

REFORM Case Study

No. 0704 July 2007

Improving Governance Practices in Mexico: The Path to World-Class Performance

Roberto Newell G. and Armando Chacón Villar
The Mexican Institute for Competitiveness

In the early 1990s, Mexico's decision to integrate into the global economy led to profound institutional reforms. These reforms aimed to change governance practices in the Mexican political economy – both in the private and public sectors – to improve the way in which policy decisions are made and carried out.

While Mexico has successfully put in place the fundamental pillars of its governance infrastructure, the country must strengthen key institutions in government and the private sector. Doing so is crucial for development, as the experience of the global economic powers clearly shows the link between decentralization, transparency, and accountability on the one hand, and institutional development and improved market performance on the other.

One of the key challenges Mexico faces is how to build a legislative consensus around fundamental issues of free market access, the rule of law, and a better business climate. Also concerning is the lack of investor protection and weak disclosure, transparency, and accountability mechanisms at the corporate level. These issues must be properly addressed for Mexico's capital market to grow and for the economy to remain competitive.



Center for International Private Enterprise
OECD Development Centre





The Center for International Private Enterprise is a non-profit affiliate of the U.S. Chamber of Commerce and one of the four core institutes of the National Endowment for Democracy. CIPE has supported more than 1,000 local initiatives in over 100 developing countries, involving the private sector in policy advocacy and institutional reform, improving governance, and building understanding of market-based democratic systems. CIPE provides management assistance, practical experience, and financial support to local organizations to strengthen their capacity to implement democratic and economic reforms. CIPE programs are also supported through the United States Agency for International Development.



The Development Centre of the Organisation for Economic Co-Operation and Development was created in 1962 by the OECD in Paris as an interface between OECD member countries and the emerging and developing economies. The Development Centre conducts comparative analysis and promotes informal policy dialogue on development issues of mutual interest for OECD member countries and the emerging and developing economies.

This case study is part of the CIPE-OECD Development Centre series on governance and investment in emerging markets.

For more information, contact:

Center for International Private Enterprise
1155 Fifteenth Street NW • Suite 700
Washington, DC 20005
USA

ph: (202) 721-9200 • fax (202) 721-9250
web: www.cipe.org • e-mail: cipe@cipe.org

Charles Oman, Senior Economist
OECD Development Centre
2, rue André Pascal
F-75775 Paris Cedex 16
France

ph: +33 1.45.24.82.00 • fax +33 1.45.24.85.00
web: www.oecd.org/dev • e-mail: dev.contact@oecd.org

Introduction: Institutional Reforms in the 1990s

Institutional reforms of the 1990s brought about major changes in the way the Mexican economy operated. The most drastic reforms were implemented during the first half of the decade; the process slowed down in the second half due to, among other factors, the financial crisis of 1995-1996 and the loss of a majority position in the Federal Congress in 1997 by the Institutional Revolutionary Party (PRI).

Among the major milestones of the reform process, Mexico's participation in the General Agreement on Trade and Tariffs (GATT), the signing of the North America Free Trade Agreement (NAFTA), and changes in its foreign investment law certainly stand out. The resulting integration of Mexico into the global economy served as a catalyst for a number of good governance reforms. However, the process was not without challenges.

Consider NAFTA. The philosophy behind NAFTA was to build a free trade area where decisions regarding production and consumption would take place as a result of open interaction between supply and demand throughout the region. The supporters of NAFTA believed that by dismantling tariff barriers and removing restrictions to capital and investment flows, the integration of cross-border production chains would lead to efficiency gains and facilitate better distribution of goods at lower prices. However, member countries' comparative advantages have not been fully exploited, hampered mainly by the permanence of non-commercial barriers and economic distortions (such as subsidies) that are a clear obstacle to open interaction.

The reform process of the 1990s was accompanied by privatization and deregulation of key economic sectors such as maritime transportation, railways, construction and operation of roads and bridges, aviation, telephone systems, satellite services, and land holdings. At the onset of the 1990s, these sectors were either under strict state control or subject to intense regulation. The government exercised its regulatory control over anything from quantity and

ways of production to pricing decisions and provision of services. For example, before the deregulation of transportation, concessions granted to provide these services included the routes each concessionaire could serve and an obligation to charge prices established by the relevant regulation.

There are instances of privatization processes which, while having left much to be desired in terms of increased competition, led to significant improvements in the coverage and quality of services. This was the case of telephone services and railways, where privatization in 1995 brought significant cost reduction benefits.

The mediocre results in terms of improving overall living conditions after privatization and deregulation led many to question the viability of this strategy for liberalization. Obvious failures in deregulation and privatization have contributed to this skepticism. One might think of the 1995 collapse of the newly privatized bank system and the scandalous toll roads bailout, which came at a high fiscal cost to taxpayers. While far from being evidence against increased competition and transparent regulation, such failures were a signal that something had to be done about the weak institutional and regulatory infrastructure that undermined well-intentioned reform efforts.

As such, the root cause of public disappointment with the liberalization process in the 1990s was not liberalization itself, but rather all the delays in the agenda of structural reforms. For privatization and deregulation to really work, investment- and innovation-friendly regulations must be put in place – replacing protectionism, subsidies, and special concessions. Moreover, in the public governance arena, discretionary powers of public officials, corruption, overall uncertainty, and weak legal protection all had to be properly addressed.

What Mexico's experience shows is that a liberalization process is never automatic and that the role of government should not be ignored. It is government that provides institutional infrastructure, ensuring predictability, reliability, and transparency in economic transactions and public governance. Another related lesson is that once market

liberalization gets underway, the task of ensuring that reforms benefit all levels of society cannot be given only to the current government, because that government is inevitably affected by short-term political interests. That task must be delegated to autonomous and accountable institutions rather than individual political agents.

This study takes a closer look at Mexico's reforms, the types of institutions that were put in place by those reforms, and the resulting successes and shortcomings. Outlined below are the three universal levels of reforms: macro, meso, and micro. This paper will discuss and evaluate examples of liberalization reforms in Mexico.

Common elements in opening and liberalization processes around the world (from IMCO):

Macro Level: Stability

- Institutionalization of policymaking.
- Macroeconomic stabilization: balanced deficits, prices and debt control respond to transparent long-term rules and criteria.
- Political democratization.
- Increased congressional participation in policymaking.

Meso Level: Competition

- Institutional architecture of regulation following liberalization, privatization and deregulation.
- Privatization and deregulation of key sectors.
- Regulation aimed at open access, certainty in transactions, and correcting market failures.
- Regulation and monitoring by independent, transparent, and accountable institutions that fulfill unequivocal mandates.

Micro Level: Efficiency

- Institutional operation of corporations and government organizations.
- Corporate governance.
- Public governance.

Macro Level Reforms

Macro level reforms have a broad impact on the economy's liberalization and global integration process.

They are the pillars of macroeconomic and political stability and the preconditions to success of the overall institutional reform blueprint.

Every country's economic well-being and ability to attract and retain investment depends on a favorable and stable environment with a degree of certainty for investors, firms, and individuals. Macroeconomic stability measures used by those agents for short-term decision-making are largely captured in the levels and variability of inflation, exchange rates, and interest rates, since their effect on production and employment has been broadly documented. Accordingly, economic policy in emerging economies has focused on the adjustment of the short-run fiscal and monetary variables (fiscal deficit, debt management, exchange rate regime, international reserves, internal credit) to build confidence and expectation of stability in the long term.

In Mexico, following the traumatic experience of the 1980s – with multiple episodes of rampant inflation, exchange rate crises, interest rate volatility, debt crises, and sluggish growth – economic policy embarked on stabilizing the macroeconomic environment via the restructuring of external debt and a stringent fiscal and monetary stance. Many of these policies were added on as covenants in debt restructuring packages from international financing organizations, which included targets for public deficit and inflation controls tied to monetary policy.

After the success of the 1988 stabilization plan ("Pact for Stability and Economic Growth"¹), the outbreak of the exchange rate and financial crisis in 1994-1995 exposed persistent structural weaknesses in monetary control mechanisms and the exchange rate regime. Lessons learned from the crisis encouraged fundamental reforms aimed at more effective and sustainable approaches to control inflation, as well as to mitigate costly speculative attacks enticed by fixed or crawling peg exchange regimes financed with international reserves. The crisis also made evident the crucial role of healthy public finances (revenue sources, public spending, fiscal deficit and debt management) in determining inflation, exchange rates, interest rates, and risk perception.

These macroeconomic reforms were intended to set a foundation for growth in the face of new challenges posed by opening the economy to international competition. Stability generated by the reforms was sustained during the presidential transition of 2000, without the usual currency devaluations. Monetary discipline also resisted the contagion effects from the acute crisis in Asia, Russia, and Brazil during 1997-1999,² and even the 2000 U.S. recession, exacerbated further by 9/11.

Today, the Mexican economy enjoys single-digit inflation, lower and more stable interest rates, and moderate exchange rate volatility, as well as a current account deficit consistent with the exchange rate regime, a foreign investment profile, and the term structure of dollar-denominated obligations. Combined, these factors have promoted greater confidence amongst domestic and foreign investors, and have lowered the country's vulnerability to internal and external shocks.

