OECD

Economic Survey of Mexico, 2000

Summary

Overall, the improvement in economic performance noted in recent Surveys has continued and growth prospects for Mexico are relatively favourable, based on the increasing internationalisation of the economy, which has been spurred by recently-signed trade agreements and supported by structural reforms implemented over several years to foster private initiative. Public finances are in near balance, inflation is falling and the current account deficit is moderate. However, the expansion has lasted only a few years so far and the challenge, after ensuring a smooth transition to a new administration, is to secure strong sustainable growth over the longer term. Standards of living have improved only marginally over the past decade and inflation is significantly higher than the OECD average, so that the process of economic convergence has some way to go. Continued monetary restraint and fiscal discipline will be needed to reduce inflation expectations. The success of past fiscal consolidation efforts needs to be reinforced by moving forward in related areas of public sector management: setting policies in a comprehensive medium-term framework; further modernising the public administration and budget processes and enhancing the effectiveness of public spending. Moreover, although the structural reform agenda of Mexico has been remarkable during the past decade, the full benefits have not yet been realised for the population as a whole. Mexico should take the opportunity created by the current benign climate to move forward in areas where the reform process has stalled. Measures are needed to strengthen tax revenue to meet spending needs in areas where the social and economic returns are potentially high. Product market competition, though it has been significantly increased, remains underdeveloped in some important sectors. A deepening of the structural reform process would allow Mexico to achieve its full economic and social potential. ■

This Policy Brief presents the assessment and recommendations of the 2000 OECD Economic Survey of Mexico. The Economic and Development Review Committee, which is made up of the 29 Member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

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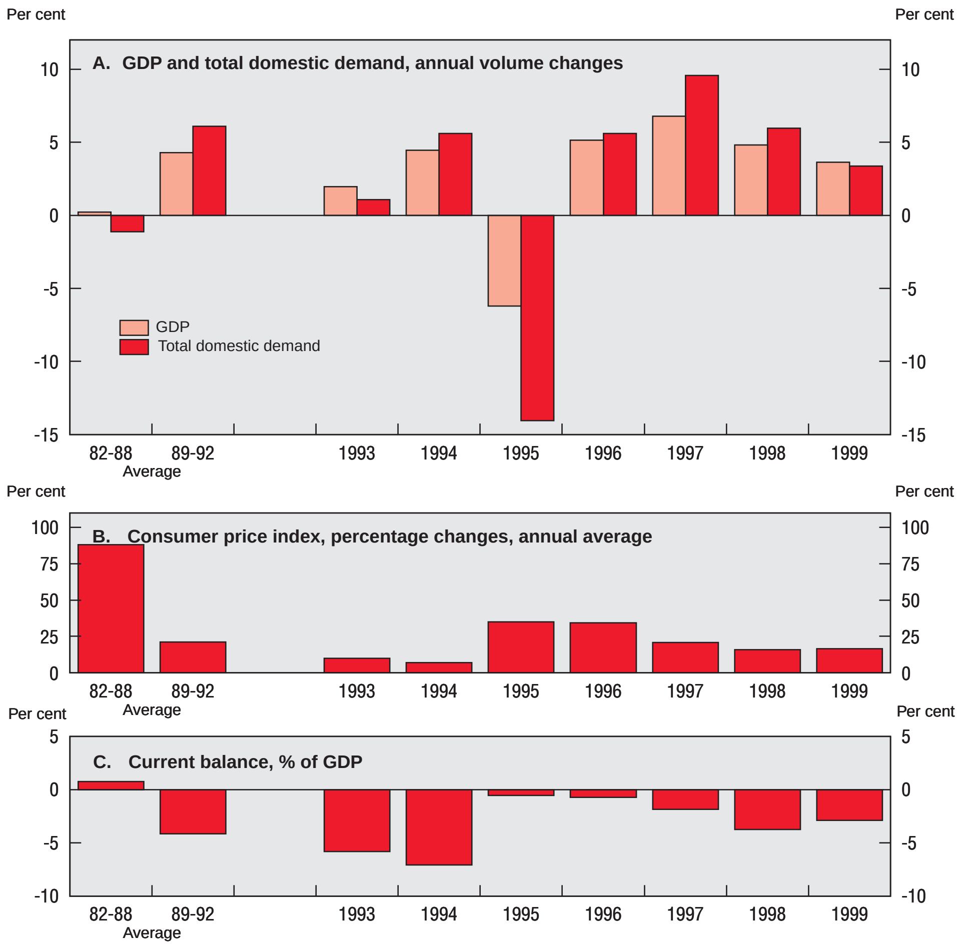
Organisation for Economic Co-operation and Development

How has the Mexican economy performed?

