECB well. That is the reasonable explanation for what looks like a fairly high-interest-rate monetary policy.

7 It now stands at 26% (imports plus exports, including services, which have increased especially rapidly). \[
\frac{[1097b + 1468b]}{9963b} = .257 \text{ in 2000.}
\] Taking merchandise alone, the number is 20% of GDP; this is the measure that has tripled.

8 My statistical relationship says that every additional 1% in the openness ratio (merchandise X+M/GDP) raised a country’s income roughly .33 percent over the period 1970-90. E.g., the difference between Albania and Singapore (say 200%) is an additional 66% of income. For the US, a .12 rise in openness since 1960 works out to a 4% contribution to per capita income.

9 \[
\frac{[1126.3b - 672.7b]}{[9318.5b - 7062.6b]} = .201.
\]

10 Concrete examples of the benefits of IT for the economy include firms’ inventory practices and outsourcing. The rise in measured productivity did not begin to show up until the late 1990s. But I am a fan of the Paul David hypothesis: it may take 20-40 years for the benefits of a technological revolution to be fully realized. The electricity revolution did not show up in productivity until the 1920s, even though the dynamo had been invented in the late 19th century. Some have discerned similar lags with steam power and the automobile.

11 I would also include the very unpopular move to managed health care in the 1990s, which helped reverse a strong upward trend in relative health care costs.

12 Particularly important are our labor markets, which are substantially more flexible than Europe’s. Even though many of Europe’s labor regulations were designed with the intention of protecting employment in Europe, they have often had the effect of retarding growth in employment. It is because our labor markets are flexible that we were able to create 17 million new jobs between 1991 and 2000. During this period, the working-age population increased by 14 million. In other words, private employment expanded so rapidly that we easily absorbed a reduction in the number of people in the military plus a substantial number of immigrants, while simultaneously bringing the unemployment rate down from 7 per cent to 4 per cent.

13 Another example is Reinventing Government, where the big innovation was trying to make government more efficient rather than just giving speeches about the need to do so.

14 Nevertheless, the main negative I see for the US now, paradoxically, is something quite different: We fail to realize that we have rarely had it so good overall. Americans are given the impression in the media that we have now moved into a time of economic difficulty, when it seems to me that in fact, by most measures, our economic wellbeing is still close to its all-time high. Thus we need to think about using our budget surplus to provide for the retirement of the baby boom generation, not to blow it on a big tax cut. Americans think we have high energy prices, when I think they have been too low. Thus we need to emphasize curbing the growth in demand for fossil fuels, not maximizing the supply. Some Americans believe it is a time to erect shields against threats from abroad, when it seems to me that the potential for international peace has rarely been better. Thus we need to think about encouraging North Korea and China and Russia to continue moving in friendly directions, and not to try to put up futile walls or to turn them back into enemies as the current US Administration may risk doing. But perhaps our greatest contribution to world peace is the demonstration effect. The existence of the United States shows that an ethnically diverse population can live in relative harmony and prosperity. If that inspires emulation in other parts of the world, that is the best foreign policy.
Also I think some initial comments from the Bush Administration were unwise, because they heightened recession fears. This may be why consumer confidence plunged after the November election.

It is possible that the reason long-term rates have not fallen like short-term rates is that the peculiar nature of the 10-year tax cut -- its incompatibility with a rational fiscal plan for the longer term -- have adversely affected long-run expectations. Such a pattern would be the mirror image of the favorable effect that the 1993 budget plan had on long-term interest rates and investment.

In 1994, for example, bad luck took the form of both internal political instability and external increases in interest rates.

much as the yen was overvalued against the dollar in 1995 (or the reverse in 1985).

Some say that a common currency is a necessary condition for an effective free trade area. My own view is that a common currency can eventually provide a very large boost to trade, but that there are also large disadvantages. It is ironic that three of the cleanest-floating currencies in the world today -- the American dollar, the Canadian dollar, and the Mexican peso -- belong to the three members of NAFTA. Overall, the economic integration of North America is continuing well despite the absence of currency links, and I see no reason why this cannot continue.