Despite evident progress, unresolved structural issues persist in public finance, jeopardizing long-term macroeconomic stability. Among the most significant risk factors are: insufficient fiscal revenues, lingering dependency on revenues from oil, deficit pressure from gaps in infrastructure, burdensome pension liabilities, and budgetary discretion. In managing those risk factors, the challenge of pending structural reforms in fiscal policy, labor markets, and energy is evident, as is the need for decisive initiatives to further develop weak financial markets.

All in all, in the macroeconomic stability component of a Competitiveness Index produced by the Mexican Institute for Competitiveness (IMCO), Mexico occupies the 28th position among 45 direct competitors, despite levels of inflation comparable to those of developed economies. Consequently, the index shows that long-term macro stability goes far beyond the short-term behavior of inflation, exchange rate, and interest rates. Instead, genuine long-term macro stability is the ability of government, companies and individuals to make long-term decisions on production, saving, and investments. Despite some advances, the availability and liquidity of such instruments in Mexico lags far behind more developed economies.

The Central Bank's autonomy and inflation control

Among the most decisive institutional developments to control inflation, the autonomy of Banco de Mexico (Banxico), conferred in 1993 via constitutional reform, obliterated the vicious circle that used to fuel abusive use of credit and restrain Central Bank's ability to provide price stability. During the last few years, the strategy of Banxico has been to set inflation targets similar to those of the U.S. (Mexico's main commercial partner), with an annual rate of 3 percent as an operating rule of thumb. The rationale is that greater inflation in relation to the U.S. will reflect directly on the exchange rate, increasing the cost of debt service, the current account deficit, and ultimately domestic interest rates.

Banxico's strategy relies heavily on reputation-building by regular issue of forward-looking macroeconomic indicators. It publicly discloses its inflationary targets and has transparent rules for monetary aggregates management. This strategy helps consolidate the main institutional asset of every central bank: credibility.

Banxico's main monetary policy instrument is the so-called *corto* (shortage liquidity). This mechanism is based on daily announcement of the aggregate balance banks must keep in their current accounts with Banxico. The *corto* strategy keeps a negative average cumulative balance in the banks' current accounts, allowing Banxico to signal to the market that it will not provide – at prevailing interest rates – enough liquidity to keep a zero balance in the banking system. As a result, interest rate increases and inflationary pressures are kept at bay. Currently, Banxico is contemplating replacement of the *corto* with a strategy of interest rate targets, commonly practiced in the U.S. and other developed economies.

Thanks in part to such policies, annual inflation decreased from levels in the order of 100 percent in 1982, to the current single-digit levels of around 3 to 4 percent – a major achievement as a result of the stabilization plans and structural reforms launched in the 1980s. However, sustaining stable prices and exchange rate will depend fundamentally on the consistency of fiscal policy and the continued insulation of this process from short-term political interests.

Foreign exchange policy

Foreign exchange policy in Mexico is under the jurisdiction of the Exchange Commission (Comisión de Cambios), which is the joint responsibility of Banxico and the Secretariat of Finance. The Exchange Commission also determines accumulation policy and manages international reserves. After the 1994-1995 crisis, the commission withdrew its commitment to a semi-fixed exchange rate (crawling peg) and shifted to a floating exchange rate regime, where the exchange rate is freely determined by supply and demand.

Banxico follows the policy of “sterilizing” excess or insufficient liquidity by selling and repurchasing securities (generally, Monetary Regulation Bonds), and controls the accumulation rate of reserves through foreign currency auctions. Reserves management is based on transparent rules developed to avoid interfering with the free market exchange rate. Banxico’s participation in the foreign exchange market is limited to the elimination of excess volatility by facilitating or discouraging the purchase of dollars, depending on market conditions. The Exchange Commission determines the amount and price of the dollars to be auctioned.

The financial crisis

Since the privatization of banks in Mexico (1991-1992), credit portfolios grew rapidly but without adequate supervision or discipline to evaluate and mitigate risk. Therefore, banks accumulated low-quality portfolios that, prior to the 1995 crisis, had a significantly lower recovery value as compared to book value.

The immediate trigger of the 1995 crisis was the peso devaluation, but the cost of the crisis derived mainly from the enormous number of bad loans. The crisis generated a polemic in the political realm, complicating the intervention of the Mexican Government to secure savers’ resources. The costs of bank rescue further multiplied because of (1) delays in actions to recover bad loans, (2) the extreme political character of the FOBAPROA debate (a controversial corruption-stained fund created in 1990 to resolve liquidity problems), and (3) the judicial system’s failure to provide the necessary tools for recovery of past-due loans.

These conditions created a culture of “no payment;” the consequences still affect the conduct of the financial sector:

- Most of the banks’ capital was destroyed, weakening their risk capacity.
- Thousands of debtors who defaulted still have problems accessing finance due to their bad credit history.
- The lack of “fresh” capital inevitably led to the participation of foreign banks in the re-capitalization process.
- The crisis made it evident that most banks lacked systems to evaluate risk and make good credit decisions.

The bank rescue was successful in so far as it protected the majority of the funds deposited in the system. Nevertheless, the rescue costs were significant and the crisis generated a reversal in the financial system.

Perhaps more importantly, the financial crisis led to several beneficial reforms:

- Better capitalized banks and a financial sector strengthened by incorporating newcomers (mainly foreign) with fresh capital and better management systems.
- Creation of the IPAB (government deposit insurance institution), which provides a limited liability insurance scheme in which depositors look after their own resources.
- Creation and formalization of credit bureaus, making available information about debtors’ credit history.
- Strengthening of the CNBV (Securities and Exchange Commission) and reforms of the legal framework governing banks (the new Ley de Concursos Mercantiles – equivalent to chapter 11 of the U.S. Bankruptcy Act, stronger bank capitalization regulations, and a modernized supervision of the Bank Regulation Commission).
- Creation of the AFORES (pension fund asset management), which privatized and individualized the workers’ pension fund, a new funding source that will gradually strengthen and add liquidity to Mexico’s capital markets.

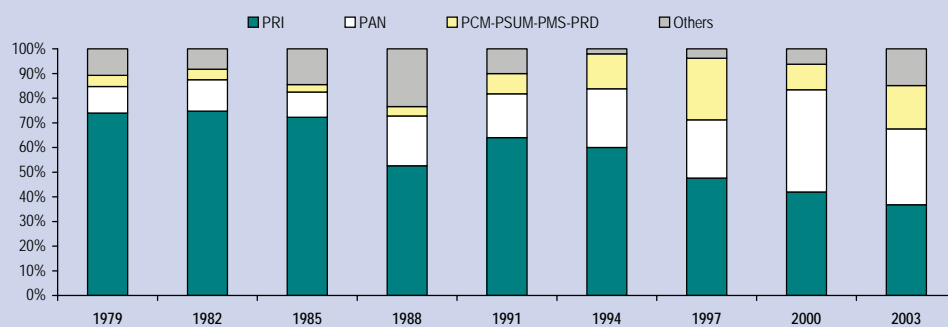
Political stability and the political reform

During the last decade, Mexico’s political system has gradually liberalized. Restrictions to freedom of speech have disappeared, as has the subordination of the entire political system to the whims of the presidency. At the vortex of this change, IFE (the Federal Electoral Institute) and TRIFE (the Federal Electoral Tribunal) have emerged as genuinely independent and accountable institutions. By their commitment to fair and transparent elections, they are the cornerstone of democratic political reform, subject to their continued ability to remain neutral against political pressure.

The institutional reforms concerning the election process were the turning point for the new political balance, with political parties counter-balancing a weakened presidency through an increased congressional participation in the economic policy debate. This was a decisive factor in the PRI’s loss of the majority in the House of Representatives in 1997. Until then, Congress had been dominated by the President-PRI duo, which allowed regulations, budgets, and programs to be easily and quickly approved: more ruling capacity at the cost of less democracy.

However, these positive changes have not been accompanied by institutional reforms toward improved governance. Today, interests represented in Congress are many and diverse, but the beneficiaries of reform tend to use Congress as a political showroom for dramatic statements to maximize media coverage, while keeping safely away from the most urgent aspects of an economic policy agenda. In particular, the debate around protracted structural reforms and the annual budget has reached an impasse, with a negative impact on medium- and long-term stability. Ideally, six-year revenue and expenditure budgets overlapping between presidential administrations would generate higher certainty and continuity in public finance, but no such provisions exist so far.

Figure 1: Congress Composition by Political Party



Source: Zamitiz, Héctor y Hernández, Carlos. “La composición política de la Cámara de Diputados” en *Revista Mexicana de Ciencias Políticas y Sociales*, 136, January-March, 1990, pp. 97-110, Chamber of Representatives of the Congress of the Union and IFE.

Government spending

Fundamental reforms in the Mexican Government’s spending included a strategy for the decentralization of the largest public spending items – education and health – coupled with increased transparency and accountability. Education and health together represent more than one third of budget expenditure.

As far as the efficiency of education spending, Mexico’s scores on the 2002 PISA (International Program for Students Evaluation) exam in reading and mathematics were quite similar to those of other Latin American countries, such as Argentina, Brazil, Chile, and Peru, but significantly lower (up to 30 percent in reading and 50 percent in mathematics) than the average in developed countries such as Finland, Japan, and Switzerland. Also, according to a study from the National Institute for the Evaluation of Education, students from private schools perform better, both in reading comprehension and in mathematics, than those from public schools (knowledge in urban public schools is 10 percent less and in rural areas 25 percent less than in private schools). More concerning, only 58 percent of 15-year-olds in Mexico attend school at all.