In contrast to the situation at the time of the previous OECD Economic Survey of Mexico, the economy is expanding quite strongly and inflation is falling. In early 1999, economic activity was suffering from the repercussions of the global financial turbulence and the decline in oil prices; the peso had depreciated significantly and inflation had increased. But timely policy action in response to the successive shocks proved effective in restoring confidence; with inflation beginning to fall again, interest rates resumed their downward trend, and the peso exchange rate stabilised. Helped by the continued strength of the United States and the pick-up in global activity, economic activity also rebounded from the second quarter. Private domestic demand strengthened, and as the expansion spread across sectors of activity, labour market outcomes improved. Having widened substantially in 1998, the current account deficit narrowed, to just below 3 per cent of GDP in 1999, and the fact that it has been mainly financed by foreign direct investment may be taken as a reflection of enhanced policy credibility. Increased investor confidence may also have been founded on significant structural reforms which have been introduced in the public and financial sectors, as well as to the decade-long progress achieved by Mexico in product-market liberalisation. Completing the reform agenda and achieving macroeconomic convergence will have to be the priority tasks of the new administration which will take office later in the year.

Economic performance is expected to remain broadly favourable over the short term. The continuation of a positive business climate should

Mexico's economic performance



Source: Instituto Nacional de Estadística Geografía e Informática (INEGI); OECD, *National Accounts*.

underpin private spending, so that as and when the United States economy slows, the growth impulse is likely to shift from the external to the domestic sector. Overall, the momentum built up in the second half of 1999 should help support somewhat faster real GDP growth, of around 4½ to 5 per cent this year and next. As private sector demand strengthens further, broader-based growth should allow a continuing significant rise in employment. This will be matched by a growing labour force, as a result both of demographics and re-entry of workers from the informal economy. Despite some sectoral bottlenecks, the labour market so far has not been a source of tension. According to OECD projections, inflation is projected to come down gradually to around 7½ per cent by the end of 2001, under the assumption of an unchanged nominal exchange rate. This benign scenario, however, could be affected by developments in the United States and international financial markets. If the projected slowdown in the United States requires significantly higher interest rates, that could unsettle financial markets. More generally, the Mexican economy remains vulnerable to confidence effects, in part related to the political transition and associated uncertainty. In recognition of this, initiatives have been taken to shield the economy from possible election-induced volatility (blindaje), encompassing actions to secure Mexico's access to foreign financing and to maintain monetary and fiscal policy discipline. ■

Is the disinflation process on track?

To preserve foreign and domestic confidence and to continue the disinflation process, the authorities have maintained a relatively tight monetary stance. Monetary policy responses are linked to a range of indicators, comprising the exchange rate, inflation expectations, wages, demand and output growth and, on the monetary side, the daily path of base money. The twelve-monthly rate of CPI increase serves as the nominal reference point and from December 1999 and December 2000 this is targeted to fall from 12.3 to at most 10 per cent. Beyond the short term, the aim is gradually to bring down Mexican inflation to be in line with that of its main trading partners by 2003. When expectations about price developments appeared to be out of line with the disinflation objective, monetary policy was tightened at the start of the year 2000 and again in May. The disinflation objective is justified by the fact that the costs of inflation are very high, in terms of distorting national savings, reducing investment horizons and worsening income distribution. It should, nevertheless, be emphasised that the timetable for convergence, though feasible, is ambitious. The experience of disinflation in other OECD economies demonstrates that inflation reductions become more difficult to achieve the nearer an economy gets to price stability, so that monetary policy faces a major challenge and will need to be supported by appropriate fiscal policies and further structural reforms.

