July 30, 2001

President Vicente Fox Quesada
Mexico

Presidente,

With this letter, I keep my long-delayed promise to write to you about the reactivation of economic growth in Mexico. I have studied the reports your collaborators sent me. Although these reports have proven indispensable, my letter does not address the close interpretation of the economic data nor deal with the technical details of policy. I lack the local knowledge needed to move at this level.

Instead, I try here to go to the heart of some of the problems and possibilities we discussed during our conversations in Mexico. Whatever advantage I may have in offering these observations and suggestions results from my situation as an outsider looking from a distance, and with greater detachment, at the predicament your government now confronts. This advantage is, of course, the reverse side of a grave disadvantage, which is the lack of intimate acquaintance with the circumstance. I cannot achieve the focused attention and the intimate insight into constraint and opportunity that may come with direct responsibility. I must take the advantages and disadvantages of my position as I find them, and do the best I can in the execution of this task.

What I lack in close connection, I make up for in empathy. I desire the success of your administration in the opening up of a new path for Mexico and for Latin America with more fervor than I can either justify or explain.

THE SITUATION AND THE TASK

Hoover or Roosevelt

All issues in your presidency have now been overtaken by a single overriding problem: the question whether to be Hoover or to be Roosevelt. To administer scarcity or to coordinate dynamism. It is true that you do not face a sudden crash. It is also true that just as the economic downturn in the United States has pushed Mexico down, so recovery in the United States will eventually bring Mexico up.

These qualifications, however, provide no reason for complacency. The consequences of the present economic decline may irreversibly tarnish your administration. They may they prevent you from keeping your promise to ensure high growth. They may also starve your social initiatives and poison your political ones. Moreover, the helpless dependence on rescue through a quick American recovery reveals a dependence on the United States so extreme as to cast doubt on the feasibility of any strong national project in Mexico.

A surrender to Hooverism -- the idea that Mexico must stoically undergo the interruption of growth -- would be a tragedy for you as well as for your country. All of your instincts and skills go toward action and production. You are not cut out to serve as a trustee of stagnation, and that is not the role the Mexican people assigned to you when they elected you.

Can you, however, become a Roosevelt? By becoming a Roosevelt I mean using the fight against recession to achieve a dramatic broadening of economic opportunity and empowerment. In this letter, I argue that there is a way to turn the present setback into a breakthrough. This way is not radical in its methods. It does not affront the established macroeconomic orthodoxy about sound management of monetary and fiscal policy. It is, however, unconventional. It requires imagination in conception and boldness in execution. Like any serious, transformative program, it will provoke disagreement and conflict. However, it can also help trigger the organization and alignment of social constituencies and political groupings capable of sustaining it.

Faced with the choice between passive resignation and active resistance to it, the temptation may be great to hedge your bets and split the difference. It is a bad escape: it will irritate without overcoming, and tantalize without satisfying. I argue here for a course of decisive action.

Constraints on economic reactivation

Three circumstances, together, define the special character of economic slowdown in Mexico now. These same circumstances also shape your possible response.

The first circumstance is the extreme dependence of the Mexican economy, especially of Mexico's foreign trade, on the economy of the United States. To moderate this dependence should be one of your goals. Moderated or not, it is likely to remain overwhelming in the immediate future.

The second circumstance is the unvailability to you of the traditional forms of expansionary monetary and fiscal policy. Monetary policy lies in the hands of an independent Central Bank that remains focused, under its inflation targeting regime, on monetary stability to the near exclusion of any concern with growth. (I shall have more to say below about the nature and implications of this orientation.)

The room for expansionary fiscal policy, in the conventional sense, is drastically restricted by the need you recognized early to increase the abysmal tax take of the Mexican government. Moreover, given the views prevailing at the Bank of Mexico, any failure to raise more money in tax without also spending less money would likely cause the Central Bank to adopt an even more restrictive monetary policy.

To recognize these facts is no license to embrace as a good the commitment to fiscal austerity and monetary restraint in the midst of a severe recession. Do not fool yourself. This not economic orthodoxy. It is the pseudo-orthodoxy the rich countries now try to impose on the poor countries, and the strong on the weak. It is one thing for you to find your hands tied. It is another thing to commemorate their being tied as a token of virtue. Your job is to find a way to untie them.

The third circumstance is more removed from the agenda of economic policy and the discourse of the business press. However, it imposes what is by far the most important constraint on the prospects of the country. A vast part of the economically active population continues to lack the barest access to the resources and opportunities of production -- technical or professional education, credit, and the prospect of a decent job in an organization run on the basis of merit. The production system remains thin in its ability to substitute imports and to export products made with Mexican components.

As a result, in an economic downturn such as the one that is now beginning to take place in Mexico, a frightening series of events have occurred, almost unnoticed. They are characteristic of the performance of the Mexican economy in a downturn, but no less destructive for being predictable. As the economic slowdown has deepened, unit costs have gone up and productivity has gone down. Productivity growth in the industrial sector -- the single most important predictor of the future of the Mexican economy and of the evolution of the real wage -- has now fallen below 2%. And, in the first quarter of 2001, as the growth rate of imports of both capital goods and intermediate goods fell precipitously, the import of consumption goods grew by almost 30%. The appreciation of the peso, supported by substantial inflows of capital from abroad, and by the confidence-mongering of the Central Bank, has subsidized the consumption of the comparatively well off.

The problem of restrictive monetary policy

The single-minded pursuit of monetary stability to the detriment of any commitment to rekindle economic growth in a country in which tens of millions of people remain desperately poor might well be condemned as perverse. The international and Mexican business press salute this orientation as a demonstration of orthodoxy. The truth, however, is that it is not first-world orthodoxy to maintain a restrictive monetary policy in the face of a dangerous recession. It is an abuse of inflation-targeting procedures to apply them without regard to a rapid decline of real economic activity.

This policy may be ineffective, even for the narrow purpose of minimizing inflationary pressures. As domestic production and imports of capital and intermediate goods plunge, the urge to consume remains strong, and imports of consumption goods continue to rise. It is a recipe for further inflationary pressure, even in the throes of recession. The result is to give a pretext for further restraint in monetary policy, thus closing a circle that squeezes the Mexican economy dry.

