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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Pursuant to Article 1 of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, the Organisation for Economic Co-operation and Development (OECD) shall promote policies designed:

– to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
– to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
– to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

The original Member countries of the OECD are Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The following countries became Members subsequently through accession at the dates indicated hereafter: Japan (28th April 1964), Finland (28th January 1969), Australia (7th June 1971), New Zealand (29th May 1973), Mexico (18th May 1994), the Czech Republic (21st December 1995), Hungary (7th May 1996), Poland (22nd November 1996), Korea (12th December 1996) and the Slovak Republic (14th December 2000). The Commission of the European Communities takes part in the work of the OECD (Article 13 of the OECD Convention).

Publié également en français.

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BASIC STATISTICS OF MEXICO

THE LAND

Area (sq. km)	1 964 375	Inhabitants in major cities (thousands, 1995)	
Agriculture area (sq km) (1990)	394 000	Mexico City	16 674
		Guadalajara	3 462
		Monterrey	3 022

THE PEOPLE

Population (thousands, February 2000)	97 483	Employment[1] (thousands, 2000)	39 634
Inhabitants per sq. km (2000)	49.6		
Annual population growth (1990-1998)	1.9		

PRODUCTION

Structure of production, 2000 (per cent of total, 1993 prices)		GDP in 2000 (US$ billion)	574.7
		GDP per capita in 2000 (US$, using PPPs)	9 137
Agriculture	4.3	Gross fixed capital formation in 2000 (per cent of GDP, 1993 prices)	20.5
Industry	28.0		
of which: Manufacturing	20.4		
Services	67.7		

THE GOVERNMENT

Public sector indicators (per cent of GDP, 2001)		Composition of Parliament (September 2001)	Senate	Chamber of Deputies
Public sector total expenditure	22.8	PRI	60	209
Federal government total expenditure	17.6	PAN	46	207
of which: capital expenditure	1.6	PRD	16	52
Federal government revenue	16.3	Other	6	32
Net debt of public sector (December 2001)	23.0	Total	128	500

FOREIGN TRADE

Exports of merchandise (per cent of GDP, 2000)	29.0	Imports of merchandise (per cent of GDP, 2000)	30.4
Main exports (per cent of total, 2000)		Main imports (per cent of total, 2000)	
Manufactures	87.3	Intermediate goods	76.6
Petroleum products	9.8	Capital goods	13.8
Agriculture	2.5	Consumer goods	9.6

THE CURRENCY

Monetary unit: Peso	Currency units per US$, average of daily figures:	
	Year 2000	9.4528
	Year 2001	9.3443
	January 2002	9.1619

1. People economically active according to results of the National Employment Survey.

This Survey is based on the Secretariat's study prepared for the annual review of Mexico by the Economic and Development Review Committee on 29th January 2002.

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After revisions in the light of discussions during the review, final approval of the Survey for publication was given by the Committee on 13 February 2002.

•

The Secretaria's draft report was prepared for the Committee by Bénédicte Larre, Marcos Bonturi and Sebastian Schich under the supervision of Nicholas Vanston.

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The previous Survey of Mexico was issued in July 2000.

Assessment and recommendations

After five years of expansion, real GDP growth came to a standstill in 2001

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.

The recovery is projected to take root in the second half of 2002, but the degree of uncertainty is considerable

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.

The macroeconomic policy stance has remained cautious

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.

Monetary policy should continue to be aimed at establishing the economy firmly on a disinflationary path…

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.

… while fiscal discipline needs to be maintained

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.

A medium-term policy framework could help foster confidence

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.

A major tax reform was approved, but further action is needed

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.

Structural reforms have improved economic performance, but weaknesses remain

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.

A wide-ranging structural reform strategy needs to be continued…

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.

… including human capital development, poverty alleviation and measures to improve the functioning of the labour market…

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.

... and fostering entrepreneurship

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.

Privatisation and liberalisation should lead to greater competition, in the electricity sector in particular

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.

Action taken since 1995 has strengthened the financial sector…

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.

... but the banking sector remains relatively inefficient

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.

How to ensure a resumption of credit to the private sector when the recovery takes root?

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.

Summing up

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 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.

I. Recent developments and prospects

The period of expansion which followed the recovery from the 1995 peso crisis continued into 2000, but the upswing came to a halt in 2001. Trade with the United States fell sharply, and overall activity stagnated (Figure 1). Inflation continued to slow, helped by the strength of the peso. As domestic demand weakened, the current account deficit came down below 3 per cent of GDP in 2001, mostly financed by foreign direct investment. Given the absence of major imbalances, the slowdown is expected to be temporary. Led by a projected pick-up in foreign demand, real output growth should gain momentum in the course of 2002. But the timing and scale of the recovery are uncertain and will largely depend on external developments.

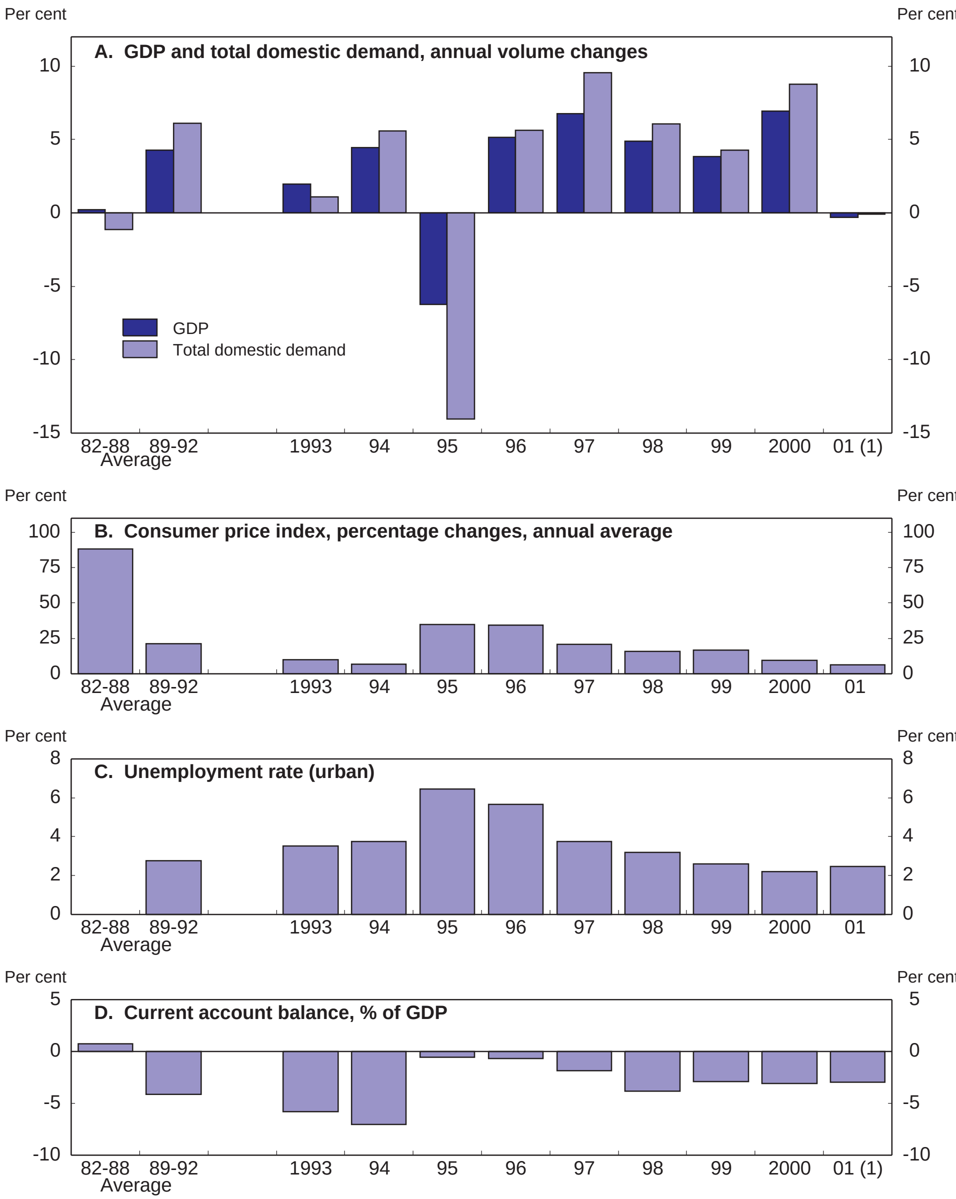
A sharp slowdown in output growth, falling employment and disinflation

Following the 2000 boom, economic activity slowed sharply

Underpinned by robust exports to the United States and booming private consumption and investment, output growth reached 6.9 per cent in 2000. But GDP growth turned negative in the last quarter (seasonally adjusted annual rates)[1] under the combined effects of the deceleration of demand in the United States and weaker government spending. Business sentiment remained positive throughout the year, but deteriorated markedly in 2001.[2] The slowdown of the economy intensified in 2001 and GDP is estimated to have fallen slightly over the year as a whole. The close relationship between the manufacturing sectors in the United Sates and Mexico, with the fast development of production-sharing schemes in NAFTA, brought about an almost immediate response in Mexico's industrial production. After expanding by more than 7 per cent in 2000, manufacturing output declined by almost 3½ per cent over the first 3 quarters of 2001, year on year (Table 1). Construction fell by even more over the same period, while output in most service sectors continued to grow.[3]

Household purchases, which showed considerable strength in 2000, continued to expand in early 2001, but at a slower pace. Strong employment growth and high real wage increases boosted disposable income in 2000. Then employment weakened in the course of 2001 and overall household real disposable

Figure 1. **Mexico's economic performance**



1. 2001 OECD estimates.
Source: Instituto Nacional de Estadística Geografía e Informática (INEGI); OECD, *National Accounts*.