Concerning health spending, the OECD reports that between 1990 and 2001 Mexican expenses in health care increased two percentage points, reaching 6.6 percent of GDP, as compared to an average 8.4 percent in OECD countries. If this estimate is expressed in per capita terms, the gap between Mexico and the OECD average grows significantly.

Privatization of the pensions system

In July 1997, the transition to a new pension system was announced. The privatization plan would move from a defined benefit system where current contributions from active workers are used to cover current disbursements to retirees, toward a system of worker contributions to individual accounts managed by specialized financial institutions. Regulation issued for the management of individual accounts along with tight supervision from the regulatory agency (CONSAR) generated high visibility, security, and transparency in funds management.

Currently, more than 33 million workers (over 99 percent of the potential market)³ have an individual account. Estimates show that by 2010, resources under Afores' management will represent approximately 18 percent of GDP. The foreseeable deregulation of these funds could be a driver of the so-far sluggish convergence of corporate governance practices with world-class standards.

Electricity sector reform

In 1992, an amendment to the Law of the Public Service of Electrical Energy limited participation of domestic and foreign private investment in electricity generation by independent power producers (IPPs). The new law allowed for independent production, self-supply, co-generation, sale to CFE (Federal Electricity Company), and export. It also incorporated a vehicle for "project-financed" infrastructure development under build-lease-transfer contracts, while retail price of the electricity would continue to be set by the Ministry of Finance.

The reform was intended to bring private investment to reduce reliance on stringent public finances and funding from international development agencies. Despite constitutional modifications allowing for IPPs, of the combined 36,000 megawatts of Mexico's national capacity, IPPs hold only 3.3 percent.

Meso Level Reforms

Deficiencies in administrative regulation hinder market performance and increase the cost of doing business in Mexico, both in regard to the time and resources necessary to obtain appropriate permits and the uncertainty of obtaining them despite promised time and resources. Studies conducted by IMCO and the World Bank (see the "Doing Business" index) show that the amount of red tape to start a business in Mexico is higher than the OECD average, as are the time and cost of starting a business.

As a direct consequence of such high costs of entering the formal sector, Mexico has significant levels of informality. What is more troubling, according to the ITESM's⁴ Survey on Ruling and Entrepreneurial Development (2002), popular perceptions of corruption are largely directed at key federal institutions, local and state governments, and those in charge of enforcing regulations.

Figure 2: Cost of Starting a Business

	Mexico	LA/ Caribbean	OECD
<i>Number of formalities</i>	8	11	6
<i>Time (days)</i>	58	70	25
<i>Cost (% of per capita income)</i>	16.7	60.4	8.0
<i>Minimum capital (% per capita income)</i>	15.5	28.9	44.1

Source: Doing Business 2005, World Bank. Available at www.doingbusiness.org.

Against this backdrop, a large-scale privatization and deregulation process in key sectors of the economy called for institutions capable of handling divestiture processes, managing the transition, and setting the pertinent sector regulation that would replace government's direct intervention. To ensure regulatory consistency, two institutions were created: CFC (Federal Commission for Competition) and Cofemer (Federal Commission for Regulatory Improvement).

Horizontal regulators

During the last two decades, Mexico has taken significant steps forward both in regulation and public spending efficiency. However, there remains a vast agenda of initiatives to consolidate market openness and liberalization, and to reduce operation and transaction costs (high compliance, labor, and energy costs, along with the cost of other production inputs distorted by the lack of sufficient competition and market flexibility).

Cofemer was created in 2000 with the mission to oversee the regulatory environment. Among the most significant efforts undertaken by Cofemer, the implementation of the System for Fast Opening of Enterprises (SARE) aims to reduce the steps and time required to open a business from the national average of 15 steps in 112 days steps to five steps in two days. The benefit for the nationwide implementation of the program has been estimated as a drop in regulatory direct and indirect costs from 15 percent of GDP to 10 percent of GDP, equivalent to about 40 percent of non-oil tax revenues.

Better regulation should correct distortions that affect the functioning of the market. Ineffective reform initiatives so far have consisted of imposing further regulation, generating even higher compliance costs, creating further protection for politically connected business entities, magnifying legal uncertainty, and encouraging black markets.

While corruption is indeed one of the most visible costs of excessive regulation, its highest costs are loss of flexibility and market performance. Faulty regulation increases the cost of doing business and does not offer adequate protection from abuses of monopoly power to the detriment of competitiveness and individual consumers. Given that small enterprises, women, and youth are often most affected, simplification of existing laws and introducing more efficient regulation in Mexico would be economically and socially “profitable” efforts.

Unfortunately, the Federal Commission for Competition (CFC) is likely to have a hard time coping with unlawful practices, as it lacks adequate

resources and legal powers to enforce anti-trust and other legislation. The 2004 OECD Peer Review of Competition Law and Policy in Mexico is an assessment of the many shortages in CFC’s powers, institutional architecture, and mandate (corroborated by CFC officials themselves):

- Lack of independence, as CFC does not have enough resources and financial autonomy and its President Commissioner is appointed by the Executive.
- Lack of coordination with other government agencies and lack of influence (CFC’s recommendations are non-binding).
- Lack of jurisdiction to investigate unlawful practices, such as corporate conglomerates and collusion among market players, or to declare moratorium programs.

Finally, as part of its international commitments, Mexico also adopted the Convention to Fight Corruption of Foreign Public Services in International Commercial Transactions in 1999. This law sought to increase transparency in public administration and accountability in government performance. The State Secretariat of the Public Function was created to manage the activities formerly carried out by the Secretary for Administrative Control. Its mission is to “...lower the levels of corruption in the country and to provide absolute transparency over the management and performance of institutions and civil servants in the Public Federal Administration.”

Other important legal changes were also introduced to achieve stricter control of public resource management through substantial amendments to laws such as: the Public Federal Administration Organic Law, the Federal Law of Administrative Responsibilities of Public Servants, the Law of Acquisitions, the Law on Public Works, the Law on Transparency and Access to Information, and the Professional Civil Service Law.

It is beyond doubt that the spirit and determination with which these legislative changes were introduced came out of the urgent necessity to curb corruption and boost government institutions and officials’ credibility.

However, measures to limit arbitrary decisions and the impunity enjoyed by many dishonest civil servants should be less focused on individual procedures and more on overall performance. Otherwise, “regulatory panic” will be the most palpable effect of the new laws among civil servants personally liable for wrongdoing. This would result in sluggish, over-regulated procedures and over-allocation of resources to compliance activities.

Sector-Specific Vertical Regulators

Telecommunications. In 1990, the Mexican telecom sector was in crisis, unable to match growing demand for services. Formerly state-owned Telmex’s finances were so tightly tied to the availability of the government’s fiscal revenues that there were no resources to fund the needed expansion. Clients had to wait months or years for a phone line, and a black market of unofficial providers operated with the government’s tacit consent. The frequency of breakdowns was very high and the average time of repair was unacceptably long. In order to complement the income derived from taxes and maintain Telmex’s excessive employment levels, the Federal Government also charged special surcharges on long-distance call rates. That made telephone use more expensive and weakened the competitiveness of companies relying heavily on telecommunications (banking, tourism, exporters). In contrast, local service fee rates were lower than the levels required to cover normal investment and operation costs.

To address these problems, the national government decided to undertake a reform of the telecommunications sector in 1989, consisting of three major objectives:

- Change the conditions affecting the sector’s poor performance (eliminate special taxes that were affecting Telmex’s income and repressing long-distance traffic, pursue aggressive expansion to satisfy demand for minimum coverage and phone line density, improve service quality and productivity levels).
- Privatize Telmex, allowing the new shareholders to manage the company’s finances and operations so as to achieve the desired transformation

- Introduce competition to the sector in local, cellular, and long distance services through re-balancing fees.

The reform that started in 1990 was complemented in 1995 with a new law on telecommunications that established conditions for the entry of new competitors, and introduced regulations concerning the spectrum used to transmit television, radio, and data signals. The reform also involved creation of the Federal Commission for Telecommunications (Cofetel), which regulates the majority of the country’s telecommunications market.

It is estimated that between 1990 and 2003, the telecommunications industry allotted \$40 billion to diversifying and improving the quality of its services. Once Telmex was privatized, it was possible to widen the phone network faster than before the reforms. Today, though access to telephone service⁵ is still below the average levels in comparable economies, the main challenge is no longer the extent of coverage. Even the regions with the lowest level of development have surpassed the average access to coverage in 1990.

In 1990, another major challenge for the telecommunications sector had to do with the quality of services rendered. As a part of the reform, quality goals and disciplinary actions were established, generating strong incentives to improve service. The quality indices of Telmex have continuously improved since 1990 and the same can be said of newcomers to the industry. Furthermore, services offered have become much more varied – including Internet, voice, video, and other data services.

Finally, before the reform, charges for phone services were considerably distorted: none of the charges for the most important telecommunications services corresponded to the marginal costs for providing them. Though the speed of adjustment was slower than in other countries, today the average charges for the most common services are cheaper than a few years ago.