In these circumstances, an explicit inflation-targeting regime could help inflation expectations adjust more rapidly, thus avoiding some of the potential adverse effects on output from real interest and exchange-rate increases. But for such an approach to be sustainable, issues relating to implementation need to be clarified, including the definition of the price index to be adopted as a target. To enhance the communication of its policies, the central bank has begun to publish a quarterly inflation report, increasing transparency and accountability. Meanwhile, ensuring that inflation expectations adapt will require that the central bank stands ready to take remedial action against possible slippage on the inflation front. Only by delivering results consistently and over a period of time, will monetary credibility continue to be enhanced and the longer-run costs of inflation convergence be kept to a minimum. ■

Is a medium-term fiscal policy framework needed?

Fiscal restraint has been, and continues to be, an essential element in the disinflation strategy. Thanks to steady and strong fiscal consolidation, which addressed several structural weaknesses, Mexico has enjoyed healthy public finances for several years: the budget deficit has been kept between zero and 1¼ per cent of GDP since the peso crisis; and by 1999, the public debt had been reduced to around 25 per cent of GDP (from 38.5 per cent four years earlier), with a manageable time profile for its external component. Mexico's fiscal commitment has been reflected in a pro-active fiscal policy that has consistently met fiscal targets despite the vulnerability of budget revenue to volatile international oil prices. In 1998, in particular, the government achieved its target by enacting drastic spending cuts, in response to the drop in oil-related revenue. Conversely, when revenue turned out to be higher than budgeted in 1997 and 1999, spending was increased. However, although this record of fiscal discipline has strengthened credibility in the government's resolve, it has tended to make for short-term volatility in government outlays. Setting up a contingency fund for revenue windfalls – as set out in the budget decree for 2000 – should help to damp the impact of external shocks on revenue, and hence on spending. For this mechanism to be fully effective, however, clear rules need to be established as to the investment and disposal of the accumulated funds.

The commitment to fiscal discipline has underscored the authorities' intention to maintain strong fundamentals in the face of external vulnerability. However, to make fiscal policy more effective and reassure markets on the maintenance of a responsible fiscal stance in the longer term, it would be useful if multi-year objectives were announced and set in a comprehensive policy framework. A step towards this was taken with the elaboration of a National Programme for Financing Development for 1997-2000. But the authorities have not yet been ready to go beyond a single administration term in their planning. To be useful, the medium-term framework should be updated at regular intervals with a planning horizon of fixed length. Even though subsequent administrations cannot be committed by a predecessor's actions, transparency would be enhanced if a benchmark were established against which to evaluate future actions. The framework should explain the principles guiding macroeconomic policies over a period of several years and the strategy for structural reform that backs it up. In setting out the budgetary requirements needed to establish the basis for sustained development, longer-run fiscal-related challenges will necessarily have to be taken into account to ensure that the budget is maintained in structural balance over time. These include the cost of the social security reform for private sector workers and that of the financial-sector support package, as well as the impact on the federal budget of the new fiscal relations with the states. Altogether these are estimated to amount to some 5 per cent of GDP per year over the next ten or twenty years. There are also future pressures relating to off-budget infrastructure projects contracted out to the private sector (PIDIREGAS) and pension liabilities for government employees, where pay-as-you-go schemes are in place. It is important that these elements are integrated into the overall fiscal planning framework. ■

How can the effectiveness of public spending be enhanced?

Fiscal consolidation efforts undertaken since the mid 1980s have been supported by structural reforms which have created a leaner public sector through privatisation and the opening up of sectors previously reserved to state intervention. This process of retrenchment has led to a refocusing of public spending. Primary expenditure was brought down from a peak of just over 30 per cent of GDP in the early 1980s to around 18 per cent in 1999, compared with a present average for the OECD of 40 per cent. The general government now accounts for only 11 per cent of total employment –- half the proportion in Europe or Canada – and the wage bill is relatively small relative to GDP. In addition, there has been a rapid decline in interest payments. As public enterprises have been privatised or shut down, federal transfers and subsidies to industry have been gradually eliminated. Subsidies to agriculture have changed in nature, with a shift away from credit and marketing subsidies towards direct income transfers and investment support. There has also been some scaling down of general consumer subsidies. But more progress could be made in this area: the subsidies that are still in place for electricity and water consumption still amount to about 1 per cent of GDP; since they appear to have a regressive impact, there would be both welfare and efficiency gains if they were replaced by targeted transfers and productivity-enhancing investment.