Table 1. **Demand and output**

Percentage changes, volume, 1993 prices

	1989-94[1]	1995	1996-98[1]	1999	2000	2001 S1[2] / 2000 S2	2001 Q3[2] / 2001 Q2
Demand							
Private consumption	4.9	–9.5	4.7	4.3	9.5	3.4	–1.0
Government consumption	3.0	–1.3	1.5	3.9	3.5	–4.0	–3.0
Gross fixed capital formation	7.8	–29.0	15.9	7.7	10.0	–9.3	–9.8
Public sector	..	–31.3	–4.0	6.2	8.6	1.1	..
Private sector	..	–28.2	21.3	7.9	10.2	–10.9	..
Final domestic demand	**5.1**	**–12.3**	**6.2**	**4.9**	**8.9**	**0.0**	**–3.0**
Stockbuilding[3]	0.2	–2.2	1.0	–0.5	0.1	–0.6	0.4
Total domestic demand	**5.2**	**–14.0**	**7.1**	**4.3**	**8.8**	**–0.6**	**–2.6**
Exports of goods and services	7.8	30.2	13.7	12.4	16.0	–8.8	–13.0
Imports of goods and services	15.9	–15.0	20.7	13.8	21.4	–5.6	–13.7
Foreign balance[3]	–1.3	8.5	–1.3	–0.5	–1.9	–1.0	0.7
GDP at market prices	**3.9**	**–6.2**	**5.6**	**3.8**	**6.9**	**–1.6**	**–1.9**
						2001 / 2000	
Output							
Agriculture, forestry, fishing	1.8	0.9	1.5	3.5	3.4	2.5	
Mining (including petroleum)	1.6	–2.7	5.1	–2.1	4.0	–0.6	
Manufacturing	4.3	–4.9	9.4	4.2	7.1	–3.9	
Construction	5.7	–23.5	7.8	5.0	5.0	–4.5	
Electricity	3.0	2.1	3.9	7.9	6.2	1.7	
Commerce	4.8	–15.5	7.0	3.4	11.1	–1.3	
Transport and communication	5.0	–4.9	8.2	7.8	12.7	2.8	
Financial services	4.7	–0.3	3.0	3.9	4.5	4.1	
Community services	2.8	–2.3	2.4	2.1	3.0	0.5	

1. Annual average growth rate.
2. Annual rates, based on seasonally adjusted data by the OECD. Real GDP fell by 0.3 per cent over the year as a whole. Aggregate demand components for 2001 Q4 were not available at the time of writing.
3. As a percentage of GDP in the previous period.

Source: INEGI; Ministry of Finance; OECD.

income may have stagnated or even declined that year, despite sizeable real wage increases in most sectors of activity.[4] Purchases of durables, which respond quickly to changes in income, fell in the second quarter of 2001, while those of non-durables and services were still rising. The fact that private consumption in volume terms has been expanding at faster rates than real GDP suggests that the decline in the private savings rate recorded in recent years may have continued in the first half of 2001. However, consumer confidence has been deteriorating and private consumption is likely to have declined in the second semester.

Private fixed investment was strong during most of 2000, in a very favourable climate, little affected by uncertainties related to presidential elections in July. Improved operating profits that year and greater availability of credit for large

Table 2. **Indicators of investment activity**

Percentage changes from same period of previous year[1]

	1995	1996	1997	1998	1999	2000	Jan.-Oct. 2001
Gross fixed capital formation' total	–29.0	16.4	21.0	10.3	7.7	10.0	–5.2
Machinery and equipment	–36.4	23.0	34.1	16.8	10.3	14.4	–5.5
Domestic Goods	–36.1	20.5	30.7	14.4	0.6	6.4	–7.5
Imported goods	–36.6	25.2	36.7	18.6	17.3	19.3	–4.5
Residential building and construction	–22.5	11.6	10.6	4.0	4.8	5.0	–4.9

1. Volume at 1993 constant price basis.

Source: INEGI.

firms provided resources for financing investment, while small and non-exporting companies continued to rely predominantly on supplier credit.[5] However, there was a turnaround in the latter part of the year, in response to changes in growth expectations and mounting uncertainties regarding the United States.Private fixed investment fell sharply in 2001. This reversal was reflected in drops in both domestically-produced and imported machinery and equipment (Table 2). As demand slowed, companies also started scaling back their accumulation of inventories. Public investment, which had been supportive of the expansion in 2000, weakened in 2001. The initial budget projections for 2001 already incorporated lower capital spending by the public sector, relative to GDP. In the event, the budgetary situation deteriorated and there were further downward adjustments to capital spending, starting in early-2001.[6]

Gross capital formation (including stockbuilding) reached some 23 per cent of GDP in 2000: although coming down from the 1997 peak, the ratio was still above that in 1994, the last year of the previous upswing (Table 3). Public saving

Table 3. **Aggregate saving and investment**

Per cent of GDP

	1994	1995	1996	1997	1998	1999	2000	2001 S1
Gross capital formation, total[1]	21.7	19.8	23.1	25.9	24.3	23.5	23.3	20.8
Gross domestic saving	14.8	19.3	22.6	24.0	20.5	20.6	20.2	18.2
Private	9.5	14.1	18.8	21.0	18.1	18.1	17.7	15.2
Public[2]	5.3	5.2	3.8	3.0	2.4	2.5	2.5	3.0
Foreign saving	6.9	0.5	0.5	1.9	3.8	2.9	3.1	2.5

1. Including inventories.
2. The public sector comprises federal government and enterprises under budgetary control. The estimate is based on Ministry of Finance's accounts.

Source: Banco de México; INEGI; Ministry of Finance; OECD.

has been lower on average over 1996-2000 than in the previous cycle, while private domestic saving has been much higher, financing in large part the investment boom of recent years.[7] Reliance on foreign saving has remained limited, with the current account deficit down to 3 per cent in 1999-2000, less than half the deficit in 1993-94. In 2001 there was a decline in investment relative to GDP, which was reflected in a reduction of both domestic and foreign saving.

The upward trend in job creation was reversed, while disinflation continued

Employment trends turned around between 2000 *and* 2001…

When economic activity weakened at the end of 2000, tensions were starting to be felt in certain segments of the labour market, particularly those for skilled labour.[8] The year 2000 was characterised by strong job creation in most sectors of activity, with formal employment (proxied by insured workers in the private sector) expanding by around 6 per cent, year on year, bringing the cumulative increase in the number of insured workers to 33 per cent since the start of the expansion (Table 4)[9] Because of the still-large labour pool working in rural areas and in the informal urban sector, open unemployment is generally a poor measure of labour market tightness. But together with various other indicators, its record low in the later part of 2000 suggested that there was little slack left at that point of the cycle (Figure 2).

The first half of 2001 saw a general deterioration of labour market conditions. Formal employment, which was still expanding at the start of the year,

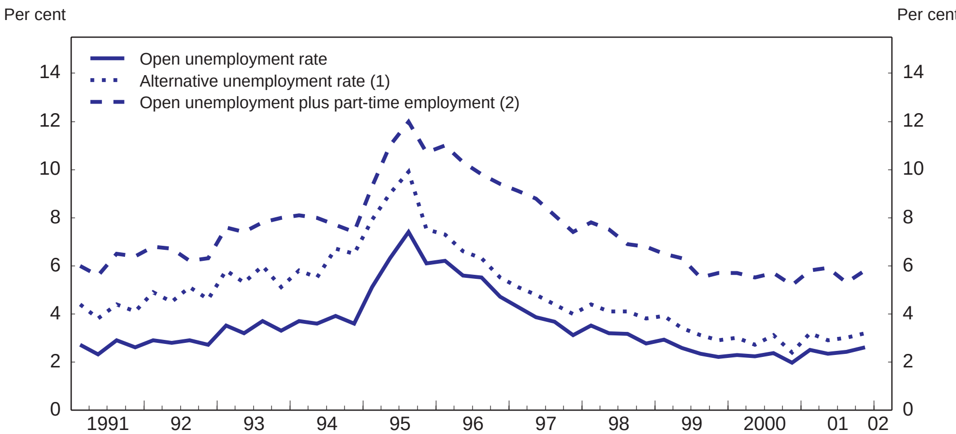
Table 4. **Labour market indicators**

Percentage changes from year earlier

	1994 Thousands	1995	1996	1997	1998	1999	2000	2001 S1	2001 S2
Insured employment[1]									
(private sector)	10 071.0	–6.1	2.5	7.7	7.8	5.7	5.9	1.5	–2.4
Permanent *of which*:	8 802.7	–3.4	3.7	8.7	4.9	3.5	5.0	1.4	–2.4
Manufacturing	2 943.4	–2.5	7.0	11.5	6.5	4.3	5.2	–2.1	–10.2
Construction	108.6	3.0	2.4	3.2	0.7	0.0	0.5	0.2	0.2
Wholesale and retail trade	1 728.0	–3.1	1.4	6.2	4.8	4.1	6.0	4.8	3.0
Transport, storage and communication	492.3	–2.0	1.1	4.3	3.9	4.7	5.9	4.9	2.2
Finance, insurance	1 702.9	–1.9	2.7	10.6	5.5	4.8	4.0	3.4	0.7
Personal services	979.0	0.4	2.7	3.5	2.0	0.7	7.9	3.9	4.9
Temporary	1 268.2	–24.4	–7.7	–2.1	40.1	24.6	12.1	1.8	–2.9
Employment in manufacturing									
Non-*maquiladoras*	..	–8.9	2.3	4.7	3.7	0.6	0.9	–2.9	..
Maquiladoras	..	11.2	16.3	19.9	12.2	12.5	12.7	1.5	..

1. Workers registered at the social security institute for the private sector (IMSS).
Source: IMSS; INEGI.

Figure 2. **Unemployment in urban areas**
As a percentage of labour force (12 years and over)



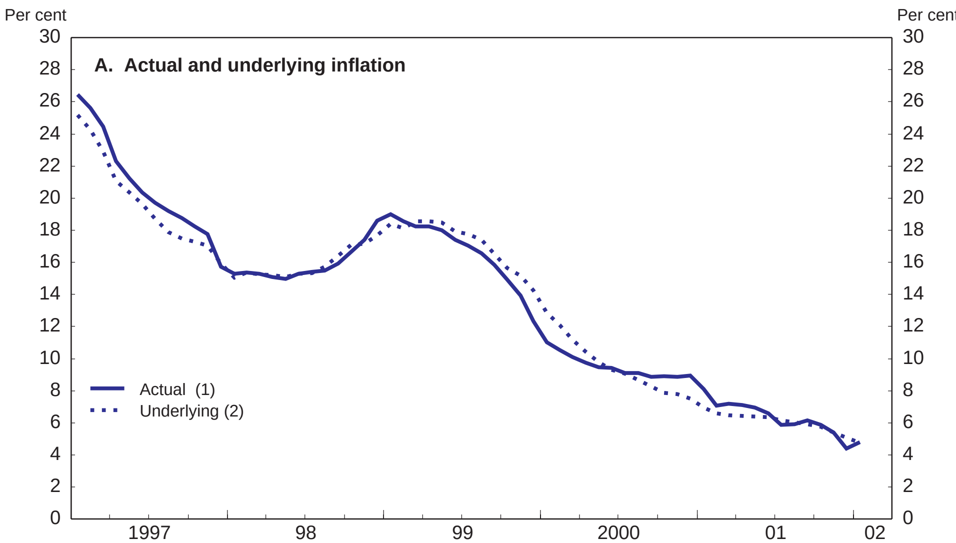
1. Includes those who stopped searching for a job but are still available for work.
2. Part-time refers to employees working less than 15 hours a week.
Source: INEGI.