Nevertheless, there are still opportunities for improvement, specifically with regard to domestic

long-distance rates and the prices charged to commercial users. There is also a good amount of work to do in making Cofotel an effective regulator. Telmex (whose strength in the market remains overpowering), followed by other competitors, was the first to oppose many of Cofotel's resolutions. They were granted legal protection and, hence, many of the agency's resolutions were never implemented. Moreover, one of the sector's key weaknesses is the lack of a clear policy for the future of telecommunications in Mexico, especially in the area of Internet services. The key limitation here is not the availability of infrastructure, but the high proportion of potential users lacking the resources to acquire a computer or an internet terminal.

Financial sector. There have been improvements in the quality of Mexican banks' portfolios favored by a more stringent regulation coupled with the new accounting standards introduced in 1997. Reserves have grown in relation to non-performing loans and, under current capitalization rules, the overall banking system has a healthier balance sheet.

Improvements in asset and capitalization quality are due to a large extent to the internationalization of bank ownership. At present, about 95 percent of commercial banks are foreign-owned. Therefore, the banking system operation rules are not only subject to tougher regulations and supervision from Mexican authorities, but they also respond to standards and best practice abroad as subsidiaries of foreign banks.

From a comparative point of view, the Mexican financial sector is relatively small in relation to the economy it serves. One of the main reasons for that is the aftermath of the 1995 financial crisis, which triggered the massive non-performing loans problem. It led to the de-capitalization of most banks and capital flight. On the other hand, long periods of economic instability have distorted the conduct of savers: many prefer the certainty of immediate consumption to the uncertainty of future consumption. The country's demographic structure has also contributed to a low accumulation of net savings because many Mexicans have not yet reached the age at which they can contribute to production (and therefore, to savings). For the same reason, the structure of dependency in Mexican families

fosters consumption instead of savings. Consequently, the level of "financial deepening" in Mexico is lower than in similar economies.

Mexican commercial banking has been, and continues to be, the most important financing source for the private sector. Even though capital markets already have a considerable size in relation to the economy, they are used mainly to finance the Federal Government by issuing public debt (88 percent); the fraction devoted to the private sector is relatively small and goes to large enterprises, mainly exporters.

There are several practical consequences of private sector dependence on commercial banking financing rather than capital markets:

- There are fewer resources to finance long-term investment (banks are a natural source of short-term financing, but they are not ideal for financing long-term assets, which is the role of capital markets).
- Available financing for small- and medium-sized enterprises is scarce and expensive, creating a severe limitation for economic competitiveness.
- Funding sources for non-banking financial intermediaries, such as the SOFOLES (mortgage lenders), are scarce.

As a result, at least in the medium term of the next five years, the competitiveness of services offered by the financial sector in Mexico will remain intimately linked to the performance of the banking sector, though it is expected that this perception will change as the resources of the SIEFORES (investment funds specialized in retirement savings) keep growing. In the foreseeable future, then, the most important financing sources will still be retained earnings and supplier financing (constituting around 60 percent of incremental financing granted to enterprises).

The 1995 crisis had a very negative effect on credit availability for enterprises.⁶ Since the crisis, banks stopped lending money to certain sectors (e.g., the agriculture), where they had experienced particularly serious problems in recovering non-performing loans. Banks also started looking for safer and more

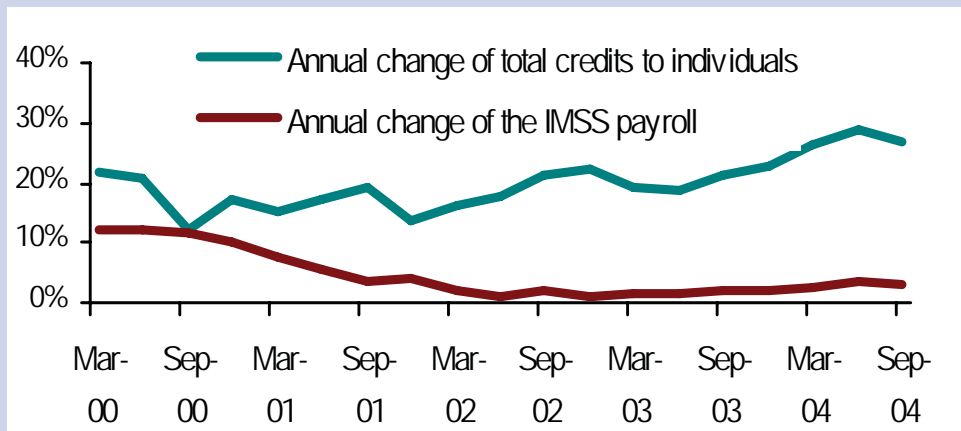
profitable alternative sources of income. Hence, the credit portfolio decreased in relation to the economy and financing for enterprises was the most affected. By the end of 2003, banks were devoting the equivalent of 2.7 percentage points less of GDP to the enterprise and housing sectors as compared to the prior six years.

Only government financing and consumption loans have increased. Credits to municipalities and governmental entities increased 22.34 percent between September 2002 and September 2004. Credit to financial institutions also grew, thanks to the funding needs of the new non-banking institutions.

Commercial bank consumption credits increased 77.85 percent between September 2002 and September 2004. These loans increased due to lower interest rates during that period, and to the implementation of new tools from the Credit Bureau such as strengthened credit analysis and improved risk evaluation systems. Also, a new culture of “repayment” moved to consolidation and mortgages boomed due to reformed rules regarding guarantees (approved in April 2003). Consumer loans portfolios had also increased substantially, mainly through credit cards. Though the stock of consumer loans is far from the levels of countries such as the U.S., it seems that this trend is unsustainable. As shown in Figure 3, consumption credit has grown consistently since 2002, though the income of Mexicans using this credit remained unchanged.

A turning point for the Mexican financial market was the launching of the Mexican Derivatives Exchange (MexDer) at the end of 1998. The availability of securitized risk hedging instruments – besides its practical benefit for companies, government, and the other credit risk takers in the economy – had significant

Figure 3: Consumption Credit Increase*



* Consumer and mortgage loans by commercial banks and Sofoles
 Source: CNBV and IMSS. - IMSS payroll is the mass of wages paid to employees insured by IMSS:
 Payroll = (SMC x N° Worker x 30) / INPC

implications for macro stability. The existence of a “market for risk” plays an important role in risk price formation and divulging. Securitization of mortgage markets was another step in the right direction, to which the internationalization of bank ownership significantly contributed through better capitalization and relevant expertise.

Other important reforms were implemented by President Vincente Fox in 2000, who in the first months of his administration took advantage of macroeconomic stability and the new democratic mandate to improve the performance of the financial sector. The most significant reforms were:

- Creation of new specialized financial intermediaries focused on financing the housing, agricultural and farming sectors.
- Passing of the Savings and Popular Credit Act to create a new non-banking financial intermediary system focused on low-income individuals, designed to avoid the fraud risk associated with prior savings programs. The two pillars of this strategy were Bansefi (formerly the Bank for National Saving) for urban areas, and Financiera Rural for rural areas.

Overall, during the 10 years that followed the 1995 crisis, the situation of the financial sector has improved considerably. However, major issues remain:

- Limiting the government crowding-out the private sector, both in the capital market and the banking system (currently, the state absorbs too large a share of the available financing resources).
- Ensuring that the offering costs and rates of the banking system are internationally competitive.
- Detecting and adopting strategies to recognize unsustainable growth of the consumption credit portfolio.
- Increasing access to finance by small- and medium-sized and rural enterprises with profitability inadequate to attract bank capital (given the difficulties in obtaining financing, these enterprises are forced to use the most expensive financing, their own profits, in order to grow).

Micro Level Reforms

At the micro level, institutional reform is driven both by changes in the regulatory framework and by pressures from greater competition and economic integration. Government and private organizations are slowly converging on best governance practices of transparency in decision-making. In the case of corporations, increased capital mobility is driving institutional change towards unified corporate governance principles and practices, and international corporate scandals are prompting investors and regulators to take a more meticulous approach to monitoring.

The McKinsey global investor opinion survey of 2002 reveals that investors are willing to pay a premium for well-governed companies, even more so when it comes to developing countries. From another perspective, a recent study from Oxford Metrica⁷ on 325 Latin American Depositary Receipts (DRs) introduced the notion that listing DRs improves shareholder value. The main results of the study are:

- Listed (Levels II/III) DRs improve shareholder value by approximately 30 percent in their first trading year and home market liquidity by around 41 percent.
- OTC DRs add 40 percent to shareholder value and 7 percent to home market liquidity.

- An upgrade to Listed DR adds a further 30 percent to shareholder value.

In contrast, termination of a listed (Levels II/III) program by Mexican firms prompted a fall in shareholder value of approximately 30 percent. Oxford Metrica's results can be corroborated by taking a glimpse at some recent delisting scandals involving Mexican stocks.

Drivers of corporate governance reform

Many domestic and international events and trends are pushing for better governance practices in Mexican corporations. The enactment of the Sarbanes-Oxley Act influenced Mexican subsidiaries of U.S. companies and related parties, and integration of the global capital markets is one of the main drivers for convergence.