Reducing public spending has not been without cost, since it has implied postponing or curtailing programmes which may have high marginal economic and social benefits. Gross investment by the general government (i.e. excluding public enterprises) is low by international standards. There is a considerable backlog in basic infrastructure such as water supply and roads and in the maintenance of school buildings. The education sector has witnessed remarkable achievements in terms of school enrolment and reduction of illiteracy in the adult population, reflecting the increasing share of public spending allocated to the sector. But demographics and better completion rates in compulsory schooling are adding to pressures on resources at intermediate levels of education. Meeting these growing needs while modernising the whole education system and further improving quality will continue to require a steady expansion of budget resources. Bringing health outcomes more into line with the rest of the OECD should also form an intrinsic part of any long-term strategy to increase living standards. Much has been done to expand coverage of basic health care. But in the longer run, upward pressures on the system are expected to intensify. ■

What is the best way to strenghten tax revenue?

The relative scarcity of tax resources and heavy reliance on volatile oil-related revenue have been important factors impeding the development of essential public programmes. In this respect, given the considerable marginal economic and social benefits of increasing spending in the above areas, the 1999 Economic Survey suggested that it would be appropriate to raise the low tax-to-GDP ratio over the medium term. Among the measures that could be taken to increase tax revenue without having adverse effects on efficiency, those that reduce the scope of preferential regimes and strengthen tax administration and compliance would be the most appropriate. Past tax reforms have created a tax system with statutory features which are relatively neutral and non-distortive; however, special regimes, exemptions and weak enforcement keep tax revenue low and make the system inequitable across different types of income and activities.The 1999 Survey made several proposals for reform in this regard, including a broadening of the VAT base and the abolition of the favourable treatment given to certain sectors under the corporate tax regime. Such special regimes have a direct effect on income by narrowing the tax base, while complicating tax administration and leading to a misallocation of resources. A more neutral tax system, in conjunction with closely focused increases in public spending would be complementary to the growth process. It has, however, been difficult to gather political support for changes in the tax system prior to the 2000 elections, so the agenda for tax reform has not advanced significantly since the last Survey. It should be a priority area for action under the next Congress and administration.

Achieving a pattern of public spending and taxation which will serve as the base for future rapid growth should also contribute to a narrowing in Mexico's currently extremely dispersed income distribution. The two objectives are not incompatible. Consumer subsidies, for example, are an inefficient instrument of redistribution, and those that remain have a regressive impact, since those who benefit most in absolute terms are the larger consumers. Eliminating such subsidies while increasing the share of resources earmarked for direct transfers targeted to disadvantaged families would have a progressive effect on income distribution. To combat more deep-rooted poverty, specific programmes have been introduced, so as to ensure that benefits are spread as widely as possible across targeted groups. One of the main instruments is the integral programme for education, health and nutrition (PROGRESA). This seeks to improve standards of living of families in extreme poverty in rural and semi-urban areas via an approach which emphasises the synergies that can be achieved in these three domains. The programme has achieved impressive results. However, its coverage has not yet been extended to urban areas. If the authorities decide on such an extension, it should replace existing targeted programmes and be carefully designed so as to maintain incentives to work. ■

How can the public administration's efficiency be further improved?

The effectiveness of public spending is highly dependent on the efficiency of public administration. Since 1997, a comprehensive reform strategy has addressed problems impinging on the administration's efficiency, including a lack of instruments to evaluate programmes and staff performance; complex bureaucratic procedures and regulations; a lack of status and motivation among civil servants, and excessive centralisation of decisions concerning both the budget and staff policies. Progress has been made on several fronts. Positive incentive mechanisms have been slowly incorporated into the public administration, supported by regular performance reviews of programmes and staff. These have enhanced management accountability and staff performance. Audit and control systems have been improved and personnel practices made more transparent, increasing agency response and reducing the scope for unethical behaviour. Line ministries and agencies, as well as state and local governments, have been granted wider discretion on spending decisions, creating the conditions for improved allocative efficiency. These reforms have been accompanied by a process of political opening, whereby Congress has acquired increased powers of legislative oversight with respect to budget decisions.