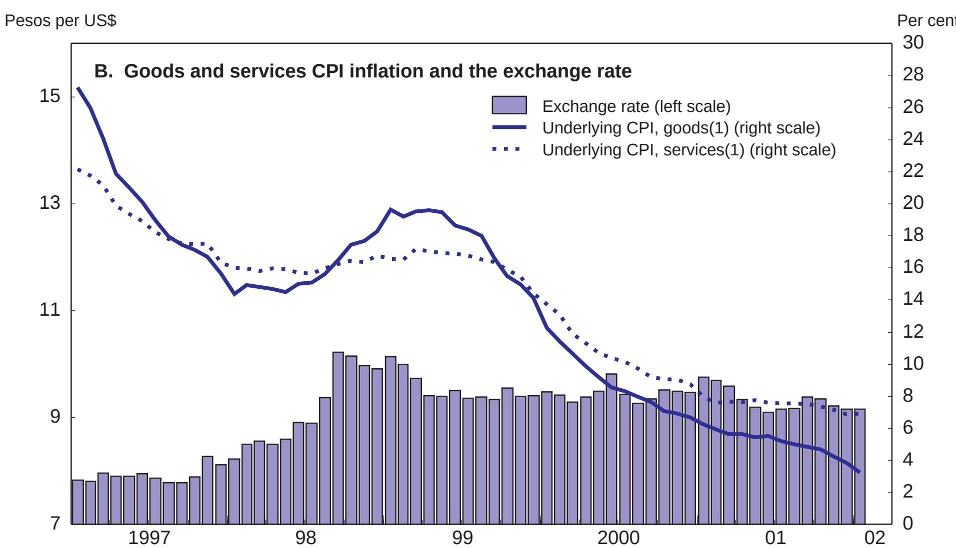
declined after mid-year, manufacturing being the hardest hit. Within manufacturing, export-oriented sectors such as metal products, machinery, textiles and clothing, have suffered the largest contraction in employment, mirroring the decline in demand from the United States. By October 2001, employment in in-bond industries ("maquiladoras") had fallen to around 1.1 million, 15 per cent less than at its record high twelve months earlier. The rising number of people working without insurance and those employed in micro-enterprises in 2001 point to an expansion of informal employment – as a counterpart to lower job creation in the formal economy – reversing recent trends.

... while the disinflation process continued

The disinflation process continued over the past two years. CPI inflation fell by more than 3 percentage points during 2000, to under 9 per cent in the 12 months to December – one per cent below the central bank target. Inflation came down further in 2001 and by year-end the 12-month CPI increase had fallen to 4.4 per cent, well below the ceiling of 6.5 per cent set by the central bank in its 2001 monetary programme. In part this reflected special factors in December that brought about sharp declines in food prices and reductions in administered

Figure 3. **Inflation trends**
Year-on-year change





1. National consumer price index.
2. Inflation excluding items with erratic developments, *i.e.* excluding prices of agricultural and livestock products, education (tuition fees) and prices controlled or agreed in concert with the public sector.

Source: Banco de México.

prices. There was some reversal of these special factors in January 2002. Core inflation,[10] although slightly higher at 5.1 per cent, December-on-December, was on a steady downward path in 2001, which continued in January 2002 (Figure 3), indicating that the slowdown of inflation was not due only to transitory factors.

Manufactured goods prices decelerated rapidly again in 2001, reflecting the strength of the peso and the weakening of external demand. As a result, inflationary pressure stemming from goods prices has been negligible. In contrast, inflation of services has been slower to decline, indicative of a slow convergence of the outcomes of wage negotiations towards nominal wage increases compatible with inflation objectives. During 2001, the appreciation of the peso, in combination with the downturn in activity, has played a crucial role in the faster-than-expected disinflation.[11]

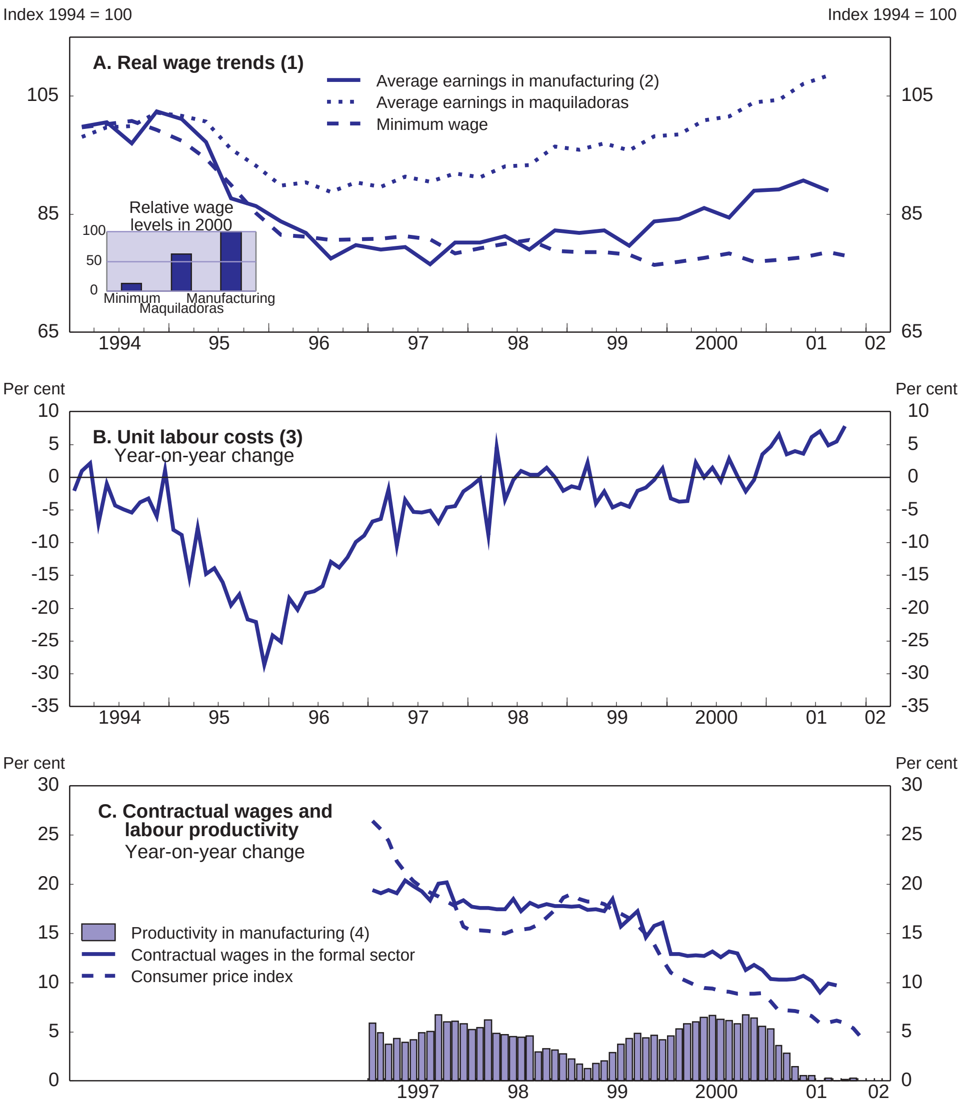
Average wage increases have slowed only moderately and not until late in 2001…

A major concern is that contractual wages continued to rise quickly during most of 2001, especially in the non-tradeable sector, where price expectations are closely linked to wage settlements. Average real wage gains set in settlements for the private sector have declined moderately, starting in the later part of 2001, reflecting a certain degree of inertia, partly explained by the fact that agreements typically cover twelve months ahead, with no revision during that period. In addition, it appears that subsequent wage negotiations are typically influenced by outturns of previous wage agreements, without fully factoring in the improvement in the price environment that might have occurred in the meantime. While wage settlements have moderated noticeably towards the end of 2001, it is too early to know whether this moderation will last.

… *implying continued real wage pressure despite the downturn*

In situations of continuing disinflation, such as observed during the past few years, nominal wage inertia translates into significant real wage increases even when the economy has started to slow down, as in 2001. Indeed, sizeable real wage pressure was recorded for the fourth consecutive year during 2000, with no notable moderation until late in 2001, notwithstanding the weakening demand for labour since the beginning of the year.[12] Despite such pressure, up until 2000 substantial productivity gains in most sectors of the economy had kept the rise in unit labour costs in check despite real wage increases. In the course of 2000, however, increases in real average earnings became stronger than labour productivity gains in the various sectors of the economy, with the exception of the construction industry. As a result, unit labour costs were pushed up, even in manufacturing where productivity gains were particularly large (Figure 4).

Figure 4. **Wages, labour productivity and unit labour costs**



1. Moving average over three quarters.
2. Manufacturing sector excluding "maquiladoras". Wages, salaries and social benefits based on INEGI monthly industrial survey.
3. Defined as the ratio of real wage to labour productivity, in the manufacturing sector.
4. Real output per persons employed. Index 1994 = 100, moving average over six months.

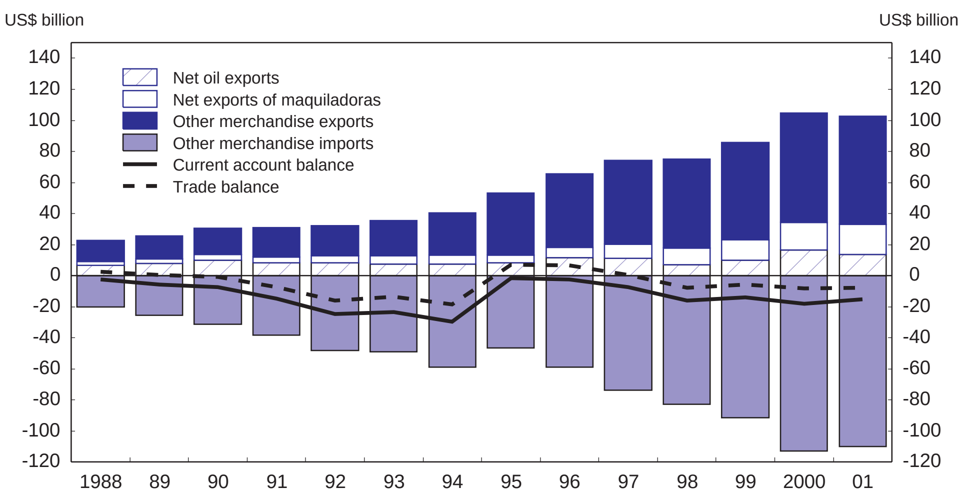
Source: INEGI; Banco de México; Ministry of Labour and Solidarity.