Such is the pseudo-orthodoxy that the financial markets and the IMF now press upon the governments of developing countries. They find in many of the central banks enthusiastic agents of this doctrine. This pseudo-orthodoxy is best understood as a functional equivalent to the late nineteenth-century gold standard. Like that regime, it treats the ability of governments to initiate growth strategies without having to win the prior approval of the financial markets strategies of national development as the problem rather than as the solution, and the dependence of governments on the winning of financial confidence as the solution rather than as the problem. All the more reason to question the wisdom of central bank independence in a country like Mexico.

Here, however, is the surprising fact. It is not worth picking a fight with this restrictive monetary policy or with its agents and supporters. The cost would be great. The benefit would be small. And the most promising line of solution lies in a direction that avoids confrontation. Interest rates have in fact come down. And although they are not at first-world levels -- especially not at the first-world levels characteristic of economies in recession -- they are at least within striking distance of first-world interest-rate levels in periods of economic growth. In Mexico the effect of lower interest rates on decisions to consume and to invest is far weaker than in the first-world economies or even than in the economies of many other developing countries.

IT IS NOT WORTH PICKING A FIGHT WITH THE CENTRAL BANK, BECAUSE MEXICO LIVES UNDER A REGIME OF CREDIT RATIONING. For much of the economy, and over a vast range of decisions to invest and consume, the problem is less that credit is too expensive than that it is simply unavailable. It is a constraint that applies forcefully to the vast majority of businesses as well as of individuals in Mexico, who lack access to the international credit markets.

The story is familiar. Mexican banks have the local knowledge to lend money to firms and consumers, but neither the incentives nor the culture to do so on a large scale, or across the broad range of economic activities. Foreign banks in Mexico may be more disposed to lend. For the most part, however, they have not yet either acquired the local knowledge or built the national branch system that would be needed. Nor have they yet had to contend with regulatory demands and market forces that might drive them to perform a role Mexican banks have left unfilled.

The failure of Mexican banks to fulfill the primary responsibility of financial institutions in a market economy -- the mobilization of saving for production -- is all the more unacceptable in light of the great sacrifices that the Mexican people have to had to bear to bail out the failed banks, a bailout that benefited the entire finance industry in Mexico.

The oppressive fact of credit rationing in Mexico makes the struggle for a more expansionary monetary policy, in its traditional form, less relevant. It also provides a clue to what should be a major element in a program of economic reactivation.

What can and cannot de accomplished through fiscal policy

The exclusion of expansionary monetary policy invites attention to the possibilities of expansionary fiscal policy. The room for fiscal maneuver, however, is narrowed by what continues to be a very low tax take.

I begin by reflecting on three errors in the conduct of your recent effort to raise the tax take by generalizing the value-added tax. The point is not to cry over spilt milk. It is to turn the lessons of the immediate past to good effect in the design of a reactivation program.

The first mistake was to present the tax issue in isolation from the broader program of economic growth and economic democracy that it would serve. It was not good enough to show, as you did, the additional social spending for the poor that the additional taxes would finance. You also needed to present the fiscal reform as an integral part of a program capable of bringing tangible opportunity to the broad majority of working Mexicans. But it is not too late; there is still time.

The second mistake was to cause so great a commotion, and to pay so high a political price, for what would have been a relatively modest increase of the tax take -- 2% of GDP -- even if the proposal had been accepted in its entirety. Given the price that had to be paid anyway, it would have been better to get more for it. A growth and inclusion program will neither require nor permit an across-the-board rise in general taxes. However, it will call for an aggressive use of tax incentives and penalties. To the extent that it succeeds, and begins to win a constituency, it opens the way for a new rise of the tax take in the mid-term future, with more tangible social benefit and less political cost.

The third mistake, albeit the least important, was the most noticed. The emphasis on what is an admittedly regressive tax could and should have been accompanied by further gestures toward progressive taxation. Such gestures could have taken the form of narrowly targeted exemptions from the VAT, in favor a few items characteristic of popular consumption. Alternatively, they could have offered a symbolic beginning for a future form of progressive taxation: for example, a small asset tax levied on very large fortunes. Once again, paybacks to the poor are not enough. A program for economic growth and economic democracy creates the opportunity to define the central direction of your administration.

In Mexico today you cannot promote growth by a general lowering of taxes and public spending. Even after your initial reform, both taxes and public spending remain too low to support a program of economic growth with social inclusion. However, you can and you must develop the ability of the government to use tax policy differentially, shifting the balance between finance and industry, between the money economy and the real economy, between consumption by the few and access to productive opportunity for the many.

The chief obstacle to such an unconventional use of fiscal policy in Mexican conditions is the difficulty of preventing its degeneration into a distribution of favors to a coterie of well placed interests. Mexico must not be force to choose between a government that resigns itself to passivity and a government that surrenders to lobbies. The government's economic activism, in fiscal policy as everywhere, must be rule-bound and performance-oriented. The program of economic reactivation therefore has to develop in concert with institutions and procedures that "deprivatize" the state. Such institutions must establish the instruments for decentralized, market-friendly, experimental coordination between government and private enterprise. The unconventional expansionary fiscal policy for which I argue in this letter makes sense only as part of that larger effort.

An unequipped population

The fundamental reason why tens of millions of Mexicans remain poor is the same basic reason why Mexico finds itself unable to maintain economic growth in the face of a downturn forced on it from abroad: the complete denial to most Mexicans of the economic opportunities and the educational equipment for effective action. The logic of my proposal is simple: the effort to reactive growth can and should be used as the occasion to democratize the market economy in Mexico, decentralizing access to the instruments of production, and establishing a new set of arrangements for the relation between government and business. Unlike the economic proposals, the educational reforms cannot be expected to have short-term effect. However, they can be launched in the same climate of national mobilization that the economic project requires and encourages. Further ahead, the economic and the educational programs can converge.

Given the reality of credit rationing, an unduly restrictive monetary policy is not the main problem, although it might become the main problem at a later stage. Given the need to preserve what remains an unacceptably low tax yield, your administration should not lower either taxes or spending. In fact, at the first political and economic opportunity, it should continue to raise both.

