

Economic Survey of Mexico, 2002

Summary

The prolonged commitment to macroeconomic stability and structural reform has both enabled Mexico to profit from the United States upswing in the last decade, and prevented the current recession turning into a domestic crisis and loss of investor confidence. The economy is well placed to resume strong sustainable growth, though the timing and strength of a recovery will depend largely on external factors outside policy-makers' control: even if macroeconomic conditions move unfavourably, the authorities need to continue to pursue announced inflation and budget consolidation objectives, if confidence is to be maintained. The recent tax reform reduces distortions and strengthens public finances, although further steps in these directions are required, including broadening the indirect tax base. Higher revenues will permit both needed fiscal consolidation and steadily higher provision of essential public goods and services. The decision to expand targeted policies to alleviate acute poverty is welcome. But raising the living standards of the poorer sections of the population on a permanent basis will depend on achieving sustained stronger growth. This will require continuing efforts to raise educational attainment levels, and long-run investment programmes to improve the amount and effectiveness of basic physical infrastructure especially in rural areas. The economy's growth potential would also be enhanced by measures to strengthen competition in sectors where it is signally lacking, including energy and communications. After a series

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This Policy Brief presents the assessment and recommendations of the 2002 OECD Economic Survey of Mexico. The Economic and Development Review Committee, which is made up of the 30 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.

of reforms, the financial sector is now more solidly based, competitive and liquid, though productivity remains weak, and financial intermediation under developed. Nevertheless, the framework conditions seem to be in place. Indeed, so long as cautious macroeconomic policies continue to be pursued and further progress is made in structural reform, it is to be expected that credit will expand endogenously with time, underpinning economic growth. ■

When will the economy pick up?

Following five years of vigorous output growth, the business climate began to deteriorate in late 2000, in response to the sharp slowdown in the United States economy. Investment plans were quick to respond to the weakening of foreign demand; employment growth fell in the course of 2001; and, with a lag, consumer confidence wavered. Rising uncertainties following the 11 September terrorist attacks in the United States exacerbated these trends. As a result, GDP fell slightly in 2001. Even so, it is important to recognise that the present downturn, unlike previous ones, has not been associated with macroeconomic instability or a crisis of confidence, but rather reflects the increasing integration of Mexico into NAFTA and the resulting synchronisation between Mexico and the United States economic cycles.

OECD projections are for a recovery of the Mexican economy from around the middle of 2002, triggered by a pickup in exports. With interest rates expected to remain low and stable, investors are likely to respond quickly to the upturn in demand. Consumer price inflation is projected to continue to fall, allowing real incomes to expand; and increasing slack on the labour market over the past months suggests that there will be no lack of skilled labour when activity picks up. Hence, household spending is likely to strengthen. Overall, real GDP is projected to grow by 1½ per cent on average in 2002, gaining considerable momentum in 2003, although this will depend on the timing and strength of the projected rebound in the United States. ■

How was a confidence crisis avoided in 2001?

Mindful of the emerging market status of the Mexican economy, policymakers there have in recent years oriented macroeconomic policy towards fiscal prudence and a non-accommodating monetary stance. Credibility has been gained, and investor confidence bolstered, by a good record of meeting short-term budgetary and inflation targets. The year 2001 was no exception. The new government announced that the public sector deficit would be lower than a year earlier, despite a less buoyant economic outlook. The monetary authorities maintained a tight stance until well into the year, easing only after inflation expectations had appeared to come down towards the projected path. This policy mix succeeded in maintaining confidence and bringing inflation down, and has helped increase the decoupling in market risk perception from other emerging markets. ■

Is there room for maneuver in macro policies?