Unit labour costs continued to rise in 2001. With productivity outturns being highly procyclical, the economic slowdown has implied that output per worker stagnated or even declined in some sectors. As typical for an economic slowdown, the payroll did not adjust immediately to the contraction of output. This has translated into lower productivity growth, in particular in the manufacturing sector, while real labour costs continued to rise, with adverse implications for competitiveness.

The external sector

The trade and current account deficits widened only slightly in 2000 in proportion to GDP, as buoyant net oil exports largely offset the deterioration in non-oil trade. Developments in 2001 stand in sharp contrast. As a result of the weakening of domestic demand and increased trade integration in NAFTA, with demand for Mexican and United States goods moving in tandem, the non-oil trade deficit narrowed, oil exports fell and the overall trade deficit stabilised (Figure 5). Resilient tourism receipts and higher workers remittances in 2001 allowed the current account deficit to come down to 2½ per cent of GDP in the first nine months of the year (Table 5).

Figure 5. **Foreign trade and the current account**



Note: Current account data for 2001 data are January-September, at annualised rate.
Source: Banco de México.

Table 5. **Current external account**

US$ billion

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Exports, f.o.b.[2]	51.9	60.9	79.5	96.0	110.4	117.5	136.4	166.5	158.5
Oil	7.4	7.4	8.4	11.7	11.3	7.1	9.9	16.4	12.8
Non-oil	44.5	53.4	71.1	84.3	99.1	110.3	126.5	150.1	145.7
Imports, f.o.b.	65.4	79.3	72.5	89.5	109.8	125.4	142.0	174.5	168.3
Trade balance excluding oil exports	–20.9	–25.9	–1.3	–5.1	–10.7	–15.0	–15.5	–24.4	–22.5
(Per cent of GDP)	–5.2	–6.2	–0.5	–1.5	–2.7	–3.6	–3.2	–4.2	–3.6
Trade balance	**–13.5**	**–18.5**	**7.1**	**6.5**	**0.6**	**–7.9**	**–5.6**	**–8.0**	**–9.7**
(Per cent of GDP)	–3.3	–4.4	2.5	2.0	0.2	–1.9	–1.2	–1.4	–1.6
of which: *Maquiladoras*	5.4	5.8	4.9	6.4	8.8	10.5	13.4	17.8	19.2
									Jan.-Sep. 2001[1]
Non-factor services, net	–2.1	–2.0	0.7	0.5	–0.5	–0.9	–1.8	–2.3	–3.5
of which: Tourism	2.1	2.4	3.4	3.8	3.9	3.6	3.6	4.0	4.0
Investment income, net	–11.4	–13.0	–13.3	–13.9	–12.8	–13.3	–12.9	–14.5	–13.3
Transfers, net	3.6	3.8	4.0	4.5	5.2	6.0	6.3	7.0	9.3
Current balance	**–23.4**	**–29.7**	**–1.6**	**–2.3**	**–7.4**	**–16.1**	**–14.0**	**–17.8**	**–15.1**
(Per cent of GDP)	–5.8	–7.1	–0.6	–0.7	–1.9	–3.8	–2.9	–3.1	–2.5

1. Annualised rates.
2. Including trade by *Maquiladoras* (in-bond industries).

Source: Banco de México.

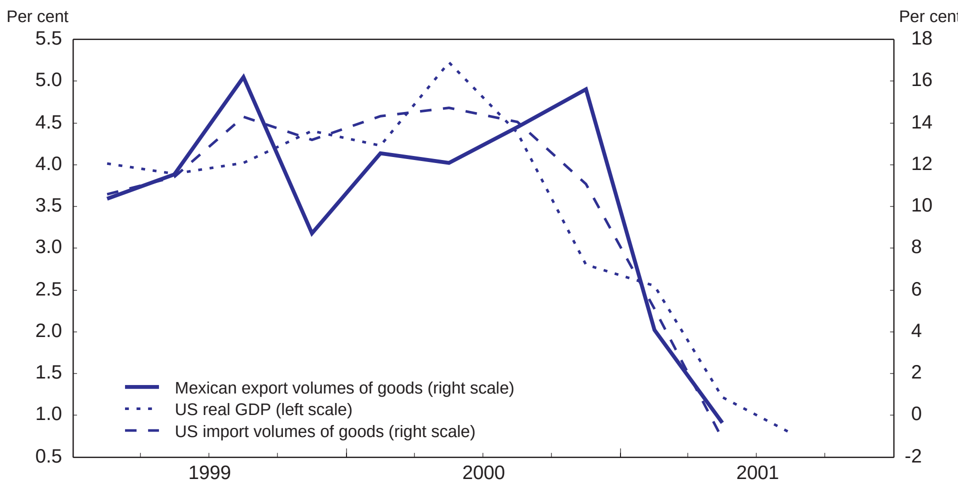
Mexico's external trade flows are increasingly influenced by activity in the United States

Mexico's export performance largely reflects the country's increasing integration into NAFTA, with the United States, in particular, accounting for almost 90 per cent of exports. The continued strength of United States demand was important in explaining the sustained growth of Mexican exports until late in 2000, with the auto industry and the Information and Communication Technology (ICT) sector making a particularly large contribution. During most of 2000, moreover, high oil prices prevailing for most of the year and strong external demand boosted oil export revenues.[13] In 2001, Mexican export trends similarly mirrored the sharp slowdown in activity in the United States (Figure 6). Furthermore, Mexico's export mix makes it more exposed to sectors which have been the hardest hit by the downturn, among which the ICT sector (18 per cent of Mexico's total exports).[14]

After a large rise in 2000, caused by the buoyancy of domestic demand and manufacturing exports, merchandise imports subsequently weakened, at the same time as exports. They dropped by 3.5 per cent in 2001 in dollar terms, the decline being amplified by the downward adjustment of domestic demand, in particular business fixed investment and inventories. The synchronisation

Figure 6. **Activity in the United States and Mexican exports**

Year-on-year change



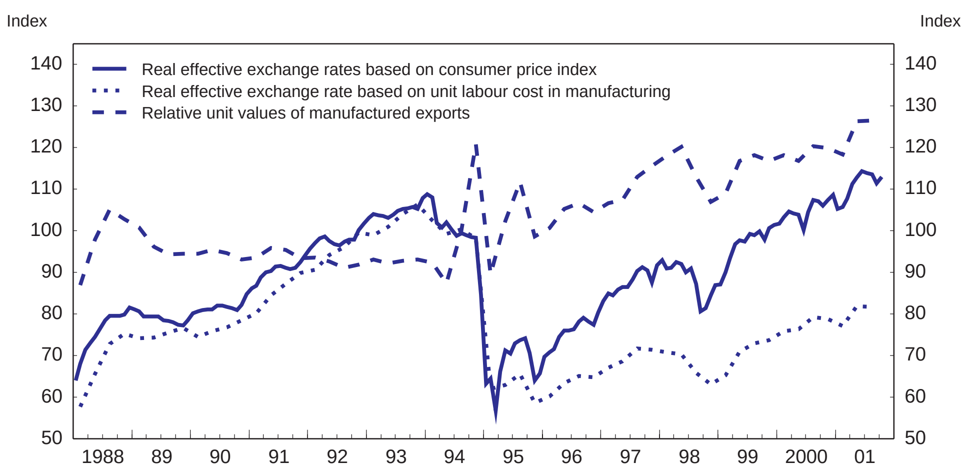
Source: OECD.

between export and import trends reflects increased integration with the United States, which has been associated with growing trade in intermediate inputs. In the process, Mexican firms have become more export oriented as production-sharing arrangements have developed.[15] These arrangements have increased bilateral trade in manufacturing products, often intra-firm. Strategic decisions taken at the level of the firm now have direct and immediate implications for production sites on both sides of the border. These developments, together with the high import-content of Mexican exports, likely explain the rapid response of Mexican trade to the slowing of the activity in the United States.

Competitiveness and export performance

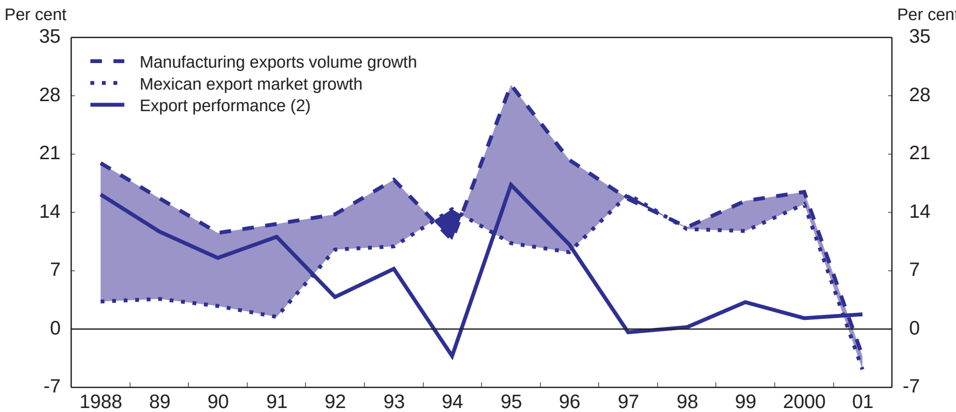
As noted above, the major factor affecting the external balance in 2001 has been the fall in exports to, and imports from, the United States, in combination with lower oil exports. But the increase in unit labour costs and the appreciation of the real exchange rate may also have played a slower-acting role. Different measures of the real effective exchange rates give a mixed picture, though all of them show steady deterioration from the low point reached at the time of the 1995 devaluation. Those based on relative export prices and consumer prices have increased since 1995 to above the pre-crisis levels of 1993-94 (Figure 7), indicating

Figure 7. **Real effective exchange rates**
Index 1994 = 100[1]



1. Indices in US$ terms.
Source: OECD.

Figure 8. **Export performance in manufacturing**
Percentage changes, year-on-year[1]



1. OECD estimates for 2001 as published in *Economic Outlook* 70, December 2001.
2. Export performance is defined as Mexico's growth exports of manufactures relative to its main partners' growth of imports of manufactures in volume terms.