In spite of the progress made, there are several areas in which public expenditure management and control can be improved, via greater Congressional involvement and streamlining in the Executive branch. In the first place, consideration should be given to a revision of the budget process. Legislative oversight could be made more effective by increasing the time allotted to Congress to examine the budget draft. Perhaps the area where returns would be highest is the strengthening of Congress's auditing and control mechanisms. This would provide a balance to the Executive's actions that is now lacking. The newly-created auditing body (Auditoría Superior de la Federación) should play an important role in this regard and its potential should be fully exploited. As Congress performs a more systematic and result-oriented evaluation of programmes, current control mechanisms within the Executive branch can be simultaneously adapted. Overall, such changes should be consistent with the government's ability to enforce a hard budget constraint.

At the same time, recent moves by the Executive to simplify and streamline the currently complex process of spending approval are to be welcomed. The improvement in intra-governmental information channels among ministries and agencies, which is accruing from the implementation of a new electronic communication network, is also serving to enhance the control function of central budgetary authorities, simplifying and expediting administrative procedures and strengthening transparency and accountability. Better information channels should lead to more effective personnel policies, including the improvement of performance reviews. Human resource management remains inefficient overall, as a result of a two-tier system in which there is a lack of flexibility at the operational level, but excessive mobility at managerial level created by the high proportion of political appointments. Options for reform should include the establishment of a professional civil service, while avoiding excessively generous job tenure. State and local governments should be encouraged similarly to improve their administrative capacity. Finally, efficiency would be enhanced if market-based instruments for the provision of public services were more widely used. ■

What is the situation in the financial sector?

Following the costly array of official support programmes for banks and debtors launched since the 1994-95 peso crisis, the operational framework of the banking system has been significantly improved with the approval by Congress in December 1998 of a package of financial sector reforms. The lifting of the remaining restrictions on foreign investment in the financial sector, together with the removal of legal uncertainties, have opened the way for a restructuring and consolidation of the financial sector and the lowering of public debt servicing costs. Measures to reduce the coverage of the deposit guarantee scheme and the tightening of prudential regulations have reduced the danger of unsound bank lending. At the same time, the launch of a last debtor support programme (punto final) has led to a marked decline in non-performing loans. Important problems remain to be solved, however, without which a private market for credit cannot expand. From a credit-supply perspective, bank capitalisation has improved; but, due to legal and administrative considerations, creditor banks have been unable to dispose of unwanted government paper, with effects on bank liquidity and the supply of loanable funds. The liquidity management by commercial banks should become more efficient as previously non-tradeable notes are replaced by negotiable instruments. New capitalisation and provisioning rules were announced in September 1999, and risk-based credit rating rules have also been strengthened. As regards institutional reform, the recent approval of a new legal framework for bankruptcy and guarantees has met the urgent need to remove the existing legal bias in favour of debtors which has impeded credit supply. These are important steps towards financial normalisation, which should pave the way for the full completion of the recovery in the Mexican financial system and for a fuller realisation of Mexico's growth potential. ■

What about product-market competition?

From a product-market perspective, wide-ranging structural reforms have made the Mexican economy more open, flexible and responsive to market forces. This has produced significant results, including reductions in prices and increases in consumer choice and the quality of services. However, while the ports, airports and railways have seen significant efficiency gains from liberalised entry, much remains to be done to increase competition in other network areas. The incumbent has been able to retain a dominant position in the fixed-line telecommunications sector, while most of the electricity and oil sectors are still closed to private initiative, and state-ownership is still significant in air transportation:

- In the electricity sector, government proposals to liberalise the sector are still being discussed in Congress. Meanwhile, a process of reorganisation has started at CFE, the state-owned electricity company, splitting it into separate administrative units that will buy and sell electricity in an internal "shadow" market. However, this measure is unlikely to lead to the creation of an efficient electricity market and is no substitute for a coherent reform strategy, such as the one outlined in the original reform proposals.
- In the air transportation sector, authorities have announced the intention of privatising CINTRA,

the holding company in which four airlines, including the two largest, have been consolidated. But privatisation awaits decisions on a number of regulatory and industrial organisation issues, including whether or not to split CINTRA before the divestiture. A split may be preferable on competition grounds. Whatever decision is made, the competition authorities should ensure that airport slot allocations are transparent and do not distort competition.