The Mexican stock market remains relatively underdeveloped, with only 140+ companies listed on the Mexican Stock Exchange. After a period of relatively rapid growth of market capitalization in the years preceding the signing of NAFTA, the upward trend lost its momentum after the 1995 financial crisis, followed by stagnation. Bylaws of listed companies are hard to access and compensation disclosure is not required by law. Difficulty in accessing this information is itself an indication of the infant state of governance practices in Mexican corporations.

Though domestic levels have fully recovered to their pre-crisis levels, financing from abroad has not, and it is limited to debt instruments with virtually no new financing from equity issuing in the domestic or international markets.

In spite of the meager development of Mexico's capital markets by any reasonable measure (size, depth, liquidity), integration with global markets is unavoidable. Movements in the IPC, the main indicator of the Mexican Stock Exchange (BMV), go hand in hand with those of the main stock markets globally – naturally more so with U.S. markets.

From the many forces pushing for better governance, the ones that will set the pace of change

in the immediate future are the internationalization of Mexican commercial banks, the enactment of the New Securities Market Law, and the deregulation of pension fund managers (AFORES).

As discussed earlier, roughly 95 percent of Mexican commercial banks' assets are controlled by foreign banks. These subsidiaries share their parent company's governance and compliance standards and are increasingly paying more attention to the governance practices of their clients. Even the few remaining domestically-controlled institutions share these practices when it comes to syndicated loans. International conventions like Basel and Basel II have also found their way into the revised capitalization rules for financial institutions.

The Securities Market Law enacted in 1975 was reformed in 2001 to incorporate higher standards in disclosure and audit controls. However, the reform left untouched fundamental aspects concerning board structure and the allocation of corporate roles and responsibilities. Closely related, the still-binding 1934 Mercantile Partnership Law enshrines concepts, roles, and obligations clearly no longer adequate to the requirements of a modern corporation. In this sense, the New Securities Market Bill currently being discussed in Congress is a major step in the right direction. Under this initiative, boards would incorporate precise designation rules, while intermediate bodies within the board acquire specific roles and are made accountable. It would also ensure increased minority shareholder protection and empowerment, provide a bridge between private and public companies, and more certainty on exit for venture capital.

One of the most recent and significant steps towards a better governance culture was the issuance of a Corporate Governance Best Practice Code (CGBPC) in 2000. The code consists of 54 aspects of governance grouped in six categories: board structure, board operations, evaluation and compensation, audit

(external and internal), strategic planning and finance, and general shareholder meetings.

The CGBPC was a joint effort of the private sector and the government (Secretariats of Finance and the CNBV). Compliance with the principles of the CGBPC is not yet mandatory or enforceable. However, listed companies must report to the CNBV annually on their adherence to the code. Self-evaluations are disclosed yearly on the Mexican Stock Exchange website.

Despite of being a self-assessment tool, there is a considerable variance in adherence and across different categories. Twenty-nine percent of respondents can be characterized as non-compliant showing an adherence of less than 70 percent. Also striking is the

Figure 4: Issues Undermining Governance in SOEs

Governance Functions	Independence	Checks and balances
⇒ BODs	⇒ A superdirector	⇒ Imperfect congressional oversight
⇒ Management	⇒ President/Congress appointment	⇒ Focused in Procedure not performance
⇒ External Audit	⇒ Audit Agency	⇒ Focused in Procedure not performance
⇒ Disclosure	⇒ Transparency Law and Agency	⇒ Focused in Procedure not performance

Source: IMCO

fact that the compensation and evaluation category is consistently the one showing lower adherence over time. On the other hand, higher general adherence to audit principles relative to other categories comes at no surprise when we consider that tax revenues rely heavily on large corporations, which are in turn subject to close scrutiny by the tax authorities.

A major remaining gap in Mexico's development of sound corporate governance practices (see Figure 4) is the critical need for such reforms in state-owned

enterprises (SOEs). For instance, virtually no progress has been made in Pemex, although reforms have been twice attempted. This poor governance performance is strongly related to the capture of key SOEs by unions related to political parties. Significant welfare and efficiency losses follow.

Implications of Mexico’s Integration into the Global Economy

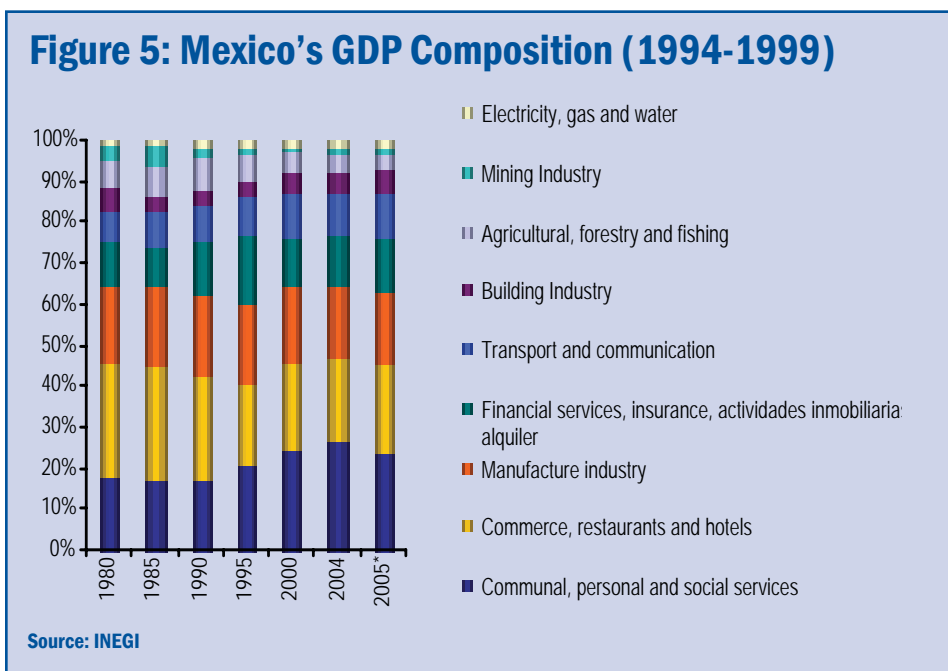
Over the last decade and a half, Mexico’s economy has been profoundly changed in response to trade and financial opening. The signing of NAFTA in 1992 came with the expectation of a radical transformation of the Mexican economy propelled by the vast trade and partnering opportunities created by the new zone of free trade and capital mobility. Fifteen years after NAFTA’s signing, changes are profound in three dimensions: (1) the redefinition of the role of the state, (2) trade flow size and composition, and (3) investment flows and the integration of capital markets.

Within the context of market liberalization and opening, the Mexican government has taken on the task of making itself “leaner” through an aggressive privatization program. The government’s participation in GDP was cut in half during the 1988-2003 period, from almost 10 percent to less than 5 percent. In spite of this dramatic resizing, the long-overdue structural reform to allow for private investment in the energy sector still leaves the state with significant participation in the economy.

One of the foremost effects of trade liberalization has been a sharp increase in the share of trade in the economy. After NAFTA, the share of international trade (imports + exports) in the Mexican economy has increased considerably, growing from 29 percent of GDP in 1982 to 56 percent in 2002. Since the largest part of the trade flow is with the U.S., the Mexican

economy closely follows that of the U.S. The same applies to capital markets, as foreign direct and portfolio investment from the U.S. has grown significantly with Mexican companies’ increased access to U.S. debt and capital markets.

The evolution of Mexico’s GDP composition clearly reflects the global trend where primary activities like agriculture and mining lose share in the aggregate, accounting for the increasing sophistication of the Mexican economy. The outstanding growth in the transport and communications sectors in particular, as well as manufacturing, is a natural response to the increase in trade flows following the signing of NAFTA.



One of the lingering problems in the Mexican economy as it increasingly faces global competitive pressures is persistent lack of flexibility in the labor market. The root of the problem lies in a regulation that attempts to protect the population considered to be at a disadvantage. But contrary to these intentions, the regulation distorts the market and ends up having an opposite effect for the very group it was meant to protect. By imposing high costs on hiring and firing workers, it discourages job creation and pushes the poorest segment of society into the informal sector. In Mexico, indicators of these costs are twice as high

as those observed in OECD countries and significantly higher than average in Latin America and the Caribbean.

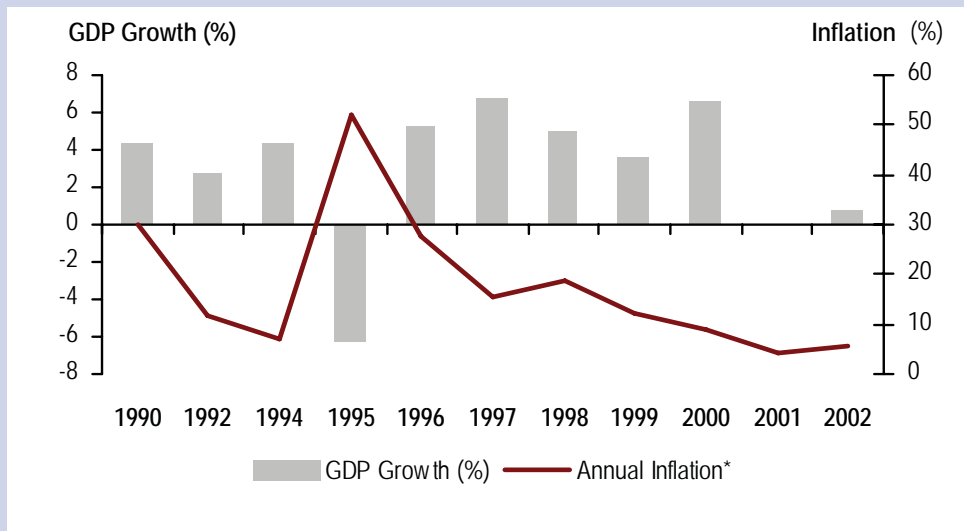
Giving flexibility to labor contracts does not mean that the state abandons its commitment to social support for the most vulnerable part of the population. On the contrary, in countries with greater flexibility in labor contracts, the state and the regulators focus their efforts on mitigating temporary negative social impact with such initiatives as unemployment insurance.