Source: OECD.

a steady erosion of Mexico's price competitiveness. But measured on the basis of unit labour cost in manufacturing, the real effective exchange rate in 2001 was still below its pre-crisis level, suggesting that exporters did not reduce their unit profits over recent years. And although the non-oil external deficit is smaller than before the peso crisis (it stood at less than 4 per cent of GDP in 2001, against 6.2 per cent in 1994) it, too, showed a tendency to deteriorate in the upswing from 1995 to 2000. Overall, the strength of manufacturing exports over the past decade or so has allowed Mexico to gain market shares (Figure 8). This outcome would suggest that factors not related to price-cost competitiveness are also at work, including the presence of a wider and more diversified manufacturing export base, resulting from large-scale investment in the sector.[16]

The current account deficit has been easily financed by stable capital inflows

In recent years, the current account deficit has been largely financed by long-term external resources. Net inflows of foreign direct investment (FDI) have generally been predominant, exceeding US$12 billion per year on average in 1997-2000; before that, even in the wake of the peso crisis, FDI had remained high. At US$13.5 billion, FDI inflows financed more than three quarters of the current account deficit in 2000 (Table 6). Portfolio investment on the other hand

Table 6. **Capital account and the balance of payments**

US$ billion

	1993	1994	1995	1996	1997	1998	1999	2000	Jan.-Sep. 2001
Capital account	**32.5**	**14.6**	**15.4**	**4.1**	**15.8**	**17.5**	**13.5**	**18.2**	**16.3**
Liabilities	**36.1**	**20.3**	**22.8**	**10.4**	**9.0**	**17.1**	**17.5**	**11.1**	**22.7**
Loans and deposits	2.8	1.1	23.0	–12.2	–8.8	6.2	–4.5	–0.6	–2.1
Public sector	–2.2	–0.4	11.5	–8.9	–6.1	1.5	–4.8	–2.6	–3.0
Development banks	0.2	1.3	1.0	–1.2	–1.0	0.2	–0.8	0.9	–1.1
Non-financial sector	–2.4	–1.7	10.5	–7.7	–5.0	1.3	–4.0	–3.5	–2.0
Bank of Mexico	–1.2	–1.2	13.3	–3.5	–3.5	–1.1	–3.7	–4.3	0.0
Private sector	6.2	2.7	–1.8	0.2	0.7	5.8	3.9	6.3	1.0
Commercial bank	3.3	1.5	–5.0	–1.7	–2.0	–0.1	–1.5	–2.1	–1.7
Non-financial private sector	2.8	1.2	3.1	2.0	2.7	5.9	5.5	8.4	2.6
Total foreign investment	33.3	19.2	–0.2	22.6	17.9	10.9	22.1	11.6	24.8
Direct investment	4.4	11.0	9.5	9.2	12.8	11.6	12.2	14.0	22.4
Portfolio investment	28.9	8.2	–9.7	13.4	5.0	–0.7	9.9	–2.3	2.4
of which:									
Stock market	10.7	4.1	0.5	2.8	3.2	–0.7	3.8	0.4	0.3
Money market	7.4	–2.2	–13.9	0.9	0.6	0.1	–0.9	–0.0	0.0
Foreign currency securities	10.8	6.3	3.6	9.7	1.2	–0.1	7.1	–2.7	2.1
Assets	**–3.6**	**–5.7**	**–7.4**	**–6.3**	**6.7**	**0.4**	**–4.0**	**7.1**	**–6.4**
In banks abroad	–1.3	–3.7	–3.2	–6.1	4.9	0.2	–3.0	3.6	–4.0
Direct investment abroad	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	–3.6
Credits to non-residents	–0.3	0.0	–0.3	–0.6	–0.1	0.3	0.4	0.4	0.2
External debt guarantees	–0.6	–0.6	–0.7	0.5	–0.7	–0.8	–0.8	1.3	2.4
Other	–1.5	–1.3	–3.3	–0.2	2.7	0.7	–0.6	1.9	–1.4
Memorandum items:									
Current account	–23.4	–29.7	–1.6	–2.3	–7.4	–16.1	–14.0	–17.8	–11.3
Capital account	32.5	14.6	15.4	4.1	15.8	17.5	13.5	18.2	16.3
Errors and omissions	–3.1	–3.3	–4.2	0.0	2.2	0.7	1.0	2.4	0.9
Changes in net international reserves (increase = –)	–5.9	18.4	–9.6	–1.8	–10.5	–2.1	–0.6	–2.8	–5.9

Source: Banco de México.

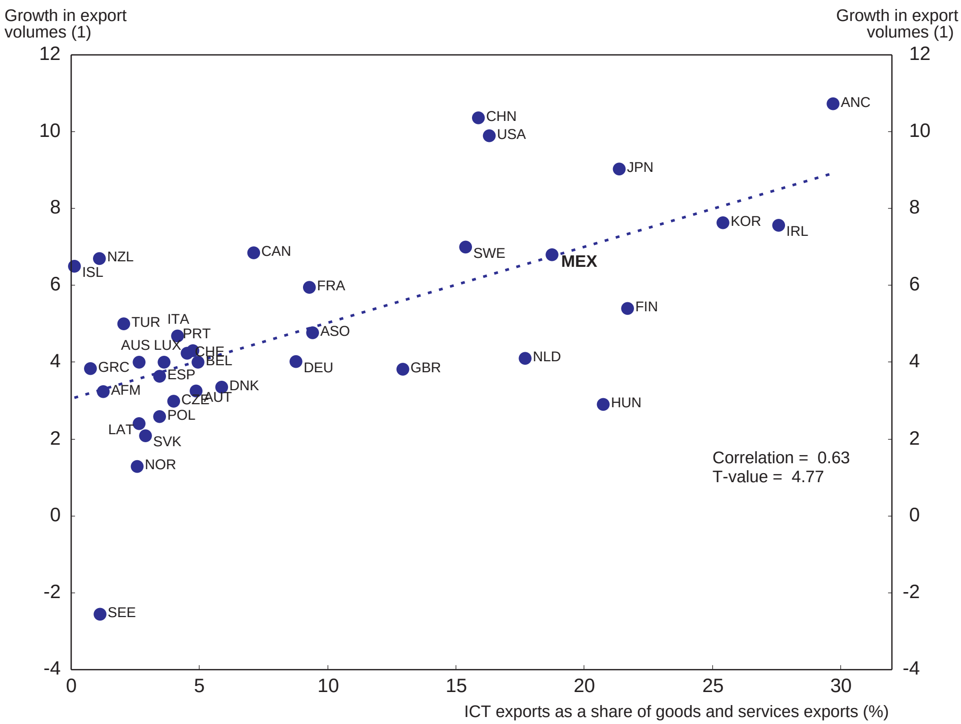
recorded a small outflow, associated with foreign currency securities (mostly public) being paid back. In 2001, net FDI inflows were boosted by the Citigroup-Banacci acquisition, and are expected to reach a record high of about US$25 billion.[17] More fundamentally, strong inflows of FDI signal improved risk perceptions; they contributed to strengthening the peso and raising the level of international reserves. The risk of contagion from credit problems in other emerging markets seems to have fallen. Investors' perceptions of Mexico have been strengthened over recent years by the track record of the authorities in implementing prudent macro-economic policies – under a floating exchange rate regime –and the absence of major imbalances.

Following an expected recovery in the course of 2002, economic activity should regain momentum

In the near term, the negative impact of the slowdown in Mexico's main trading partner is expected to dominate economic performance. The OECD is projecting a further contraction of Mexico's export markets for manufacturing products in 2002, with a recovery in the second half, gaining strength in 2003. Renewed uncertainties after the terrorist attacks of 11 September in the United States are expected to continue to affect confidence indicators in Mexico over the months ahead. However, there are some favourable factors at work on the domestic front: despite the financial crisis in Argentina, conditions in Mexican financial markets have been relatively stable. Short-term interest rates have been low in real terms since August 2001 (notwithstanding a temporary rise in September). The budget for 2002 foresees a financial deficit for the public sector (federal government and public enterprises) of 0.65 per cent of GDP, unchanged from the 2001 projection. This would imply a cautious fiscal policy stance, with no further discretionary tightening. In this context little stimulus is expected from public investment (see next chapter).

Once the main uncertainties from abroad are dispelled, the rebound of the Mexican economy is expected to be quite strong. There are no constraints on the labour market. And although private consumption is likely to be subdued because of continued weak job creation, business investment should benefit from a more favourable business climate already in 2002. With the improvement in confidence and the return to "business as usual", domestic demand is projected to recover in the course of 2002. A stronger pull from the United States from mid-2002 onwards should entail a substantial external stimulus, the more so since Mexico is specialised in ICT products (Figure 9). Real GDP growth thus should regain momentum, helped by the more supportive external environment. However, because of the negative carry over from end-2001 and the projection for economic recovery only from mid-2002, output growth is expected to be low on average for the year. By 2003, it could reach 4 per cent (Table 7). As the recovery

Figure 9. **The projected strength of exports in 2003 and exposure to ICT**



Note: ANC: Dynamic Asia, ASO: Other Asia, LAT: Latin America, AFM: Africa and Middle-East, SEE: Central and Eastern Europe.

1. Growth in export volumes of goods and services in 2003 less growth in 2002, based on the OECD *Economic Outlook* 70 (December 2001).

Source: OECD.

gets underway, both abroad and domestically, trade flows should pick up; the current account deficit could widen somewhat over the projection period, reaching perhaps 3½ per cent of GDP in 2003.

Headline inflation is expected to be around 4½ per cent by the end of 2002, under the usual OECD technical assumption of unchanged exchange rates. Against a background of falling inflation, weakening activity and labour market slack, agents are expected finally to adjust their price expectations down. Nominal wage settlements, though sticky, should also come down, in line with inflation targets. The risk is that, if wage adjustments do not take place on the scale needed, employers will achieve the adjustment through more drastic layoffs.

Table 7. **Short-term outlook**

	2000	2001[1]	2002[1]	2003[1]
	Percentage changes from previous period			
Demand and output (volume)[2]				
Private consumption	9.5	2.8	1.7	4.0
Government consumption	3.5	–2.5	0.7	2.5
Gross fixed investment	10.0	–4.9	3.0	6.1
Final domestic demand	8.9	0.7	1.9	4.3
Stockbuilding[3]	0.1	–0.5	0.2	0.3
Total domestic demand	8.8	0.2	2.0	4.5
Exports of goods and services	16.0	–3.2	0.7	7.5
Imports of goods and services	21.4	–2.4	2.2	8.7
Foreign balance[3]	–1.9	–0.2	–0.6	–0.7
GDP at market prices	6.9	0.0	1.5	4.0
Prices (annual average)				
GDP deflator	10.8	6.0	5.3	4.8
Private consumption deflator	8.9	6.5	5.2	4.5
	Levels			
Current account balance				
Per cent of GDP	–3.2	–3.0	–3.3	–3.5
US$ billion	–18.4	–18.2	–22.0	–25.6

1. OECD estimates and projections, as published in *Economic Outlook*, No. 70, December 2001. Based on data available on 11 February 2002, the rate of change of real GDP in 2001 is estimated at a negative 0.3 per cent.
2. At 1993 constant prices.
3. Change as a percentage of previous year's GDP.