The objective of the monetary authorities is to bring inflation down gradually, from 4.4 per cent year-on-year at the end of 2001 to converge with that of Mexico's main trading partners – interpreted by the Bank of Mexico as a CPI inflation rate of 3 per cent – by December 2003. Recent successes in reducing inflation should not lead to complacency. The experience of other OECD countries shows that inflation reduction becomes increasingly difficult as price stability approaches. There was considerable inertia in contractual wage bargaining during most of 2001, perhaps in part reflecting slow adjustment of agents' expectations to official inflation objectives. Some of the factors behind good inflation performance in 2001 – a strong peso combined with a weak economy – could prove to be temporary. At the start of 2002, to prevent second round effects of upward adjustments in public sector prices, the Bank of Mexico tightened the monetary policy stance. Continued caution on the part of the monetary authorities is required to meet their medium-term objective, as is support from fiscal policy. The question arises of how best to exercise monetary policy thereafter. The central bank has moved to an explicit inflation-targeting regime as is now the case in a number of Member countries. As

inflation comes down, the precise modalities will need to be monitored to determine whether changes in the operational framework are required to improve its effectiveness.

Fiscal discipline was exerted in 2001 in a difficult environment. Because revenue windfalls in the buoyant year of 2000 were either spent then or used to reduce debt and create the Oil Stabilisation Fund, the government had no room to ease the fiscal stance. On the contrary, the deficit target for 2001 was lowered even though it was clear that the economy was slowing. In the event, activity proved even weaker than anticipated, and oil revenue lower. The government responded by adjusting public spending down as needed to meet budget targets. The implementation of the budget thus required a significant tightening. The public debt – at some 40 per cent of GDP, including debt related to the bank rescue package after the 1995 peso crisis – is not high by OECD standards, which might suggest that there is room for a less stringent approach to fiscal policy. However, there are other pressures on public finances which need to be taken into account, for example contingent liabilities related to private construction of public infrastructure, and the liabilities of the public sector employees pension system. Although the budget deficit has been kept between zero and 1¼ per cent of GDP since the peso crisis, the broader public sector borrowing requirement, which includes the servicing of contingent liabilities, amounted to 3.8 per cent of GDP in 2001 (excluding non-recurrent revenues). The underlying fiscal position thus remains fragile, and a continued tight policy stance is required. The 2002 budget, which provides for an unchanged deficit of 0.65 per cent of GDP, despite projected sluggish growth in the economy, is consistent with this.

Despite underlying fragile public finances, and a strong case for higher public spending on social and economic development goals, the government's commitment to, and record of, fiscal discipline has greatly enhanced credibility in its resolve to strengthen economic fundamentals. One consequence, though, has been that expenditure has tended to be volatile, and the financing of core programmes erratic. Financing them by borrowing has been ruled out because it would negatively affect investors' confidence, outweighing immediate benefits of the spending. Strengthening public finances further should thus remain a near-term objective. This objective would be

easier to attain if tax reforms succeed in strengthening the revenue base, and reduce dependence on volatile oil revenues. Once a structurally stronger budget is attained, more reliance could be put on automatic stabilisers; and setting fiscal policy within a medium-term framework that is updated regularly could subsequently help anchor private sector expectations and foster market confidence. The framework should include a set of multi-year expenditure objectives and a strategy for structural reform. A number of longer-term fiscal issues would have to be addressed, and explicit and implicit liabilities would need to be taken into account. When integrating the various challenges facing fiscal policy, a reasonable medium-term objective would be to bring the PSBR to balance, and maintain it there over time. ■

Has the tax reform gone far enough?

Given that it is important both to consolidate the budget further and increase spending in essential areas, a tax reform which would strengthen tax revenue, while reducing tax distortions, has been a priority for some time. An appropriate reform would enhance the revenue generating capacity of the tax system, by broadening the tax base and improving surveillance and enforcement. In December 2001, Congress approved a major tax reform which differed in some important respects from the proposals sent by the administration. It retained most of the fundamental features regarding simplification of the system, and the elimination of special regimes and distortions, especially as regards direct taxes. On the other hand, the law as passed did not address the need to widen the VAT base. All in all, the reforms are estimated by the authorities to increase revenues by about 1 per cent of GDP in 2002. Further action will be necessary to achieve the objectives of durable fiscal consolidation, and provide sufficient resources for expanding the provision of public goods and services. A reasonable benchmark would be to raise revenues by an additional 2 percentage points of GDP. ■

What are the priorities for long-term development?