Assessment of the Governance Transformation to Date

In order to discuss Mexico’s improvements and challenges in this field, it is necessary to define what is understood by macroeconomic stability and how it relates to governance. Conceptually, macroeconomic stability refers to the prevalence of moderate and stable levels of inflation, interest rates, and exchange rates. Though there is no precise rule for the optimum magnitudes and volatility⁸ of these variables, international experience and economic literature confirm the role of macroeconomic stability as one of the fundamental elements that determine a proper climate for investment and sustainable growth. Other key factors include institutional infrastructure and the openness of the economy.⁹ Figure 6 shows the strong correlation between one of the main variables of stability – inflation – and the growth rate of GDP.

A stable macroeconomic environment has tangible effects on competitiveness and performance of companies, markets, and the economy in general. Figure 7 shows the fiscal and monetary policy levers available to governments to promote stability in prices, exchange rates, and interest rates. Fiscal policy must aim at keeping the government solvent in the

Figure 6: Inflation and Growth in Mexico (1994-1999)



Source: Bazdresch, Santiago and Werner, Alejandro “Contagio de las crisis financieras internacionales: el caso de México.” Banco de México. November, 2002.

long run by achieving revenue sources that correspond to expenditures (using debt capacity responsibly). The role of monetary policy consists of adjusting the amount of monetary base, which provides the necessary liquidity for transactions in the economy and ensures stable prices through the financial system.

In Mexico, the estimates of fiscal revenue used by the government tend to vary substantially due to abrupt changes in oil prices or corporate profits. The uncertainty is magnified by common risk factors such as natural disasters, financial crisis abroad, or sudden shifts in the exchange rate. Therefore, macroeconomic policy requires the introduction of risk management strategies.

Systemic Changes in Historical Context

From the early 1950s until 1981, Mexico lived through a period of relative prosperity with almost uninterrupted growth and stability in prices, the exchange rate, and interest rates. This period is known historically as “Stabilizing Development.”¹⁰ Much of the success can be attributed to the postwar economy in the U.S., but this was also a period of orthodox management of fiscal and monetary policies coupled with prudent management of public deficit.

In contrast, the 1980s were characterized by high volatility and high levels of inflation and interest rates,

as well as recurrent episodes of distress in foreign exchange and debt markets. Periods of sharp economic recession followed (1982-1983 and 1986-1987),¹² yielding negative growth rates during almost the whole decade.

The origin of what is known until the present day as “The Crisis” can be traced back to the boom in oil prices during the late 1970s. High oil prices coincided with record activity in exploration of new reserves.¹³ Enjoying this financial boost, the government introduced a strategy of “abundance management,” leading to an unprecedented level of public spending financed through higher fiscal revenues from oil exports.¹⁴ Between 1977 and 1982, revenues from oil and gas exports totaled \$48 billion, while total sovereign debt reached \$40 billion.¹⁵

At the same time, the exchange rate was kept at 23 pesos per dollar, promoting an import increase of consumer and intermediate goods, while the share of oil exports in total exports increased from 45 percent in 1979 to 65 percent during the second quarter of 1980.¹⁶ The natural outcome of the faster

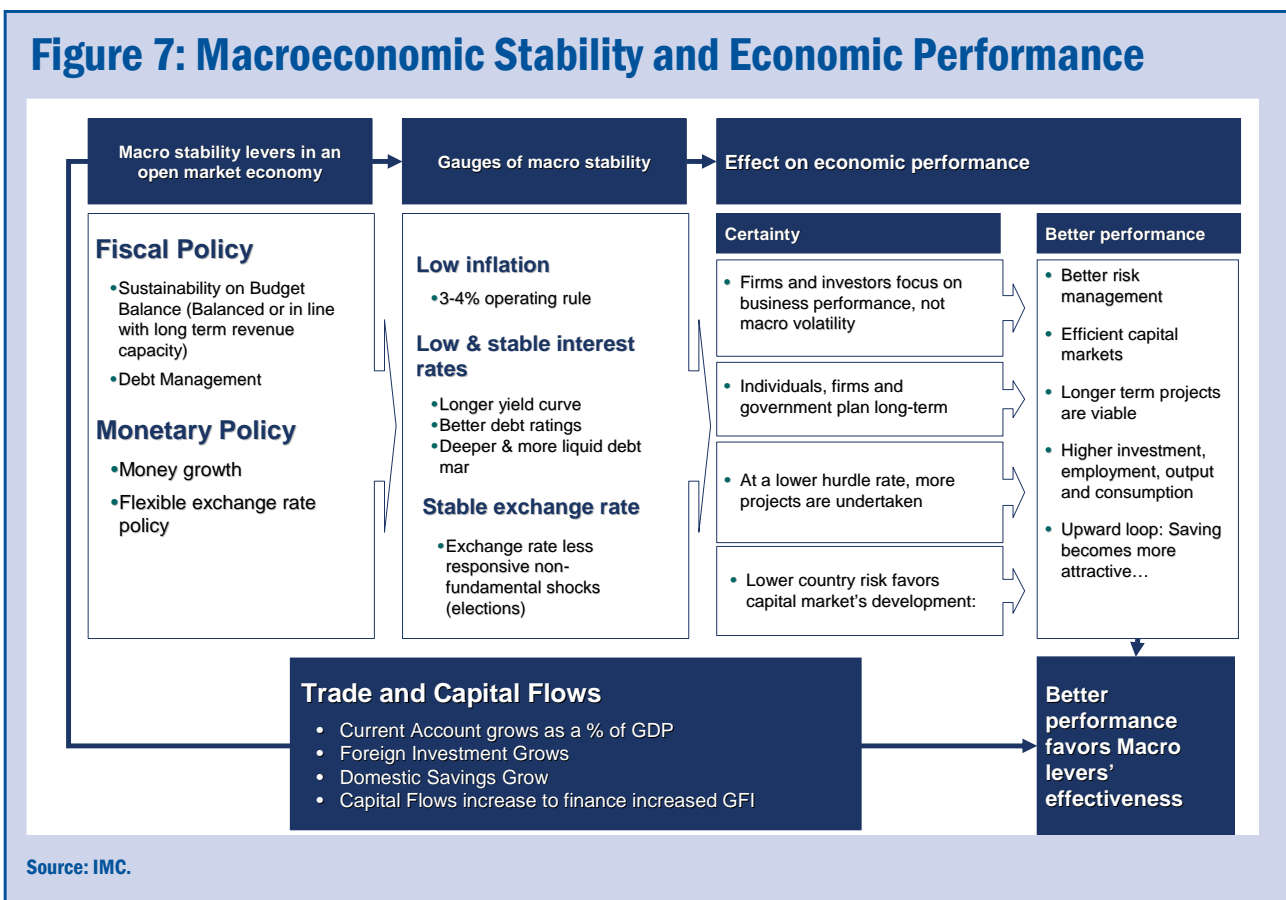
growth of imports over exports worsened the terms of exchange.¹⁷

The major factors leading to the 1982 crisis were:

- fiscal revenue highly dependant on oil prices,
- accelerated accumulation of risky debt backed by high oil prices,
- unsustainable fiscal deficit financed by oil-supported debt and the inflation tax,
- current account deficit with eroding non-oil exports,
- government-owned companies running at losses,
- a fixed and overvalued exchange rate (an open invitation to speculative attacks), and
- the composition of public expenditures with a heavy current spending component that supported enormous deficit and the government’s excessive size.

The immediate crisis concluded in 1982 with the suspension of external debt payments and dramatic nationalization of commercial banks. These actions

Figure 7: Macroeconomic Stability and Economic Performance



caused damage to the country's economy (inflationary pressures, scarcity of capital, high interest rates, lower growth, and higher unemployment) and international credibility that would take over a decade to overcome. Despite the harsh lessons learned during this period, public finances are still highly dependent on oil income, generating diverse structural weaknesses.

The financial crisis of 1994-1995 resulted in free flotation of the exchange rate (just as the crisis of the 1980s) and a massive flight of foreign capital. This had devastating consequences for the solvency of both government and private companies. Once again, the crisis evinced the need for a plan of adjustment to public finances and the restructuring of public debt.