So what is required? First, the organization of a system of decentralized credit, both within and outside the banking system. Second, the parallel development of arrangements for technology transfer and technical assistance: the development, for the economy as a whole, of equivalents to "agricultural extension." Third, the immediate launching of programs of adult education and vocational training, in collaboration with private business and local governments and in the context of a nation-wide educational program. Fourth, the unconventional use of governmental initiative to supplement the limitations of scale and capacity of the emerging sectors of the economy, either by the facilitation of systems of cooperative competition and pooling of resources or by the direct public production or provision of key missing inputs and capital goods. Fifth, aggressive use of tax incentives, stretching to the utmost the limits imposed by the Nafta and WTO agreements, to encourage investment, import substitution, and the adding of value to assembly and export industries. Sixth, as an extension of the use of tax incentives, a pro-jobs program, committing the government to suppress all payroll taxes (as well as to replace such taxes by an increment to the value-added tax) and to subsidize, through tax incentives, the employment and training of low-wage workers. Seventh, the establishment of program for National Development Vouchers that would provide a means to inject liquidity into the economy and to finance the expansion of output and the creation of jobs. These vouchers would amount to a form of public investment collateralized by future tax receipts and tied in value to a index determined by the aggregate tax yield of the federal government and the rate of economic growth. They would help kindle growth without either spurring inflation (because they would be destined for productive investment rather than consumption) or confronting, head-on, the Central Bank. Eighth, the development of a rule-based, performance-conditioned deal with big private businesses in Mexico. This deal would be struck, sector by sector, through a series of high-visibility meetings intended to identify the bottlenecks to import substitution, to a broadening of exports and an improvement of their quality. The government would commit itself to break some of these bottlenecks -- through regulatory and tax breaks, initiatives to renegotiate constraints imposed by international agreements, public investments in infrastructure, and improvements to the supply of skilled labor and technology -- in return for measurable commitments to invest in areas crucial to the strategy of economic growth.

The first four of these directions give practical effect to the attempt to connect the program for growth with the broadening of opportunity. They tap the underutilized energy of the broad majority of working Mexicans, who want to become more productive but cannot. The fifth and the sixth make up, though the unconventional use of tax instruments, for the limitations of conventionally expansionary fiscal policy. The seventh compensates for the unavailability of conventionally expansive monetary policy as well as for the relative inefficacy of such policy under conditions of credit rationing. The eighth takes advantage of the resources of big business to shape a practice of strategic coordination between business and government that is consistent with the commitments to respect the market and to "deprivatize" the state.

THE NEW ENGINE OF SOCIALLY INCLUSIVE GROWTH: EQUIPPING THE UNEQUIPPED

Forging new ways to finance broad-based production and popular consumption

The combination of economic recovery with the democratization of the economy requires a bold overcoming of the constraint imposed by the fact that credit remains rationed, despite the relatively low level that the underlying interest rate has now reached.

The effort to overcome credit rationing should be anchored in a commitment to develop, out of the existing public banks, a grassroots network of bank branches able and willing to lend to small and start-up businesses. The development of this network should be accelerated under a fixed timetable, conceived and executed in the same climate of wartime urgency that should mark the remainder of this program.

The private-sector banks should be told that the development of this grassroots bank network by the federal government will continue on so long as they fail to do the job themselves. They should be assured of the government's intention to privatize the network as soon as the private banks demonstrate that they are able and willing to undertake the task. Foreign banks should be treated equally with Mexican banks, and their relatively greater interest in retail lending exploited as a prod to their Mexican competitors.

The effort to engage the private-sector banks may in turn lead them to pressure the Central Bank to loosen monetary policy in relatively limited forms, such as the lowering of the reserve deposit requirements. The loosening of monetary policy in direct conjunction with the financing of production should be much less troubling to the monetary authorities than would be pressure to lower interest rates across the broad. In such a context, bank regulation needs to become both more effective and less burdensome.

In principle, there is no reason to believe that the extension of bank lending to businesses would risk causing a rapid increase in non-performing loans, so long as two conditions are met. The first condition is that credit programs be administered independently and professionally, and under suitable internal and external supervisory procedures. The second condition is that the macroeconomic environment not degenerate ruinously, which is the very risk the entire reactivation program seeks to avoid and reverse.

The creation of a national, on-the-ground network of business-oriented lending should not be confused with "mini-credit," in the style of the Grameen Bank. It should be compared, instead, with the successful struggle, in nineteenth-century America, to develop local banks and credit unions. It is an initiative addressed to the millions of Mexicans who want to build a business, not to a Gandhian fringe of artisans.

The construction of such a network in Mexico should be accompanied by a concerted effort to develop mortgage-backed home buying, supported by a secondary market in mortgage-based securities. Comparative experience demonstrates that a mass practice of mortgage-based home buying exercises vast and connected effects on the level of saving as well as on the level of activity and employment.

The greater organized saving associated with the development of a mass practice of mortgage-based home buying would help diminish Mexico's dependence on foreign capital. In so doing, it would also broaden the room for maneuver in the formulation of a national project. It would come to the rescue of a construction industry that, now depressed, has the potential to stand in the front line of a broad-based economic recovery. And it would help form the constituency of small-property stakeholders on which the future of this entire political and economic program depends.

Now that the basic interest rate in Mexico has reached a level compatible with the popularization of mortgages, a second obstacle remains to be overcome: the term structure of finance, that is the ability of financial institutions to organize long-term lending and borrowing, as well as the long-term saving that helps make long-term lending and borrowing possible. The development of the term structure of finance requires, above all, confidence in the ability to master economic uncertainty, to keep it within bounds and to hedge against its destructive consequence.

Has Mexico acquired this ability in sufficient measure to dispense with bold action by the government? No one can know unless the government itself tests the limits by taking the initiative.

The way by which the government would take the initiative does not require that it develop public mortgage lending facilities, as under the present Infonavit program. Neither, however, should you exclude such direct governmental action. The measure of governmental activism, in this as in all other aspects of this program, should be determined experimentally, rather than on the basis of preconceptions and ideologies. A paramount consideration should be what the government needs to do to do bring the private sector along.