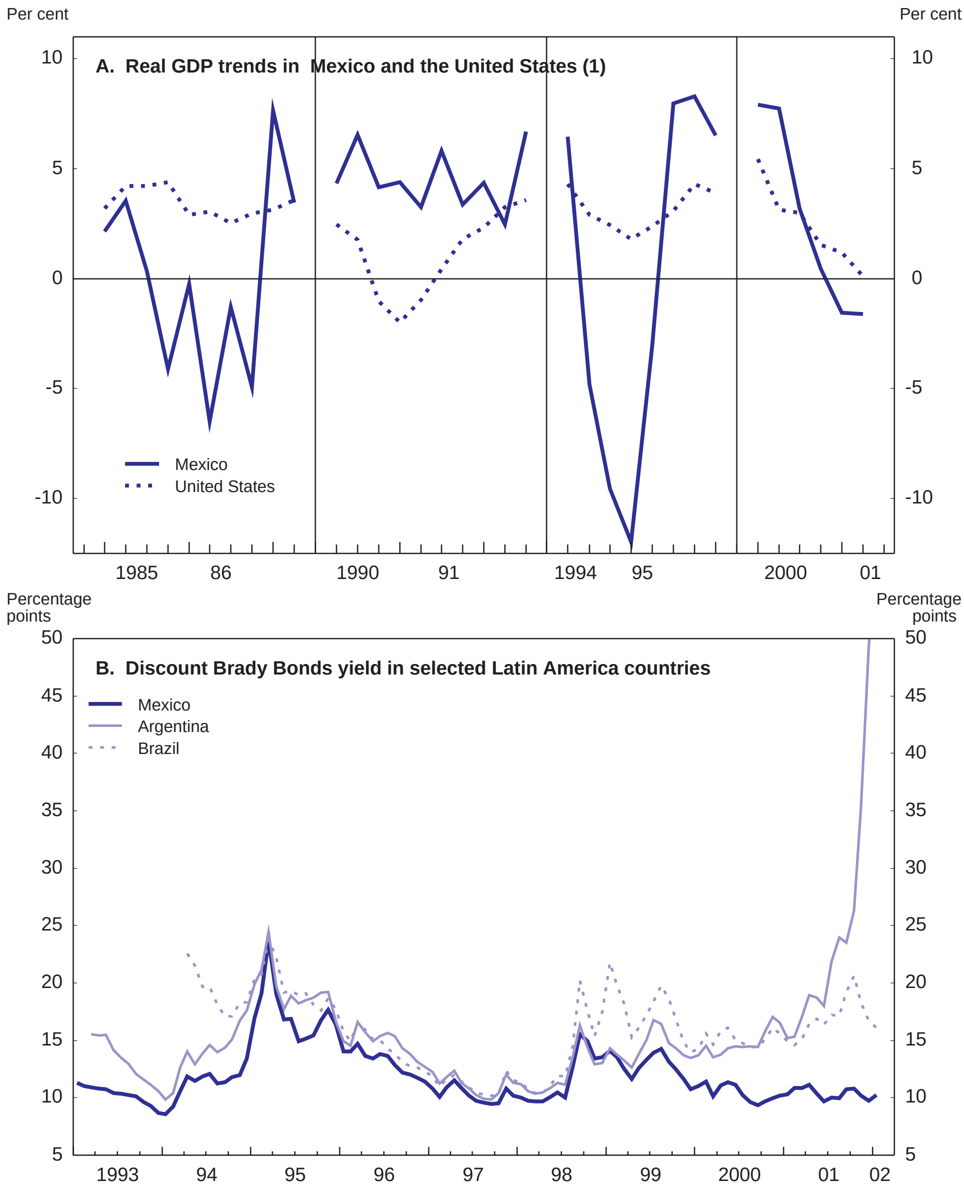
Source: OECD.

Unusually large uncertainties regarding external developments might continue to prevail until well into 2002. The timing and scale of the recovery in the United States in particular is difficult to predict, given the range of possible responses from consumers and businesses to policy measures taken in 2001. On the downside for Mexico, a slower recovery in the world economy is likely to lead to further postponements in investment plans. On the upside, relatively strong fundamentals in Mexico and a prudent macroeconomic policy stance should maintain the confidence of international markets and allow a rapid upturn when the global economic outlook clears.

Mexico's downturn in perspective

The current economic downturn in Mexico differs from previous episodes, reflecting the increasing integration between Mexico and the United States. This has led to a high degree of synchronisation between the current US and Mexican

Figure 10. **Mexico's downturn in perspective**



1. Change over the previous period, 3-quarter moving average (s.a.a.r).
Source: Datastream; OECD.

economic cycles, though the amplitude of the Mexican cycle is greater.[18] This cycle contrasts with earlier ones. Mexico's recessions in 1985-86 and 1995 coincided with positive growth in the United States, and the slowdown of the US economy in 1990-91 occurred while Mexico recorded vigorous growth (Figure 10, Panel A).

Another striking feature of the ongoing downturn is that, in contrast to experience in the 1985-86 and 1994-95 recessions, there has been neither a balance of payments crisis nor a run on the currency. To a certain degree, international investors appear to have de-coupled Mexico from other emerging markets, as evidenced by trends in risks *premia* of selected Latin American countries (Figure 10, Panel B). In the past, the discount Brady Bond yields of Mexico, Argentina and Brazil moved in tandem, and in 1995 all three suffered a sharp hike. Then, after the initial shock of the Russia and Brazil crises in 1998 and 1999, contagion effects on Mexico were more contained and short-lived than in the other countries. Since then, the risk premium for Mexico's sovereign debt has been more stable and lower than for the two other major Latin American countries, in particular in 2001 when the Argentina crisis sparked off a confidence crisis in the rest of the region. Sound macroeconomic management in Mexico has been a major factor in this outcome, and over the medium term the integration into NAFTA is likely to continue to benefit the Mexican economy.

II. Macroeconomic policies and issues

Introduction

Following the presidential elections in mid 2000 and the change of administration at year end, the authorities continued to follow stability-oriented policies in 2001 in the face of the severe deterioration in the external environment. With activity weakening and oil revenues falling, the fiscal policy response was to cut spending to match the revenue shortfall. Maintaining fiscal discipline throughout the year has alleviated the burden on monetary policy. Nominal and real interest rates declined during the year as inflation came down, helped by the strength of the peso. In this context, and with the aim of achieving medium-term inflation convergence with its main partners, the Board of Governors of the central bank set an inflation target of below 4.5 per cent for the 12 months to December 2002, while the budget for 2002 seeks to maintain the public sector deficit at 0.65 per cent of GDP. This Chapter first reports on monetary policy, while financial sector reform is reviewed in Chapter IV. The second section reviews fiscal policy and public debt management. The final section highlights a number of fiscal policy issues over the medium term, including medium-term budget planning and the proposed tax reform.

Monetary policy

The policy framework and recent outcomes

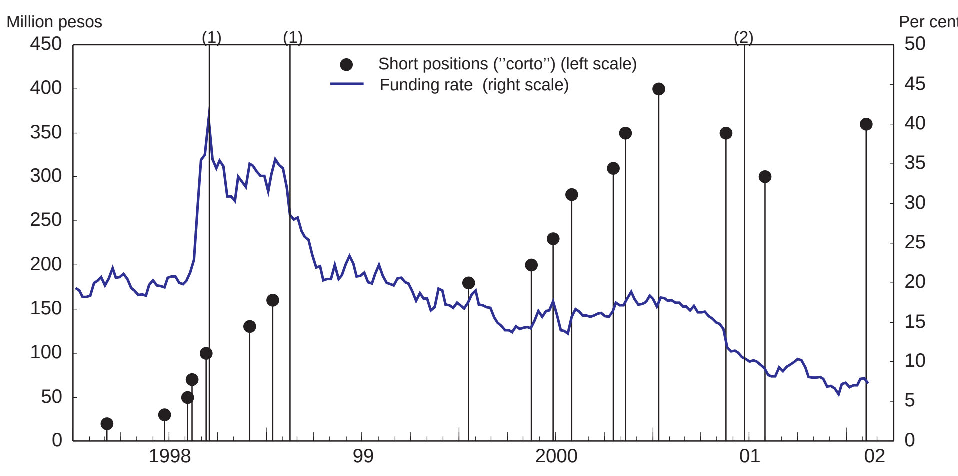
After the 1995 crisis, monetary policy focused on the growth of monetary aggregates and limits to credit growth, and this strategy was successful in bringing down inflation and rebuilding credibility. It also helped the public to understand that the origins of inflation over the medium to long term are monetary in nature. After the inflationary effects of the sharp exchange rate depreciation following the peso crisis had been largely brought under control, the main objective of monetary policy became the reduction of inflation in a gradual and sustainable way. More specifically, in January 1999, the Banco de México announced a medium-term objective, recently reiterated, of bringing down inflation to the rate prevailing in Mexico's main trading partners by the end of 2003, interpreted as an annual growth rate of the CPI (*Indice Nacional de Precios al Consumidor*) of 3 per cent.[19] The

Bank establishes annual inflation objectives for this headline inflation measure as short-term reference points towards the medium-term objective. To give additional information regarding monetary developments, the Banco de México continues to publish its estimates of the daily evolution of the monetary base.

While in the long run excess supply of money is the most basic source of inflation, over the short term inflation is the result of a variety of factors. In addition, the short-term relationship between prices and base money growth becomes more uncertain at lower rates of inflation. Consequently, the Bank now also focuses increasingly on other indicators to assess future inflation developments, such as measures of inflation expectations, wages, the exchange rate and the relationship between aggregate demand and supply. To better communicate the elements that it uses to analyse inflationary pressures and prevailing monetary conditions, the Banco de México started to publish quarterly inflation reports in April 2000.

In recent years, the Bank has had a good record in meeting its short-term targets. The objective of the monetary policy programme for 2000 was a maximum twelve-month rate of CPI inflation of 10 per cent by December 2000, down from 12.3 per cent the year before. This was successfully accomplished, partly because of the restrictive monetary policy stance during that year. To realise its objectives, the Banco de México increased the "corto" six times during 2000 (Figure 11).[20] The

Figure 11. **Monetary policy actions**



1. On 15 September 1998 and 15 February 1999, a compulsory deposit was first introduced and then increased, respectively.
2. On 22 June 2001, the Bank of Mexico asked banks to make voluntary deposits.