Apart from the enormous cost in lost growth and wide-spread bankruptcies, the crisis led to the deterioration of banking system assets that required a large-scale bailout to preserve deposits. The loss in market value of the banks' portfolio at the outbreak of the crisis is estimated at around \$25 billion.¹⁸

In 1989, a few years before the crisis, Mexico's 18 state-owned commercial banks had been privatized (reversing the nationalization of 1982). Among the main factors that explain the vulnerability of these privatized banks were:

- The high price paid by buyers (200 percent of book value, much higher than the average in the U.S. at the time).
- Expansion of internal credit, together with the elimination of reserve requirements and the increase in deposits.
- The high vulnerability of portfolios to movements in the exchange rate (credits granted in dollars).
- The lack of experience (and perhaps negligence) of the new owners together with an accelerated expansion of credit (especially for consumption), which increased from 16 percent of GDP in 1993 to 39 percent in 1994.¹⁹
- Increased lending to riskier clients (as more stable companies gained access to the U.S. capital markets – generating a higher foreign exchange risk – banks lent to companies with lower credit-worthiness).²⁰

There are diverging theories on the causes of the 1994-1995 crisis. Some authors (notably R. Dornbusch) hold that it was the result of an overvalued peso, financing of public deficit through the expansion of internal credit, accelerated expansion of consumption, current account deficit, and the fall in reserves,²¹ coupled with deterioration of the banking system portfolio and the excessive amount and short-term structure of dollar-denominated instruments (Tesobonos). Others maintain that there is no evidence to support the overvaluation hypothesis and that the current account deficit was manageable and sustainable through the positive balance of the capitals account of the balance of payments.

Whatever the opposing theories on the causes, it is evident that the developments achieved by then in macroeconomic management contributed to an accelerated recovery. In contrast with the slow recovery that followed the crisis of 1982, the negative effects of the 1994-1995 crisis over inflation and growth were overcome in less than two years.

The 1994-1995 crisis conveyed valuable lessons for the design of macroeconomic policy, and the transition to a flexible exchange rate was compatible with the needs of Mexico's globalizing economy. The ensuing return of macroeconomic stability overcame challenges traditionally conceived as insurmountable, such as a presidential transition without exchange rate turmoil. The effect of the crisis in the financial and banking systems did expose structural weaknesses in relevant regulation and forced reforms. Today banks are subject to more stringent capitalization rules, credit scoring policies and portfolio ratings in line with international standards (Basel I and II). Supervision and monitoring have also been reinforced, and corrective measures have been put in place for debt management in order to reduce the exposure of the economy to external shocks.

A less welcome but natural consequence of Mexico's higher integration with the global economy has also been the higher risk of crisis contagion, where a crisis in one region significantly affects economic performance elsewhere. The main channel of transmission for contagion is through capital markets. For example,

Figure 8: Summary of Structural Transformations in the Mexican Economy

“Stabilizing Development”

1954-1981

- Stable growth
- Prices, exchange rate, and interest rates stability
- Moderate deficits

Debt Crisis

1982-1984

- Debt crisis
- Deterioration of exchange terms and petroleum prices
- Foreign interest rates increase
- Banks nationalization
- Dual exchange rate
- Capital controls (to avoid foreign currencies flight)
- Restrictions and fees on imports
- Immediate Program of Economic Reorientation

1985

- Earthquake destroys capital and infrastructure
- Fiscal Reforms (Introduction of VAT and limitation of exceptions and exemptions on Income Tax)
- Mexico joins GATT; advances in trade agreements

1986

- Abrupt fall of petroleum prices
- Primary surplus deterioration

Economic Recovery and Opening

1986

- Baker Plan for debt restructuring

1987

- Economic Solidarity Pact together with devaluation and fixed exchange rate in 1988 to control inflation

1988

- Debt restructuring

1989

- Brady’s Plan: \$48 billion debt swapped for bonds secured by petroleum
- Exchange rate follows a crawling peg at a rate lower than inflation
- Economic Stability Pact

Crisis and Opening Consolidation

1994

- Strict deficit management
- Debt control and current expending financial limitation
- VAT from 10 percent to 15 percent
- Economic Recovery Alliance
- NAFTA is signed
- Mexico becomes a member of the OECD
- Reforms of the Foreign Investment Law

1995

- Devaluation, exchange rates and financial crisis, and free flotation of the exchange rate
- Banxico’s autonomy
- Inflationary objectives announcements
- Information and transparency
- Stabilization fund for petroleum incomes
- Support for deposits is reconsidered

Source: IMCO.

the individual risk rating of Latin American countries is influenced by the rating of the entire region and vice versa.²²

Current Policies

Balance of payments

The current account of Mexico’s balance of payments has improved significantly during the last decade. Though there is a commercial deficit of around 1.5 percent of GDP, this indicator has decreased steadily from the 1990s, contributing to the relative stability of both foreign exchange and interest rates, and facilitating the control of inflation.

As long as Mexico maintains a balanced commercial position and keeps attracting foreign direct investment, macroeconomic stability will not be compromised. Despite the decrease in the current account deficit, the economy has been losing ground in exports to the U.S. in favor of China and India. Therefore, it is imperative for the Mexican economy to keep and improve its appeal as a favorable destination for foreign investment.

Monetary policy

As already mentioned, improvements in monetary policy to control inflation owe their success to a large extent to the consistency of fiscal policy. In 2003, fiscal deficit was a half a percent of GDP – low compared to the levels observed in past decades and in comparison with other countries.

The public balance on the expenditure side responds to cuts in current spending, privatizations of state-owned companies, along with the amortization and restructuring of liabilities. On the income side, the second half of the 1980s witnessed several tax reforms designed to increase tax revenues, such as the introduction of the Value Added Tax in 1984, which has experienced temporary and permanent increases in periods of fiscal need. Income tax has also undergone significant modifications aimed at increasing government revenue through the cutback of exception regimes and preferential benefits such as accelerated depreciation of fixed assets, tax consolidation, and tax havens. The participation in tax revenues of excise taxes on cigarettes, liquor, soft drinks, gasoline, and lotteries has also increased significantly.

Public finance

Public finance accounting has experienced significant improvements in transparency with the inclusion of expenditures and liabilities traditionally left aside in deficit accounting. The definition of deficit is now designated as Financial Requirements of the Public Sector (FRPS): “FRPS are computed on the basis of the traditional public balance [deficit], adding up the financing needs that correspond to activities excluded from the balance.”²³ FRPS include: *Pidiregas* (firm investment commitments with a postponed impact on expenditure recording), interest on debt contracted by the banking and highway bail out programs (IPAB and FARAC, respectively), the program for banking debtors support, contingent liabilities from loans to the private sector from national development banks, miscellaneous adjustment items as the inflationary component of servicing inflation-indexed debt, and actuarial reserves for social security-related liabilities (IMSS and ISSSTE). After the 1995 crisis, FRPS reached their peak at 6 percent of GDP.

Debt management

A common denominator of stabilization strategies undertaken as a reaction to crises has been debt restructuring. The strategy has included lengthening debt maturity and bring its service to more manageable levels, as well as accelerating amortization through extraordinary income from privatizations and oil

export revenues. As a result, the principal debt amount was reduced from 45 percent of GDP during the 1980s to its current levels around 25 percent of GDP.

Increased average debt maturities also have an effect on inflation expectations through their impact in government’s liquidity. To limit exposure to currency instability, domestic financing is preferred, reflected in the increased participation of domestic debt and the corresponding decrease in foreign liabilities.

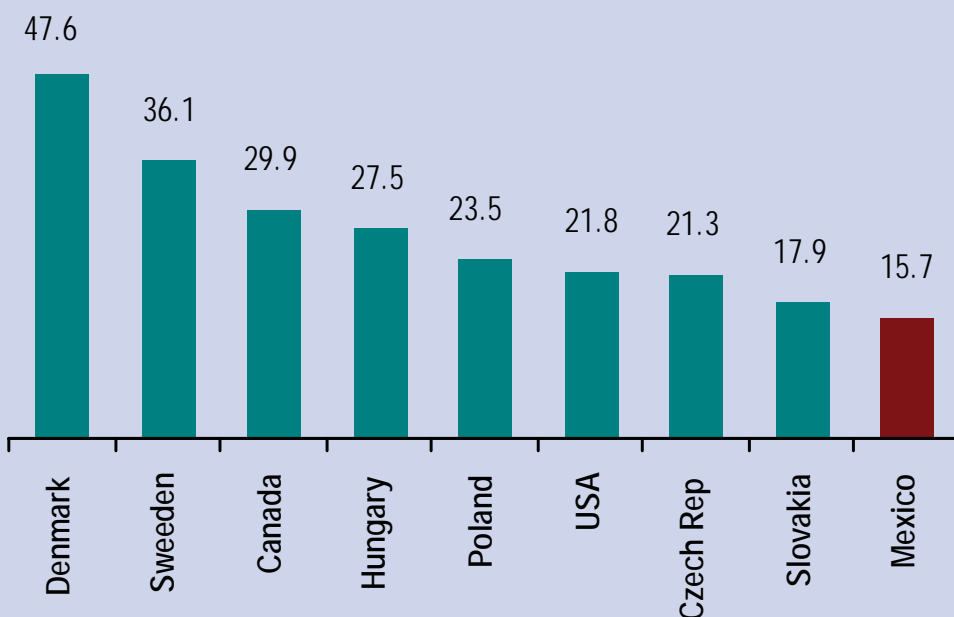
One of the obvious direct results of prudent debt management has been a stronger credit rating for Mexican securities (reduced country risk) with a significant impact in competitiveness through reduced funding costs for the whole economy. Mexican sovereign debt has reached and maintained investment grade in recent years with the major international credit rating agencies.