The experience of the United States is telling. The mortgage market is central to the American system of long-term saving and investment. It is unthinkable in its present form and vast dimension without two governmental supports: the mortgage interest income tax deduction and the practice of mortgage securitization through the unique, semi-public Fannie Mae and Freddie Mac agencies. Through this system, the federal government effectively guarantees the credit risk in mortgages up to a certain ceiling, thus lowering the price of mortgages and homes and establishing the basis for liquidity in the mortgage market. This liquidity has in turn made possible the development of a secondary market in mortgage-backed securities, practiced on a mass basis by the same semi-public entities, thus contributing to an enormous deepening of the American capital market.

Mexico needs some such device, whether or not combined in its initial stages with a broadening of public mortgage lending to low-income home buyers. There is great interest among fund managers in the United States in long-term peso-denominated Mexican securities indexed to inflation. The development of a secondary mortgage market in Mexico, predicated, as it would have to be, on a solution to the problems of the term structure of finance, would enable Mexico to access large pools of American capital.

Generalizing the example of agricultural extension

Agricultural extension is the name commonly given to decentralized public assistance to farming, especially to family-size farms. It emerged in the nineteenth-century, both in the United States and in some European countries, as part of the effort to develop family farming on the basis of a series of partnerships between the family farmer and the local and national governments. The core of agricultural extension was the combination of direct technical advice and assistance to the farmer with the facilitation of access to information, technology, and markets and the encouragement of networks of cooperative competition among the farmers. The farmers in such networks competed among themselves while pooling some resources and efforts.

In no country has the system of agricultural extension been generalized to the non-agricultural economy. (On the other hand, cooperative competition has become a mainstay of some of the most successful regional economies in the world, from Silicon Valley to north central Italy.) Yet such a generalization is precisely what Mexico now needs as part of a program for economic reactivation.

I doubt that any of the existing development banks or agencies in Mexico offer a suitable starting point for such a national effort. It may be better to begin from scratch, with a National Development Organization that would emphasize the opening of access to credit, technology, expertise, and markets. Such an agency would have to commandeer for its own use some of the offices and personnel of existing federal establishments throughout the country as well as to build new offices and hire new personnel.

Its most important jobs would be: (1) to screen individual workers for jobs and training programs;(2) to administer such programs in cooperation with private business; (3) to identify technologies and practices suitable to the needs and capacities of small and medium-sized enterprises and start-up business; (4) to make such technologies available, especially by joint-ventures both with Mexicans firms and with public or private firms in other parts of the world (e.g. China and India); (5) to identify and help propagate the most successful local business practices; (6) to support the development of cooperative-competitive networks among groups of small and medium-sized businesses; (7) to work with larger export-oriented firms in efforts to identify and overcome obstacles to the deepening of "clusters" or "chains" of enterprises in established capital-intensive sectors of industry; and (8) to fund and direct, preferably in partnership with private firms, a few strategic production initiatives that would make simple technologies available to groups of smaller, less advanced businesses, or that would contribute to the emergence of clusters of world-standard enterprises.

Everything except money. Yet rapid economic reactivation is impossible without a massive expansion of access to credit. How is such an expansion to be achieved under the prevailing restraints of a relatively restrictive monetary policy adopted by the Central Bank? And how can it be made fiscally and financially responsible?

Expanding credit under conditions of monetary restraint

The government does not, and will not, have either the money or the personnel to lend money, prudently and effectively, on the vast scale that is needed for a program of economic reactivation and reorganization like the one I propose here. How can the government gain the most benefit from its limited financial and human resources? How can it use these resources to lay the basis for a deepened and decentralized credit system, one that can learn to dispense with the crutch of public intervention and assistance?

The basic solution lies in the relation of public screening and public guarantees to private lending. The government would act in three ways. First, it would work with the private-sector banks to establish an agency that would screen for credit risk small, medium-sized and start-up businesses. It would also establish, together with the private sector banks, a training program to form the personnel needed for the decentralized credit efforts I next describe.

The second form of governmental initiative would be the provision of credit enhancement: the award of partial public guarantees of the loans made by the private or public-sector banks to such screened debtors. These guarantees would compensate for the inability of the private borrowers to provide sufficient collateral. To limit moral hazard problems, however, the public guarantees would offer only partial coverage of the credit risks. It is a solution analogous to the Fannie Mae and Freddie Mac mortgage system as well as to the use of IMF or United States Treasury money to guarantee government paper in some of the sovereign-debt restructurings of the recent past.

Such a system can work on a large scale only if the private-sector foreign and Mexican banks can be persuaded quickly to expand their retail banking operations. The professional credit screening and the partial public guarantees would compensate for the relative costliness of the small-scale lending, and make possible cost-effective administration of a loan portfolio with what should be (to judge by comparative and historical experience) a relatively low level of nonperformance.

In the present Mexican environment, foreign (and especially the Spanish) banks seem the most likely pioneers in this effort to democratize credit under the aegis of a decentralized public-private partnership. If necessary, they should be offered other advantages to induce them to begin the process, in just the way that a foreign investor might be induced to make large capital investments in transport, communication, and energy. And the federal government should encourage the expansion of Mexican banks that could use their comparative advantage of local knowledge and connections to develop a national branch network.

The third initiative would be a public-private venture capital system, focused on start-up businesses, particularly those with the potential to replace imports, to add value to exports, or to multiply linkages between the more advanced and the more backward sectors of the production system. Such a venture-capital system should become a private-sector business as soon as possible. It may, however, have to begin as a public enterprise, following the example of the public venture funds with which the European Union has been experimenting. Given the unavoidable limitation of scale, the goal would be to launch a broad range of experiments at the production frontiers of the Mexican economy.

Such experiments could help inspire the transformation of the Mexican economy in two distinct ways. Some of the experiments would show how advanced economic practices can be made useful to smaller, relatively uncapitalized businesses. Others would help push Mexican production beyond the practices of standardization and copying that now characterize it at all levels.