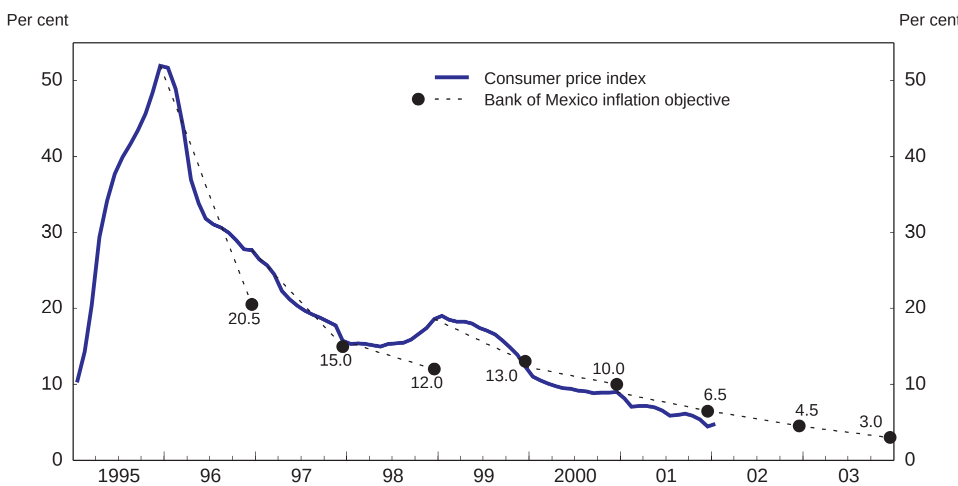
Source: Banco de México.

effects of these policy measures probably started to come through during the year. By December, the twelve-month rate of CPI inflation was 9 per cent, one percentage below target, and base money had deviated relatively little from its expected path. With a view to achieve a "soft landing", the Banco de México raised the "corto" again in January 2001. A preoccupying development was that even though they had fallen during 2000, contractual wage increases were still close to 10 per cent at year end, considerably higher than the sum of the inflation target and foreseeable gains in labour productivity.

The monetary programme for 2001

The objective for 2001 was to bring the twelve-month inflation rate down to a rate of at most 6.5 per cent by December (Figure 12). The Monetary Programme was published in January 2001 against a backdrop of contractual wage negotiations which appeared to be based on inflation expectations significantly above official targets. It stressed that a restrictive monetary policy was required to correct economic agents' inflation expectations. The programme projected a base money growth of 13.6 per cent by end-2001, which was deemed compatible with the inflation objective, given the projections at that time regarding real output growth and the decrease in the velocity of circulation of money. Specifically, the

Figure 12. **Inflation objectives**
Percentage changes over 12 months



Source: Banco de México.

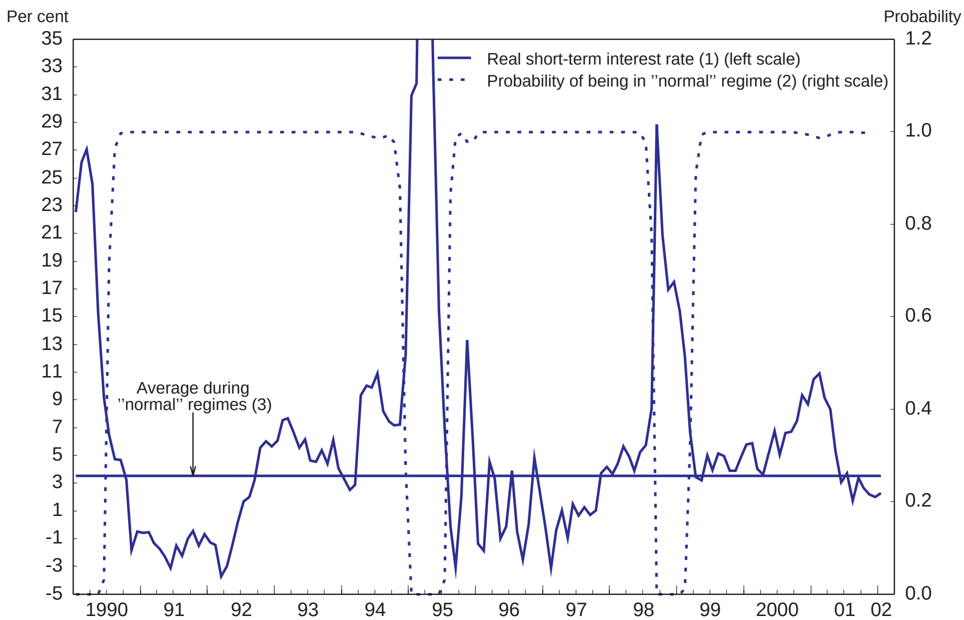
projections were real output growth of 4 per cent and a remonetisation factor of 2.6 per cent (about half of that in 2000), implying a modest increase of the stock of currency in circulation as a proportion of GDP.

In 2001, the monetary base rose at a lower rate than projected, reflecting principally the slowdown in activity. The slowdown in activity also contributed to weakened credit growth in the second half of 2001.[21] Strong capital inflows, reflecting the acquisition of Mexico's largest locally-owned bank, Banamex, by Citigroup, as well as a general improvement in risk perceptions of the Mexican economy, contributed to upward pressures on the peso exchange rate. In this context, Banco de México suspended, as of June 2001, the rule-based sale of foreign exchange put options in place since August 1996, with the aim of reducing, via this mechanism, any further accumulation of international assets, which were already high by historical standards.[22] The continuing strength of the peso during 2001, together with slowing economic activity, reduced inflationary pressures, although only during the last quarter of 2001 did contractual wage growth come down noticeably.

Against this background, the Banco de México modified its monetary policy stance during the year, lowering the "*corto*" twice, in May and July. Thus, despite the strong peso, monetary policy conditions have in fact been eased since the first quarter of 2001. And short-term real interest rates were below 4 per cent before the end of 2001, which appears to be low by recent historical standard (Figure 13).[23] Inflation came in below the target rate in 2001 for the third consecutive year. The increase in the "*corto*" in February 2002 in response to a CPI hike should ensure that inflation will remain on its downward trend over the near term.

For 2002, the Board of Governors has committed itself to achieving an inflation rate below 4.5 per cent, which is deemed to be consistent with gradual convergence towards the medium-term objective. Some of the risk factors mentioned in past inflation reports have not completely disappeared. In particular, nominal increases in contractual wages have only very recently come closer to the sum of the inflation target and foreseeable gains in labour productivity. As emphasised in the 2002 monetary programme, high contractual wage increases continue to create substantial inflationary pressures. The monetary policy stance would have to become more restrictive, with implications for employment, if wage growth was incompatible with short and long-term inflation objectives. It is also important to preserve the advantages that have been obtained from pursuing sound monetary (and fiscal) policies in terms of the observed improvement in country risk perceptions regarding Mexico. These include *e.g.* the upgrading of Mexican sovereign bonds to investment-grade status and the fact that Mexican financial markets and instruments have been relatively immune from economic and financial turmoil in Argentina and Turkey.

Figure 13. **Real short-term interest rate**[1]



1. 1-month CETES rate minus year-on-year inflation in current month. Note that this ("*ex post*") real interest rate is similar to the ("*ex ante*") real interest rate estimated by the Banco de México over January 1997 to December 2001 (communication from the central bank). The Bank's estimate uses the average of expected inflation, according to survey data collected by INFOSEL, instead of current inflation.
2. Probability that the real rate is drawn from the "normal" regime, given that any month's real interest rate is drawn from one of two regimes, *i.e.* periods of either "exceptionally high" or "normal" rates. To identify "normal" and "exceptional" regimes, a simple two-state Markov-regime-switching method was applied to the real interest rate data during the 1990s.
3. Average during "normal" regimes, estimated to be 3.5 per cent.

Source: Banco de México; OECD.

Further challenges

As the short-term guidance regarding future inflation provided by base money growth has diminished, the monetary policy strategy has been modified during the last few years. Monetary policy in Mexico has moved to a direct and formal inflation targeting approach. The bank committed itself for the first time in the 2000 monetary programme to the transition towards such a strategy and the 2001 monetary programme confirmed its adoption. As a general rule, more precise goals have the potential to increase both the transparency and accountability of monetary policy. Monetary policy works both through its influence on short-term interest rates as well as through the expectations it induces in the markets; and greater transparency can speed the response of aggregate demand, to the extent that markets correctly anticipate future policy moves. Moreover, enhanced transparency is necessary to ensure accountability. Accountability has the potential of improving the central bank's performance and it is facilitated by the setting of precise targets against which the outcomes could be compared. The experience of several OECD countries that have adopted a direct inflation targeting strategy since 1990 points to the potential benefits of this strategy. However, whether the potential benefits are realised depends on how effectively the strategy is designed and implemented. In this context, as inflation comes down further, several elements could be evaluated to strengthen the framework (see Box 1).

While clearly important for credibility building, the role of an inflation-targeting strategy should not be overestimated for at least two reasons. First, it would be difficult to attribute all of the success of lowering or maintaining low inflation in OECD inflation targeting countries to the credibility gains arising from their new strategies. Often, the changes in strategies were accompanied by more fundamental changes to the institutional framework for monetary policy in terms of increased transparency, independence and accountability (see *e.g.* Schich and Seitz, 2000). Also, in all cases the falls in inflation were accompanied by significant negative output gaps, induced by the high real interest rates that accompanied the disinflation process (Kennedy, 2000). The situation in Mexico is complicated by the fact that inflation currently is still high, while in most OECD countries that target inflation directly, explicit inflation targeting was introduced after inflation had fallen. Thus, the social costs of achieving the inflation targets might be greater in Mexico than they have been in other OECD countries. Under these circumstances, the credibility of the new framework is likely to be put under a particularly hard test, as the sustainability of the new framework may be questioned. Second, it should be borne in mind that ultimately credibility is earned by performance, *i.e.* by delivering low inflation on a continuous basis.[24] Thus, while the achievement of the inflation target in 2001 has been facilitated by the unexpected slowdown of activity and the strong peso, the current setting of monetary policy should continue to be adapted already with a view to bringing inflation down further and maintaining low inflation over the medium-term horizon, so as to further strengthen the positive track record.