Mexico was able to benefit from the expansion in North America, largely as a result of the process of

structural reforms and deep structural changes over the last decade. Domestic saving has financed strong investment with only a limited deterioration of the current account. Job creation in the formal sector has been strong and real wages have recovered after the drastic adjustment that followed the peso crisis. Productivity gains have kept unit labour costs in check until recently. The Mexican export structure has become broader-based, including strong growth in high and medium technology goods, and this has allowed a favourable export performance. But a number of structural weaknesses persist. A large informal sector co-exists with formal employment. Poverty is widespread and acute poverty remains significant, particularly in the South. Basic infrastructure, such as roads, sewage treatment and electricity supply, is often inadequate. The productive sector continues to be characterised by a dual structure, with a dynamic export sector made of large competitive enterprises, which have easy access to financing including from abroad, and a less efficient domestic market-oriented sector. The latter comprises medium-sized to very small enterprises, which suffer from financing constraints, exacerbated since the banking crisis, and poor infrastructure support. Strong sustainable growth is required on a wider basis to absorb the continuing rapid increase in the labour force and achieve further progress towards social goals in the areas of education, health and poverty alleviation.

The new administration has stressed the importance of continuing policy actions on a wide front to foster private investment and productive employment opportunities, with special focus on better integrating disadvantaged social groups and regions in the development process. A comprehensive strategy requires forceful structural reform concentrating on the following priorities:

- further develop human capital and review labour market institutional arrangements and regulations;
- dismantle barriers to entrepreneurship and facilitate access by smaller firms to credit on commercial terms;
- deepen the liberalisation of network industries (where the reform process has stalled), by creating the appropriate regulatory framework and actively enforcing competition rules. ■

How can the labour force become more productive?

Targeted action for the poorest families, through PROGRESA, the integral programme for education, health and nutrition, has been widened in scope. This is welcome, as it has proven effective in achieving the goals it was set for. Major progress has also been achieved over the years in increasing school enrolment, providing basic health care and enhancing social protection more generally. Now that educational access is improved, efforts should focus on further raising the quality of public education, including more technical streams and vocational training to ensure a successful transition from school to work. In this context, public training services also need to be strengthened, to aid the process of modernisation and restructuring of the economy. Encouraging the transition of workers in the informal sector to the formal sector is a priority. It would be facilitated by measures to ease employment regulations, including those on “atypical” forms of work, and those that strengthen the links between the payment of taxes and contributions to entitlement to benefits, thus making formal activities more attractive to workers.

Favouring the creation and survival of small enterprises is high on the new government’s agenda. Helping to boost the growth and the productivity in this sector is seen as a way to address social objectives, to the extent that smaller-size enterprises can foster income stability, growth and employment for disadvantaged groups and regions. The intention is to make business in the formal sector more attractive – and less costly – by improving the regulatory environment and cutting red tape, helping labour training, supporting technological upgrading, and developing access to credit (including micro-finance). But devising and implementing appropriate policies in this area is not straightforward. Large-scale direct intervention is unlikely to prove cost-effective. The experience of other OECD countries shows that pilot schemes and continuing evaluation are key. In the Mexican case, one of the problems encountered is that many federal programmes designed specifically for this segment of enterprises are reaching only some of them, and usually not the smallest. Priorities should include better co-ordination and rationalisation, involvement of the private sector in programme design, and evaluation of programme effectiveness. ■

How strong is the "competition culture" in Mexico?