REINVENTING FISCAL AND MONETARY POLICY IN THE SERVICE OF GROWTH

The central idea

These initiatives in favor of socially inclusive growth cannot achieve their potential, either for growth or for inclusion, unless they take place in a favorable macroeconomic climate. If the practical and psychological forces of production are bound, hand and foot, by contractionary monetary and fiscal policy, such initiatives will remain dwarfs. And nothing is more pathetic, Carlyle remarked, than a three-foot pyramid.

Yet your government cannot now give a conventionally expansionary form to either monetary or fiscal policy. Monetary policy lies in the hands of a Central Bank that, under the guise of inflation targeting, has bowed down to the cult of financial confidence, and accepted the self-mutilation the rich countries recommend to the poor ones in the name of sound finance. Even if you were able to force the Central Bank to cast this false orthodoxy aside, the benefit would be limited by the reality of credit rationing, while the price -- in loss of financial confidence -- would continue to be paid. The use of expansionary fiscal policy is inhibited by the need to struggle against the cripplingly low tax take. It is limited as well by the pressure to placate the prejudices of the domestic and international financial markets, so long as you continue to need their money as well as by the wisdom of not provoking the Bank of Mexico into a yet more restrictive orientation. In this contrast -- between the need for an expansionary economic environment and the exclusion of the traditional monetary and fiscal means for achieving it -- lies the most formidable obstacle to a program of economic recovery in Mexico now.

There is a way out. It need not affront either the rights of property or the true orthodoxy of the economics textbooks. It does not require head-on combat with the Central Bank. Nor does it imply any lessening of the effort to raise the tax yield. It requires a courageous and creative response to the circumstance of the place and the moment. Its prospects depend on its association in the popular mind with the effort to equip the unequipped, on the rapidity with which it can stoke the fires of production, and on the success of your government in developing new political and social bases for its execution.

The unconventional use of fiscal policy

I begin with the more familiar part of this set of proposals: the use of tax incentives and disincentives. After proposing a list of the most important contexts in which you should consider using differential fiscal policy as part of a program of economic reactivation, I address the major objection to such a practice: the idea that it represents a dangerous invitation to both dogmatism and clientelism -- picking winners and picking favorites, or picking losers and picking victims.

It should be the aim of this part of the program of economic reactivation to maintain and even heighten the overall tax yield. However, the emphasis should fall on lightening the tax burden, over an extended transitional period, for businesses that commit to the recovery program rather than on punishing, by higher tax rates, those that do not.

Because these proposals are all designed to break through supply constraints, they should turn the government's tax sacrifice into a medium-term increase of the tax take. The goal of maintaining the tax revenues should be understood dynamically rather than statically: the focus is on the aggregate effect over a reasonably short time -- your own "sexenio" -- but over time nevertheless. For the general character of these proposals, as of every part of this program, is to combine the democratizing of the market with the mobilization of national resources, finding new engines of growth in the economic enfranchisement of the disenfranchised as well as in the restructuring and reorientation of established business.

In this sense, my proposals for differential fiscal policy, like the entire program of which they form a part, represent less a revived Keynesianism than a progressive intervention on the supply side. Insofar as they address the expansion of demand, they do so only by simultaneously and actively seeking a breakthrough in supply constraints. Translated into the language of multiple equilibria, they seek to reach a high-level equilibrium -- more growth, productivity, and employment -- through a series of engineered and controlled disequilibria.

Consider the following fields as leading candidates for fiscal incentives and disincentives.

1. Employment and training of low-wage labor. Not only should all payroll taxes on labor be repealed, but ways should be explored to provide tax incentives for the employment and training of low-wage and unskilled or semi-skilled labor. The incentives might be provided, for example, by allowing for credits against other corporate taxes.

Business that boost productivity, economizing on labor should not be punished. But capital-intensive firms that want to deal with the government or its banks, as suppliers or clients, should be required to demonstrate their commitment to training and employment programs for new workers and job seekers. In this way, the business interest in developing a pool of more qualified candidates can be made to serve the public interest in higher employment and stronger skills.

2. Higher value-added production for export. To the extent compatible with the Nafta and WTO agreements -- testing their limits, as you should -- reward businesses that add value in the process of manufacture and export with tax breaks, and punish those that do not with heavier tax burdens. The international restraints on such a policy are likely to become acute in the implications for domestic content. However, it is vital to establish the case for distinguishing the issue of domestic content from the issue of technological evolution, despite the causal connection between them.

3. Production of capital goods and inputs for the rearguard. A major aim of the differential use of tax policy should be deepen linkages between the vanguard and rearguard sectors of the economy. More capital-intensive and technology-rich industries should produce machines and materials useful to the more rudimentary industrial, commercial, and agricultural enterprises that remain oriented to the domestic market. An example is the simplified computer that has been developed in India, with a vast range of economic and educational uses.

The government should establish. in partnership with domestic and foreign private enterprise, a joint public-private organization for the assessment, transfer, and production of suitable, cost-effective technologies. It should facilitate credit (on market rates) to enterprises that serve the production needs of firms of all scales that are oriented to the domestic as well as the foreign market. And it should give to enterprises that are willing to embark on the advanced production of simplified capital goods, inexpensive inputs, and innovative, simplified, and cost-effective technologies, a substantial grace period in the payment of the value-added tax, subject to performance-based review some time during that period.

4. The location of manufacturing facilities in the South, in the context of a concerted policy of regional development. The tool could, once again, be the award of an extended grace period in the value-added tax. Such a policy should not be

formulated and imposed from the top. It should be negotiated, with broad-based participation by experts, local governments, social organizations from the region itself as well by businesses that are willing to consider participating.

The key question in the use of tax incentives and disincentives in all these fields is not the aggregate effect on the tax take and the need to prevent serious tax loss. It is the ability to develop and deploy differential fiscal policy without sinking into political favoritism and economic dogmatism. Mexico cannot accept a choice between laissez-faire and favoritism, between a government that does nothing for production and a government that surrenders to lobbies.

In seeking to escape this impoverishing choice, Mexico must develop a form of government-business relations that offers an alternative to both the American model of arms'-length regulation of business by government and the Northeast Asian model of centralized formulation of trade and industrial policy by a national bureaucracy.