Structural Factors Jeopardizing Macroeconomic Stability

The remaining particularly risk-ridden structural factors of the Mexican economy are: fiscal dependency on oil income, insufficient fiscal revenues to fulfill pension liabilities and contingencies, firm investment commitments with postponed impact on the budget (*Pidiregas*), discretion of expenditure allocation, and lack of multiannual income-expenditure budgeting. Surveys and recommendations from international organizations, such as the OECD²⁴ and the IMF, concur that risk factors for Mexico’s macro stability are linked directly to pending structural reforms in fiscal policy, energy, and labor markets liberalization.

Tax policy: revenue insufficiency and tax reform

There is consensus on the insufficiency of current tax revenue to finance government investment commitments and close the gaps in public infrastructure and services. A measure thereof can be obtained by comparing fiscal revenues in terms of GDP with those in other countries. Figure 9 shows that the tax burden in Mexico, as a percentage of GDP, is low when compared to other nations.

Figure 9: Tax Burden as a Percent of GDP

Source: Banco de México.

Fundamental tax reform initiatives during the last two administrations were meant to achieve a system more dependant on indirect taxation by reforming VAT. The key advantage of VAT over income taxes as revenue source lies in the argument that VAT generates fewer distortions on investment and saving decisions of companies and individuals. With its uniform rate and few exemptions, VAT is also cheaper and easier to collect, and is more difficult to elude.

The main argument successfully used to counter the initiatives to eliminate all VAT exemptions and reduce its rate (with additional revenue potential up to 2 percent of GDP) has been the regressive effect it would have on income distribution, as the elimination of exemptions would disproportionately impact low-income population. The lack of political consensus on VAT reform is also magnified by the lack of popular awareness of how the subsidy implicit in exemptions disproportionately benefits the highest-income segment of the population. A solution to make VAT reform more socially acceptable could be in compensation mechanisms that would include direct transfers using registries of poverty alleviation programs already in place that encompass a big portion of the targeted lower income population. This could be supplemented with

direct transfers to individual retirement accounts of the newly privatized pension system.

For corporate income taxes, their structure must be analogous to that of other countries, in line with the opening of the Mexican economy. A domestic increase above the tax rate of other countries would go against the objective of attracting and retaining foreign investment. On the other hand, a strategy based on reducing corporate income tax rates to attract investment would not necessarily be effective, given the existing agreements to avoid double collection, under

which a foreign company receives credit for taxes paid in Mexico and later pays the differential on tax rates in its home country.

Pension liabilities

The privatization of the pension system called for an independent and reliable regulator to preserve the safety and maximize the value of the pension savings – two seemingly contradicting objectives. In spite of this privatization, though, several government pension systems continue operating under the defined benefit scheme covering workers in sectors such as: federal and state governments, the armed forces, and universities.

In 2004, pension payments to government workers, SOE employees, and decentralized agencies reached the equivalent of 6.5 percent of the budgetary revenues of the public sector, or approximately 1.2 percent of GDP. Given the expected change in demographic trends, a reform of the state's pension system is essential to secure its viability and insulate it from budgetary considerations in the absence of a transition to a defined contribution system.

Dependency on oil revenues

The problem of dependency on oil in terms of macro stability resides on the uncertainty it attaches to budget planning due to volatile oil prices: an unexpected drop in prices results in inefficient and costly budget cuts, while price peaks set incentives for excessive or inefficient spending. Fiscal dependency on oil revenue (representing around 33 percent of Mexico's revenue) implies a series of major risks for long-term economic stability:

- Budgetary risk generates uncertainty for the formation of other prices in the economy (like interest rates and inflation).
- Price volatility adds complexity to long-term budgetary planning and to the execution and continuity of investment projects and governmental programs in general.
- Price volatility also tends to postpone fundamental tax reforms that could provide less volatile sources of income.
- In the absence of a fundamental tax reform, the national oil company (Pemex) continues to bear the burden of a fiscal regime, hampering its efficient operation.
- Inefficient Pemex and special taxes on hydrocarbons translate into severe distortions on gasoline prices with a direct negative effect on competitiveness.
- The political resistance towards privatizing Pemex persists despite the evident fiscal and efficiency benefits it could generate.

The launching of the Oil Revenue Stabilization Fund in early 2000 is a significant step towards reducing the effect of oil price volatility on Mexico's public budget. The fund establishes clear rules regarding the use of additional revenue from prices above the budget reference and earmarks a significant portion for debt amortization and other capital expenditures considered "one-time" expenses. However, there are strong political incentives to manipulate the reference price to determine the accumulation or withdrawal of resources from the fund. When oil prices were high, the reference price was set well below the observed average and the amount of resources considered as "additional" became high.

It is therefore imperative to incorporate a set pricing rule that will exclude political interests when establishing the reference price for budgeting purposes. An efficient rule should guarantee that: (1) the fund's resources at any time will be enough to cover shortages during periods of prices below budget requirements; (2) excessive accumulation of funds is minimized; (3) the functioning of the fund is insulated from political pressures.

Energy sector reform

Delaying reforms to allow private investment for sufficient and efficient production of hydrocarbons and electricity generation not only foregoes highly profitable investment opportunities, but it also implies perpetuating severe distortions on energy prices. The foreseeable pressures from a growing demand for energy entails onerous investment requirements that will eventually affect public finances.

If such investments are not made, satisfying Mexico's energy demand in the future will depend on imports from the international market, likely sustaining high prices for the remainder of the decade. The negative impact of such a scenario on the balance of payments, exchange rate, and the cost structure of the economy is more than evident.

Conclusions

Long-run macroeconomic stability depends both on the economy's competitive performance and the deepening of financial markets to allow economic agents to establish long-term risk management strategies. This is a joint responsibility of economic policy and a business culture that incorporates sound risk management and good governance practices.

In Mexico, the reforms to achieve greater macroeconomic stability, started during the second half of the 1980s, have set a sound foundation for growth in the context of globalization. In fact, the opening of the economy has been an anchor for prudent management of fiscal and monetary policy. Today Mexico has a much more stable economy, resistant to sudden disturbances in domestic and external markets, and inspiring greater confidence amongst national and

foreign investors. The country's financial sector is in full recovery and it can support a higher economic growth rate.

Despite these positive developments in monetary, foreign exchange, and debt management policies, structural problems persist in public finances and potentially jeopardize long-term macroeconomic stability. The role of pending fiscal, labor, and energy structural reforms in keeping those risks at bay is paramount.

Long-run macroeconomic stability goes beyond the instant behavior of inflation, exchange rates, and interest rates. Instead, it is based on the ability of the government, private companies and individuals to make informed investment decisions and the ability to rely on long-term saving, funding, and risk control instruments. The availability and liquidity of such instruments in Mexico is still far lower than that in more stable and developed economies.

Notes

¹ Pacto para la Estabilidad y el Crecimiento Económico.

² Bazdresch, Santiago and Alejandro Werner, "Contagio de las crisis financieras internacionales: el caso de México." Banco de Mexico. November 2002.

³ www.consar.gob.mx

⁴ Instituto Tecnológico y de Estudios Superiores de Monterrey.

⁵ The density is measured using the total of fixed and cellular lines.

⁶ The Bureau of Credit has information about 30 million individuals and enterprises. Of these, 6 percent of the individuals and 14 percent of the enterprises are identified as bad credit risks.

⁷ "Evaluating the value and liquidity effects of DRS: A focus on Latin America." *Oxford Metrics*, September 2005.

⁸ Measure of dispersion (variation) regarding a given average level.

⁹ Greenspan, Alan. "The Wealth of Nations Revisited." A speech delivered at the Second International Conference of "Macroeconomic Stability, Financial Markets, and Economic Development." Mexico City. November 12, 2002.

¹⁰ Ibid.

¹¹ Desarrollo Estabilizador.

¹² Messmacher, Miguel, "Stabilization Policies in Mexico. 1982-2000." Banco de Mexico, 2000.

¹³ At the beginning of the decade, Pemex proven oil reserves were located at around 50 billion barrels.

¹⁴ U.S. Library of Congress. Federal Research Division web: <http://countrystudies.us/mexico/1.htm>.

¹⁵ Ibid.

¹⁶ Ibid.

¹⁷ Relation between price of exports and price of imports. Terms worsen when the price of imports grows faster than that of exports.

¹⁸ Barton, Dominic, Roberto Newell, and Greg Wilson.

"Preparing for a Crisis." *McKinsey Quarterly*, 2002.

¹⁹ Ibid.

²⁰ Ibid.

²¹ Around \$19 billion during the last ten months of 1994.

²² Torres García, Alberto. *Stability in Nominal Variables and the Economic Cycle: The Case of México*. Banco de Mexico, 2000.

²³ Taken from: Macroeconomics Diagnosis included in the 2002-2006 PRONAFIDE.

²⁴ 2003 Economic Review of Mexico, OECD, September 30, 2003.

The views expressed by the authors are their own and do not necessarily represent the views of CIPE or the OECD Development Centre. CIPE and the OECD Development Centre grant permission to reprint, translate, and/or publish this document provided that (1) proper attribution is given to the original author, CIPE, and the OECD, and (2) CIPE and the OECD are notified where the article is placed and a copy is provided to CIPE and the OECD.