Though competition law in Mexico is formally close to best practice in OECD countries, implementation has faced resistance, and a "competition culture" has yet to become solidly established in the private sector. In the areas more directly amenable to public policy, product market competition has been sharpened in recent years, with the opening of key public services in transport and communications to private participation and market-oriented regulations. But in some areas, such as telecommunications, the link between privatisation and competition policy has yet to be firmly established, and the authority and independence of the regulatory commission needs to be strengthened. In others, notably the electricity sector, the reform process has stalled. Fundamental reform in this sector is of vital importance for Mexico's potential growth, as installed capacity is insufficient to accommodate the expected increase in demand for power. Generation has been opened to private investment, but the share of independent production remains negligible; in addition the nation-wide state-owned company, CFE, and a smaller local one for the Mexico City area, have retained their monopoly on transmission and distribution. A proposal to reform the sector in depth was sent to Congress in 1999; it was not approved. The new administration should not delay action. The success of a fundamental reform in the sector will indeed depend on establishing a clear regulatory regime, separating ownership of competitive (e.g. generation) and non-competitive (e.g. transmission and distribution networks) segments and setting appropriate tariffs to promote rational energy consumption and allow a return on investment. Given the complex technicality of regulations in this area, best practices should be carefully examined. ■

Is the financial sector in good shape?

The major government rescue operation following the banking crisis of 1994/95 succeeded in avoiding a systemic crisis. The adjustment of the financial system gathered momentum with the approval of a major financial reform package in 1998-99. The removal of political uncertainties regarding the servicing of rescue-related debt has allowed the gradual replacement

of old illiquid debt by new tradable securities, remaining barriers to foreign ownership have been eased, and the "Punto Final" debtor support programme has led to a decline in non-performing loans. In addition, moral hazard risks have been reduced by replacing the blanket coverage on bank deposits by a limited deposit guarantee scheme. As a result, the financial sector has experienced an increase in efficiency and profitability, a system-wide re-capitalisation and an overall clean-up of balance sheets. Institutions were thus in a better position to face a more stringent supervision and regulatory framework, which included an upgrade of capitalisation and provisioning requirements. Today, the Mexican banking system is increasingly solid and as profitable as in the rest of the OECD counterparts; and the supervision and regulatory frameworks are close to best practices.

Nevertheless, the banking system scores poorly on some indicators. Labour productivity is relatively low, and further policy action is needed to facilitate the collection of bad loans. Although progress has been made in improving the regulatory framework, new bankruptcy procedures are yet to be fully tested and the exercise of credit guarantees still faces high legal costs, slow proceedings and poor enforcement at local level. Authorities should increase the resources available to judicial authorities and consider the option of creating separate commercial courts to settle disputes regarding the financial sector. Direct lending by development banks to the non-bank private sector should be phased out. Thereafter, their role in financial intermediation should remain circumscribed. Recent government proposals to refocus existing institutions are welcome and should be used as an opportunity to rationalise the operation of all state-owned financial intermediaries, including trust funds. In this context, it is important to recognise that unless the public-good nature of lending or the occurrence of market failures can be clearly demonstrated, there would be no justification for the existence of public financial institutions. Government agencies rather than banks could play a development role without creating distortions in financial markets. Finally, the co-ordination between the different regulatory agencies responsible for the financial sector should be improved, and their autonomy reinforced by a secured source of financing and by having their governing boards appointed for a fixed-term. ■