The alternative arrangements and practices the country need should be rule-based and performance-oriented, keeping administrative discretion to a minimum. They should be decentralized and participatory, providing for the engagement of interested firms and groups in a range of different venues. They should condition every measure of fiscal favor on its utility to the entrance of new firms and groups into the national and international market. And they should be pluralistic, having as their goal the development of multiple programs of strategic coordination that would coexist experimentally with one another, rather than the imposition of a single master plan. It is a prescription that applies to this entire program of growth and inclusion, as well as to the special problems of differential tax treatment.

Compensating for the lack of expansionary monetary policy: liquidity without inflation

The creation of a growth-friendly climate requires the unconventional use of monetary as well as of fiscal policy. The quasi-monetary part of my proposal is as unorthodox as the fiscal part is familiar. It nevertheless represents an indispensable part of this program. Although it is unconventional, it violates no rule of the true core of sound public finance. It merely loosens the grip of a contractionary policy, imposed in the name of financial confidence, in the midst of deep recession -- a practice, I insist, that although now commonly accepted by third-world governments, cowed by high finance and central bankers, is foreign to any generally recognized orthodoxy in contemporary economics. By loosening the grip of that recession-aggravating policy, this part of the reactivation program gives to the needs of the real economy the priority they deserve.

My proposal here serves three objectives. The first goal is to create an instrument for countercyclical management of the economy when the traditional fiscal and monetary devices of such management are unavailable. The second aim is to inject liquidity into the Mexican economy without provoking inflation through a consumption boom and a wage-price spiral: every part of the boost to liquidity remains tightly linked to the expansion of production. In the vocabulary of multiple equilibria, the point is to force movement from a lower-level equilibrium to a higher-level one. The third purpose is to link more tightly the mobilization of national resources and the democratization of economic opportunities. The additional liquidity is for the sake of broader opportunity as well as more activity.

In light of these considerations, I propose a system of National Development Vouchers. (I use the term "voucher" rather than "bond" to avoid some of the financial connotations and legal implications of the latter.) The government would issue National Development Vouchers in partial payment for development-oriented public works, at many different scales, all the way from the small to the massive. The public works program would include highways, dams, irrigation systems, public housing projects, school buildings, and community or medical centers.

The vouchers would be collateralized on the basis of future tax receipts. They would have a fluctuating value, indexed to an index that would be composed of two elements: the growth rate of the national economy and the level of tax receipts of the federal government. They would be payable directly by the government on a relatively short schedule, with the preponderance of the obligation to be met during your "sexenio." They would trade in a secondary market, which the government, together with domestic and foreign financial institutions, would help organize, so that those who accepted this paper in payment of governmental obligations could cash it in, at a significant discount, in this secondary market. The government would ensure the firms it paid with this paper of a floor to the discount in the secondary market, holding them secure against catastrophic loss and breathing confidence into the secondary market.

The use of the vouchers would be restricted to a list of areas of investment connecting economic growth with social inclusion. To ensure this connection, as well as to develop the institutional machinery of economic democracy, the range of permitted use would be the subject of an organized and ongoing discussion with three sets of groups: (1) organizations representative of different sectors of civil society, (2) businesses, especially construction businesses, which would have to rank high among those who accepted National Development Vouchers in partial payment for their goods and services, and (3) financial organizations, especially the banks, primarily private-sector banks, that would help set up the secondary market in this security.

I propose that there should be separate and simultaneous series of discussions between the government and each of these sets of groups as well as a general venue in which representatives of all would meet together. On the side of the government, the development ministries and agencies would have to work closely with the finance and tax authorities. The whole regime of negotiation would make a powerful contribution to a new form of "social partnership." These instruments for the ongoing renegotiation of what is a a social as much an economic contract would be born free from the grip of the decaying corporatist institutions of the PRI regime.

The economic logic of this National Development Voucher system is straightforward although the device through which this logic operates may appear heretical. The central purpose is to create not a generic power to spend, which can be dissipated in consumption and inflation, but a focused power to invest in productive activities capable of addressing the needs of tens of millions of people, and of creating jobs and opportunities for them. The use of indexes keyed to economic growth and tax receipts has recently been a subject of sympathetic discussion in economics, and would win the support and even the enthusiasm of many progressive economists throughout the world.

The greatest objection to this proposal will be its novelty. The second greatest objection is that it may be seen as a circumvention of the tight money policy of the Central Bank. Both these objections must be met head on. Mexico must do what every other successful country in modern history has done before it: open and invent its own way, picking and choosing from around the world, but forging the whole into a path of its own.

As to the Central Bank's preference for a restrictive monetary policy, pursued in the midst of a deepening recession, with potentially calamitous social consequences, this proposal allows you neither to attack it outright, nor to accept it with bowed head. It is the duty of any Mexican government committed to economic growth and social inclusion to find a way out, rather than to wait passively for the Mexican economy to be taken down, and then up again, by the economy of the United States. This proposal maintains the essentials of sound public finance while combating the self-mutilation recommended by the pseudo-orthodoxy of deliberate contraction in the midst of recession. It does not take the Wall Street-IMF. line (for third-world countries) on a take-it-or-leave-it basis. It splits that line into an element that can be accepted, and an element that cannot. It avoids the scourges of economic populism and high inflation, but gives commanding authority to the needs of the real economy.

STRIKING A PRO-GROWTH DEAL WITH BIG BUSINESS

The effort to equip the unequipped, and to find a surrogate for the conventional tools of expansionary fiscal and monetary policy, should be capped by a a pro-growth deal with big business. I begin with two preliminary observations that orient this part of my proposal.

The first remark is that Mexico suffers gravely from the absence of any world-class industry, in any sector of its economy. Outside the oil and gas industry, no area of Mexican production stands at the front line of international benchmarks. The successful assembly of consumer durables, for example, remains an imitative industry, operating with low domestic content and with modest skill-enhancing effects on other sectors of the Mexican economy.

The consequences of this absence of world-champion industries far exceed its immediate and tangible implications. The lack of standard-setting industries deprives Mexico of a factory of ideas, capacities, and ambitions. It robs the rest of the economy of a source of creative pressure: of bottlenecks that need to be broken and low expectations that need to be overcome. It contributes to a sense of helplessness in the face of external events, such as the recession now imposed from across the border. And it is unnecessary.