- In the telecommunications sector, recent decisions about local competition and interconnection fees are promising. However, in order to level the playing field and overcome the dominant position of the incumbent, the regulatory agency should impose additional regulations, as allowed by the Federal Telecommunications Law. To ensure the needed expansion of the network, a universal service fund should be established, with market-based mechanisms being used to ensure that it is technology neutral, transparent and non-discriminatory with respect to incumbents and new entrants.

Given the importance of these sectors for longer-term growth, remaining impediments to competition should be urgently addressed, through the lifting of remaining restrictions on private initiative and the clarification of the regulatory framework. ■

What can be done to foster employment growth in the formal sector?

The labour market in Mexico is characterised by a relatively high degree of real wage flexibility, while benefiting from relatively low labour costs and a limited tax wedge. However, the economy continues to be characterised by a large informal economy, which needs to be absorbed into the formal sector. To some extent, the social security reform for the private sector favours labour integration into the official economy, by lowering payroll taxes (for health insurance) and creating a new pension system with individual retirement savings accounts, thus making social security registration less costly and more attractive. The welfare reforms proposed in the Survey would tend in the same direction. But employment-protection provisions may still act as institutional barriers in this respect, especially to job creation by small and medium-sized enterprises. Measures to reduce the costs associated with hiring and firing workers and broaden the scope of short-term contracts could be of assistance here, while allowing probationary periods could facilitate job creation on long-term contracts. The social partners signed an agreement in 1996 defining principles of a “new labour culture”, which underlines the need for the labour market to be able to adjust to rapid changes in the economy. This agreement should provide the basis for a review of labour market institutional arrangements and regulations, including both the responsibilities of employers towards the workforce via increased training opportunities and barriers to formal employment creation in general.

The above labour-market features will have reinforced Mexico's geographical attractiveness for foreign direct investment. Moreover, recent economic performance and the weight of medium- to high-technology goods in the country's exports suggest that there has been a growing supply of qualified labour. The Survey nevertheless suggests that to ensure balanced growth and facilitate the modernisation of the economy, continued upgrading of skills and competencies is required, including implementation of the newly-created system of standards and certification of skills. Also, while foreign direct investment has helped the diffusion of new technology and know-how into the country, Mexico’s transition to a knowledge-based economy is still hindered by major weaknesses in its R&D and innovation systems. Total R&D spending is among the lowest in the OECD area, and of that the government is by far the largest source of funding. In view of these weaknesses, the Mexican government is taking a number of initiatives to foster investment in knowledge and strengthen the innovative capacity of the economy. In particular, more financial autonomy has been granted to public research institutions facilitating the development of research contracts with the business sector. Recent legislation aims to provide for a better co-ordination of government R&D activities and mechanisms to enhance the diffusion of knowledge between public and private institutions. It also includes new provisions for fiscal incentives to support R&D investment by the private sector. Such initiatives, so long as they are applied in a non-discriminatory manner, are important for enhancing the creation of technology-based firms and fostering the transition towards a knowledge-based economy. ■

For further information

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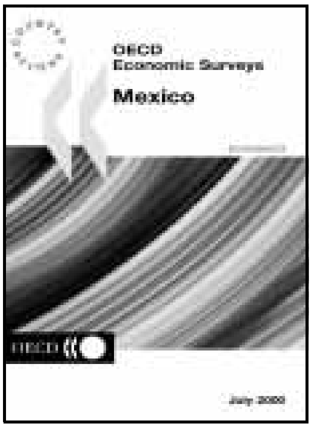
For further reading

- **OECD Economic Surveys:** Economic Surveys review the economies of Member countries and, from time to time, selected non-Members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at www.oecd.org/bookshop.



- **Additional Information**: More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at www.oecd.org/eco/eco/.
- **Economic Outlook No. 67**, June 2000.
  A preliminary edition is published on the OECD Web site approximately one month prior to the publication of the book: www.oecd.org/eco/out/Eo.htm.

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