A review of progress in structural reform

Proposal*	Recent action taken	OECD assessment/recommendations
Enhance human capital		
<ul style="list-style-type: none"> Raise educational attainment of population Facilitate the transition from school to work 	Increased funding to extend capacity; modernisation of school curricula Business sector more closely involved in design of vocational training and technical education	Continue to increase capacity and upgrade teachers skills Further strengthen vocational technical education
<ul style="list-style-type: none"> Improve job training 	System of skill standardisation and certification developed	Continue these efforts, monitor and assess results
Increase the flexibility of employment regulations		
<ul style="list-style-type: none"> Review employment protection provisions 	No action	Consider options for labour market reform: Easing of some regulations can help reduce obstacles to job creation in the formal sector, SMEs in particular.
<ul style="list-style-type: none"> Broaden scope for using short-term contracts 	No action	
<ul style="list-style-type: none"> Allow probationary periods so as to facilitate job creation through long-term contracts 	No action	
Addressing social safety net needs		
<ul style="list-style-type: none"> Continue the integral programme, PROGRESA, for the poorest 	Extension of PROGRESA, including in urban areas, after adjustments to maintain work incentives	Continue implementation
<ul style="list-style-type: none"> Continue efforts to provide basic health care to all 	Extension of the basic health package	Continue implementation
<ul style="list-style-type: none"> Advance in the reform of public sector retirement funds 	No action	Make progress
Making product markets more competitive		
<ul style="list-style-type: none"> Petrochemicals: advance in liberalisation 	No action	Step up efforts to restructure PEMEX petrochemicals and subsequently to privatise it; ensure that the process leads to competition, while preserving significant economies of scale.
<ul style="list-style-type: none"> Electricity: wide ranging reform is required to allow much needed investment and competitive prices 	Reform proposal of previous administration withdrawn. Restructuring of CFE has started	Ensure that relations between government and state-owned companies are strictly commercial. Further disengage public sector from electricity supply. Establish a transparent, effective, non-discriminatory and competition enhancing regulatory framework
<ul style="list-style-type: none"> Airlines: resolve industrial organisation issues that delayed the privatisation of CINTRA, the holding company for airlines. Splitting of CINTRA into separate airlines is preferable on competition grounds 	Splitting and privatisation have been delayed	Proceed with splitting of CINTRA and subsequent privatisation when economic situation is appropriate
<ul style="list-style-type: none"> Telecommunications: impose additional regulations on the incumbent (Telmex). 	Obligations on incumbent regarding fees service quality and information have been published.	Recent decisions on interconnection fees and services are promising; the regulator's (Cofetel) independence should be further strengthened; the law prohibiting Telmex from exploiting concession for TV services should be rigorously enforced.
	Agreement reached between Telmex and two private operators on contentious issues between them	
Use market-based mechanism to ensure universal service	No action	Proceed with reform.

* Proposals are based on detailed analysis provided in previous OECD *Economic Surveys on Mexico*.

Are the banks ready to lend more to the private sector?

An important concern is the low level of credit to the private sector. This is more of a problem for small and medium-sized enterprises, since larger companies can often access foreign borrowing. Some asymmetries in credit access between larger and smaller firms are inevitable, but the authorities should continue efforts to eliminate barriers to lending with an asymmetrical effect. Non-distorting policies that help smaller firms could be envisaged, including further action to develop secondary stock markets that allow easy and less costly entry and exit to venture investors. The low level of aggregate credit to the private sector is exacerbated by the crowding-out of private borrowing by the public sector, requiring that fiscal

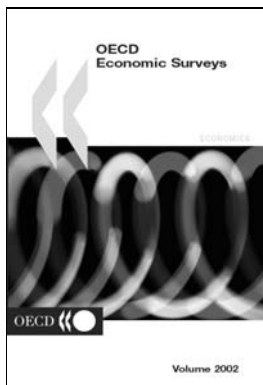
consolidation be continued. The ongoing revision of investment rules governing pension funds should facilitate diversification away from government instruments. These measures should be seen as a complement to the already impressive body of reforms implemented in the past 3 years, whose full effect will be felt in the medium-term, as financial institutions adjust and macroeconomic stability becomes further ingrained. ■

For further information

Further information on the *Survey* can be obtained from Bénédicte Larre, Tel.: (33-1) 45 24 87 95 (E-mail: Benedicte.Larre@oecd.org). ■

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.



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- **Economic Outlook No. 70**, December 2001. A preliminary edition is published on the OECD Web site approximately one month prior to the publication of the book: www.oecd.org/eco/Economic_Outlook.

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