The second remark is that a creative response to the present recession can serve as an opportunity to remedy this costly failure. In devising such a response, it is crucial, however, to distinguish the end from the means with which that end has, traditionally but wrongly, been associated. There is increasing evidence that the ascent up the ladder of productivity and comparative advantage in the world economy depends on consolidating positions in lines of production that are sustained either by economies of scale and scope, or by the accumulation of specialized skills, or by some combination of these two sets of favoring circumstances. The conquest of such niches is not the natural and continuous outcome of patient diligence in playing whatever hand the international distribution of comparative advantage happens to have dealt a country. It is the discontinuous result of private and public initiatives, working together.

So much for the goal. This aim is, however, often associated with the top-down choice by government of the right sectors by which to rise to lead the economy toward higher productivity and greater international advantage: "picking winners." It is a false association. The centralized choice of new niches for national production and international competition by a bureaucratic apparatus represents an extreme, limiting case in a spectrum of forms of strategic coordination between government and business. It may work in special circumstances, but even then at great risk of degenerating into favoritism and dogmatism. It often proves a costly shortcut.

There is no need to choose between letting established market forces (as opposed to the forces generated by a redesigned market) run their course and surrendering the choice of strategy to a cadre of enlightened bureaucrats. There is a collective action problem to solve, and in most situations it can best be solved by a form of open, decentralized and experimental coordination. Such a practice will be anxious to encourage new clusters of production in promising sectors and to help break the constraints that prevent their consolidation. However, it will be reluctant to impose a single line from the top. It is in this spirit that I explore a pro-growth deal with big business.

I propose two parts of such a deal.

The first part of the deal is a negotiation with the leaders of big business in each sector to exchange a commitment to resist the recession through strategic, productivity-enhancing investments. In this negotiation there should be no master plan, no standard terms, only an ad hoc, sector-by-sector set of understandings. The business leaders should be persuaded to make specific commitments to forward-looking investment in their respective fields. In exchange, the government should offer to break crucial bottlenecks.

Depending on the circumstances of each sector, these bottlenecks may lie in: (1) the energy, transport, and communication infrastructure of production; (2) the supply of skilled labor; (3) the transfer of more advanced technologies; (4) access to credit, on both the domestic and the international capital markets; and (5) access to foreign markets on more favorable terms, either through new bilateral agreements, or through new uses of the current multilateral arrangements.

The second part of the deal should represent an effort to arrive at widely shared and supported understandings of the sectors in which Mexico has the best chance of developing world-class industrial clusters. Independent technical experts and academic institutions as well as domestic and foreign businesses should participate in these conversations. The discussions should be focused. They should be conducted in a climate of practical urgency. A peacetime equivalent to the spirit of wartime mobilization is the ideal.

I do not suggest that the government offer subsidized credit and credit enhancements, or even special tax favors, to investors in such sectors. I simply propose that it offer to help break some of the same sorts of bottlenecks listed in my description of the first part of the pro-growth deal. The government should commit itself to overcome some such well-defined constraints, on a definite schedule, in return for definite commitments by domestic and foreign businesses to invest in the development or the deepening of the new lines of production and of the connected and supporting forms of economic activity on which those lines depend.

You should begin the negotiation of both parts of this two-part deal with a single national meeting between your government and big-business leaders. Such a meeting would provide an opportunity to present to business -- and to the country -- the entire program of economic reactivation as well as the narrower pro-growth bargain with big business. On this stage, you would have a chance to show Mexico that you are determined to turn a setback into an opportunity and to combine the mobilization of national resources with the democratization of the market economy.

The national meeting should be followed by two parallel sets of sector-by-sector discussions, corresponding to the two parts of the deal. And the discussions should be presented and used as a template for the development of organized procedures for future social negotiation. Such procedures must be able to outlast the crisis of today. They must lay an enduring basis for a new decentralized form of strategic coordination between government and business.

CONDITIONS FOR THE EXECUTION OF THE PROGRAM

There are four conditions for the realization of this program for economic reactivation. In discussing them, I go far beyond my brief. However, I prefer to be all too frank than not to be relentless enough.

The first condition is that, following the example of Madero, YOU APPEAR BEFORE THE COUNTRY AS A MAN POSSESSED BY A SENSE OF MISSION AND BY A VISION. The commitment to rekindle economic growth, however powerful its social consequences in jobs and in the alleviation of suffering, is not enough to sustain such a presentation. However, the insistence on using the struggle against recession as an opportunity to change the way Mexico is organized, to bring opportunity and hope to millions of people, and to keep Mexico from sinking into the condition of a hapless protectorate of the United States, is more than enough.

Such an appeal to the country suits many aspects of your temperament and of your beliefs. However, it is also incompatible with a desire to be universally liked by the rich and powerful, in and outside Mexico. Like every serious historical project, it conveys a message of defiance, demanding exemplary devotion and sacrifice from its individual proponents as well as from its collective agents. No man should embark on such a course of action without thinking a hundred times and looking deeply into himself.

The second condition is that at the center of power YOU ESTABLISH A

SYSTEM OF GOVERNANCE THAT WORKS. The regime of "comisionados" plainly does not work. It represents the unwarranted importation into the work of the present Mexican administration of methods of business management ill suited to the circumstance.

These methods originate in the reaction against a command-and-control style management style, and have proven effective across a broad range of situations. However, the two basic conditions for the appropriateness for such an approach are missing in your system of "comisionados."

The first condition is some rough equivalence of power, authority, and resources between the coordinators and the coordinated. Whatever their personal qualities, the "comisionados" are doomed to be unconvincing leaders: they appear before their ministerial constituents as officious meddlers with less weight than those whom they would lead. The exclusion of the most powerful ministers from their purview only increases their misfortune.

The second condition is a well defined, shared project. A business does not need one: its project is to make a profit. A government, however, that is without an agenda living in the minds of its officials, constantly renewed and advanced from the center of rule, becomes the plaything of circumstance and the victim of received ideas.

You have a vision, and so do some of your collaborators. What I found, however, at the subministerial level was a "porfiriato" of management consultants, with no clear grasp of any central program and with a liking for empty managerial proceduralism. Guided from the center, by you and by a cohesive core around you, they can do much. Left to their own devices, many of them might as well be working for Merrill Lynch, Alcoa or Arthur D. Little, and many probably have.

If you are to execute anything like the program outlined here, you need to replace the "comisionado" regime with a clear system of central direction and supervision. It need not amount to simple command-and-control. It can be compatible with a substantial measure of delegation of power and decentralized teamwork. It does, however, require that a core group around you be committed to the same project, to the same dracononian set of priorities, arranged in the same ranking and sequence, and to working together to advance them in every department of your administration. Where you need to make a set of policies and arrangements take hold quickly, you should not hesitate to create special, parallel structures within the administration, free from some of the restraints, prejudices, and infirmities of the general bureaucracy.

None of this can happen unless you make it happen, for it will resisted by many of those who must execute it, and it will be misunderstood by many of those who would benefit from it.

The third condition is that YOU FIGHT TO ORGANIZE THE CONSTITUENCY FOR YOUR PROGRAM IN MEXICAN SOCIETY. Every serious and successful transformative project helps form and bring together the constituency that supports it and makes it endure. This proposal for economic reactivation, like the broader program we have discussed so often, has a constituency. You must help this constituency find itself and organize itself. It is the constituency of millions of Mexican who aspire to initiative, advancement, and self-improvement, to a modest prosperity and independence, to dignified, active petty-bourgeois status, whether in small business or as employees. They are far more numerous than the organized industrial working class or any other social base of the traditional left. They exist outside or among the decaying remains of the corporatist structure of the defeated regime.

The central problem is that insofar as Mexico is organized today, it is organized around forms, like the traditional unions, that it has ceased to trust. Where Mexico is bursting with nonconformity and vitality, it remains largely unorganized. The new organizations of civil society are still isolated social crystals floating in a sea of disordered frustration and ambition.

To be their vehicle and agent, to give them a voice, to show them a way, must be your work. You need to speak to them, and help organize them, or, better yet, help them organize themselves, using the conflicts generated by the advancement of your program as triggers for this organizational effort. In this program of economic recovery and reconstruction, there is much to serve the role of such triggers: the development of networks of cooperative competition among small- and medium-sized firms, the organization of social groups and of emergent businesses for the purpose of accessing credit and training, the association of actual or would-be home buyers under the mortgage programs, and the call for organized social participation in the framing and implementation of tax incentives and of National Development Vouchers.

The fourth condition is TO ESTABLISH, ALONGSIDE THE PAN, A SECOND PARTY-POLITICAL BASE FOR YOUR ADMINISTRATION AND YOUR PROJECT. It is a task of the utmost delicacy, requiring for its successful execution a combination of subtlety and boldness, and the use of political complication for the sake of political direction.

You should not and cannot force the PAN to become what it is not. It has already moved a long way toward you and your proposals. It can come to embrace with genuine conviction much of a project like the one I outline here. In this project, it may be repelled by the element of institutional innovation and policy heresy but attracted by the commitment to combine the popularization of the market with the practical defense of the little guy as well as with the deepening of

Mexico's associational density. However, the PAN is simply not a sufficient partisan base. It will not gain the allegiance of many who would rise to the defense of the program for which I argue and to which, in its fundamentals, you have already committed yourself.

The potential political supporters of such a program who will refuse to enter the PAN are spread among all the other parties. They can be found among the "modernizing" or "social-democratic" wing of the PRD, among the reform elements in the PRI. They include many young, politicized people who disbelieve in all the parties. The submerged "amigos de Fox - amigos de Mexico" represents yet another source of this same indispensable undertaking.

Mexico does not need one more party claiming to be center-left and proposing to humanize the inevitable. What Mexico does need is a party committed to a practical program of gradual but cumulative institutional innovation. It needs a party that will help build a resource-rich and capacity-enhanced state that, sustained by a high level of organized domestic saving as well as by a high tax take, can work to empower the ordinary Mexican, to democratize the market and to energize democracy. A party able to use a new decentralized form of partnership between government and business, and between government and the organizations of civil society, to tread a rebellious path of national development. And determined to make this path compatible with monetary stability, fiscal realism, and openness -- psychological as well as economic -- to the world. Such a party would refuse to reproduce the institutional conservatism and the historical fatalism of European social democracy today. It would have the impatience and the boldness appropriate to a country that wants another beginning.

You should neither betray the PAN nor acquiesce in its sufficiency. You must encourage and shape a controlled political dialectic that results, step by step, in the creation of another party alongside it. The PAN and this second party would then become the two political columns on which your project would rest. How to encourage some of your collaborators to work in such a direction while ensuring that both you and they evince a genius for dosage is a task I do not envy you but from which your responsibilities will not exempt you.

As part of this task, you must bring the PAN, little by little, to see the legitimacy of such a construction, its value to the country, and even its utility to the PAN itself, which must be free to pursue its own vocation as a force within your government capable of disagreeing with other forces as well as of converging with them.

CONCLUSION

I propose here a direction, not a blueprint. Many of my detailed suggestions may need to be sacrificed to insuperable obstacles, or to be replaced by other equivalents better suited to the circumstances. The point is to reject the easy ways out: the passive suffering of the present recession and the passive waiting to be brought out of it by the future American recovery. What matters is to use the struggle to grow the economy and broaden its social base as an opportunity to keep the promise of the democratic transition, by giving that promise social and economic -- as well as political -- content.

To combine the mobilization of national resources with the democratization of economic opportunities, through a sequence and combination of innovations in policies and institutions, is the animating spirit of this proposal.

For you and for the country, the chief obstacle to the execution of such a project is neither political nor economic. It is spiritual. From you and from your government, this endeavor would require the sacrifice of the almost unanimous flattery with which you have been besieged and tempted by the rich, the respectable, and the powerful of the world. From Mexico, it would demand that it renew its determination to become a great and independent country, and that it show itself willing to invent and to resist, rather than to follow and to obey.

To help Mexico escape from passivity and mediocrity, to persuade it to stand up, to give it arms and wings, is your historic opportunity and your sacred duty.

Saludos,

Roberto Mangabeira Unger