Fiscal policy contribution to achieving medium-term objectives

Achieving the goal of price stability depends also on fiscal policy remaining supportive of the disinflation process. Securing budget outcomes in line with the objectives set in the fiscal programmes has been a contributing factor to attaining the inflation targets over the last two years. To the extent that the recently approved tax reform leads to a more soundly based and strengthened fiscal position, it is likely to provide further support for achieving price stability over the medium term

Box 1. Implementation of an inflation-targeting strategy

The implementation of an inflation-targeting strategy requires several decisions, including in particular, the choice of an inflation index to be adopted as target, the target range and the time horizon.[1]

i) As a general rule, for maximum transparency, the price index should be one that people are familiar with and that is broad-based. A broad-based measure is most relevant for the calculation of real income for households and the welfare of households is ultimately the goal for monetary policy. However, to ensure that monetary policy does not have to react to random and transitory fluctuations, the index should exclude at least the first-round effects of price changes in volatile components and one-time price jumps that are unlikely to affect the underlying trend in inflation. Examples include a rise in a value-added tax or in a sales tax. The national CPI index used to determine the Bank of Mexico's inflation objective includes volatile items such as fresh food prices. Therefore, at the beginning of 2000, the bank introduced a "core" CPI index, excluding agricultural and livestock products, education (tuition fees) and prices controlled or agreed in concert with the public sector. While the two different measures of inflation move broadly in concert over time, differentials between them are not stable over time and could be substantial on occasions (Figure 3, Panel A). While practice differs slightly among OECD inflation-targeting central banks, all have chosen to measure the rate of inflation by reference to the CPI or some version of it, often one that excludes certain volatile components in order to focus on "core" inflation. In making the choice for such an index, the central bank must make sure that the public understands the construction of the index, and does not get the impression that the central bank has chosen this one index among alternative indices in order to guarantee more favourable results.[2] Also, to assure the public that the central bank is not manipulating the index against which its performance will be judged it may be useful to have the data compiled by an agency that is independent of the monetary authorities.

ii) At present, the inflation objectives in Mexico are specified in an asymmetric way, *i.e.* in terms of the value which should not be exceeded. This approach is useful in the transition from high to moderate inflation rates. As further progress is made bringing inflation down, an alternative could be to follow the practice in several inflation targeting countries which specify a per cent range. This would have the advantage that it provides both a ceiling as well as a floor for the inflation rate. In the event that the central bank chooses to announce a range, a narrower range provides a more precise anchor for inflation expectations, provided of course that it is credible. But a narrow range reduces the bank's choices to respond to shocks. Also, unavoidable errors in controlling inflation may drive inflation outside of its range, despite the best efforts of the central bank. In this regard, the damage to credibility of missing a target range entirely is greater than that of

Box 1. Implementation of an inflation-targeting strategy (*cont.*)

missing a target point – an issue likely to be more important in Mexico than in countries with a history of stable and low inflation. While most OECD countries that target inflation directly have currently chosen a range from around 1 to 3 per cent, the Banco de México may want to choose higher or wider ranges, at least initially.

iii) Inflation targets can be set for one or more horizons. In practice, targets of less than one year or more than five years are unlikely to be meaningful, the former because inflation is not controllable at such short horizons and the latter because such distant targets would have little credibility. While practice among OECD inflation-targeting central banks differs, most seem to have chosen time horizons between one and three years for their inflation targets. In making the choice of the target horizon, the central bank has to consider the implications for the definition of the specific price index targeted (*see i*)). Specifically, choosing relatively longer horizons facilitates the use of broader indices, as swings in volatile components such as energy and food prices that may lead to short-run inflation blips tend to dissipate or wash out over somewhat longer periods. Closely related is the issue of the speed at which the central bank should attempt to reach its goals once deviations are incurred. On the one hand, achieving price stability brings large benefits to the economy.[3] Inflation, even at moderate levels, creates significant economic distortions, leading to efficiency losses. Beyond its effects on household disposable income, it has a distributional effect: the inflation tax is strongly regressive as it erodes the real value of cash balances, disproportionately held by lower income households. In Mexico, this is aggravated by the fact that access to interest-bearing bank accounts is still limited among the population. All these costs of inflation might be seen as justifying attempts to immediately bring inflation into line with its target rate. However, such attempts may require large movements in the policy instrument, possibly creating significant adverse effects in terms of real interest- and exchange-rate increases. This, in turn, could have severe effects on output and/or the current account balance. That such effects are indeed an issue of concern in Mexico is evidenced by the observation that the Banco de México has chosen a gradualist approach to disinflation following the peso crisis. In any case, to reduce the extent to which policy instruments would have to be moved, it is important for the Bank to continue to try and anticipate inflationary events and react to them pre-emptively. This points to the crucial role of the Bank's forward-looking inflation analysis.[4]

1. Recent surveys of inflation targeting are Bernanke, Laubach, Mishkin and Posen (1999), Cecchetti and Ehrmann (2000), Corbo, Landerretche and Schmidt-Hebbel (2001), Haldane (1999), Kennedy (2000), Meyer (2001).
2. Note that, recently, the construction of the national CPI published by the Banco de México has obtained ISO-9001 certification which ensures that data collection, calculation

Box 1. **Implementation of an inflation-targeting strategy** (*cont.*)

and dissemination of results are made under strict international quality standards. Also, to ensure transparency of the calculation of the recently introduced index of underlying inflation, a comprehensive methodological explanation was published. And the statistics used to calculate this index are made publicly available.

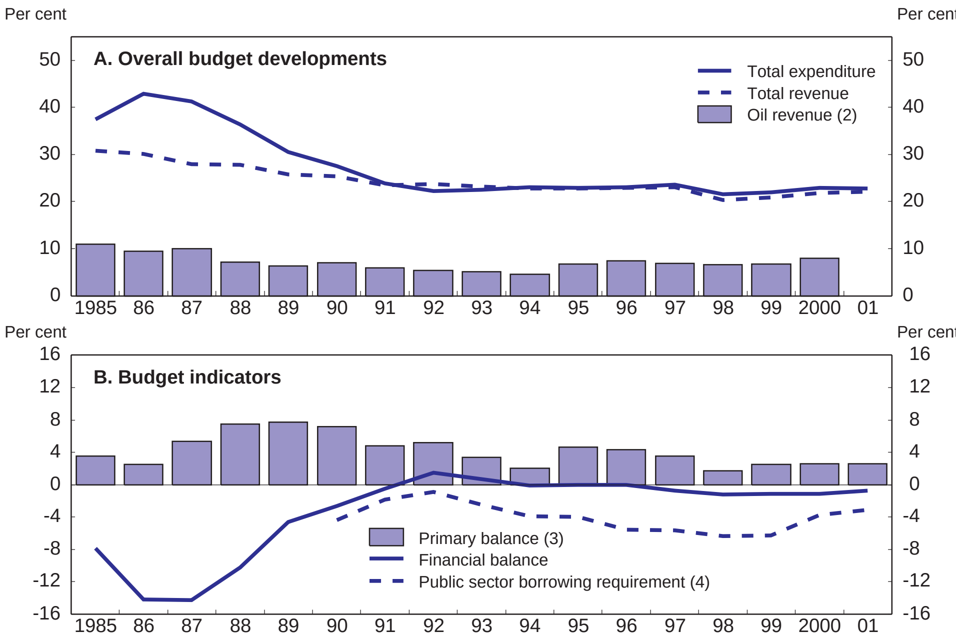
3. For a discussion of the benefits of bringing down inflation, even at moderate rates, see *e.g.* Edey (1994).
4. An important issue in this context is how to calculate the actual inflation forecast to be used as an intermediate target. Specifically, in practice, pursuing an explicit inflation target usually involves "targeting" the conditional forecast of inflation – the inflation rate expected to prevail in the future given presently available information – rather than current inflation.

Fiscal policy

Progress has been made over recent years to strengthen public finances, and fiscal policy has been cautious. Since 1998, the broad public sector deficit (federal government and public enterprises) has fluctuated between ¾ and 1¼ per cent of GDP, an outcome achieved while meeting new pressures on spending (Figure 14). The social security reform for the private sector, implemented as of the middle of 1997, has imposed a burden on the budget equivalent to 1½ per cent of GDP per year, half of which is because of the transition to a fully-funded capitalisation system, though by paying this cost, the government is reducing an implicit government liability.[25] In addition, provisions are being made to cover the cost of support programmes for banks and debtors, introduced in the aftermath of the peso crisis. The debt service obligations created for the government were estimated at 0.7 per cent of GDP in 2001.[26] Total interest payments, including the provisions made for the financial support package, have amounted to 3 to 4 per cent of GDP annually over recent years and the primary surplus (financial balance less total interest payments) reached 2½ per cent of GDP in 2001 (Table 8). The recent decentralisation has also been putting pressure on the federal budget and is expected to continue to do so.[27]

The relative stability of budget outcomes, broadly in line with targets over the past few years, has been remarkable given the vulnerability of government revenue to international oil prices (oil-related revenue accounts for about one-third of budget receipts). Faced with unexpected oil-revenue fluctuations, the government has usually responded by adjusting expenditure. An oil-stabilisation fund, such as the one created in 2000, can only partly help smooth the impact of

Figure 14. **Public sector budget aggregates**[1]
Per cent of GDP



1. The public sector comprises federal government and public enterprises under budgetary control (such as PEMEX). Financial intermediation by development banks is not included. Data for 2001 are Ministry of Finance estimates.
2. Includes oil extraction royalties, VAT and excise taxes on oil products.
3. The primary balance is the financial balance less net interest payments.
4. Public sector borrowing requirement (PSBR) includes net costs of PIDIREGAS, inflation adjustment to indexed bonds, imputed interest on bank-restructuring and debtor-support programmes and financial requirements to development banks. Non-recurrent revenues (privatisation) are not included. Further adjustment to include the net non-recurrent capital costs of the financial sector support programmes would increase the PSBR.

Source: Ministry of Finance; Banco de México.

external shocks on revenue.[28] Over the longer run, a stronger tax base is required to stabilise public sector revenue and loosen the constraints on spending (see below).

Budget execution was facilitated in 2000 by external and domestic factors...

The 2000 budget foresaw a small drop in the financial deficit and a widening of the primary surplus. In the event, higher-than-anticipated oil revenues, and booming activity resulted in public sector revenues being about

Table 8. **Public sector financial accounts**

Per cent of GDP

	1997	1998	1999	2000		2001		2002
	Outturn	Outturn	Outturn	Budget[1]	Outturn	Budget[1]	Outturn	Budget[1]
Revenue	23.2	20.4	20.9	21.5	21.9	21.2	22.1	22.7
Expenditure	23.8	21.6	22.0	22.5	23.0	21.9	22.8	23.4
Financial balance	**–0.7**	**–1.2**	**–1.1**	**–1.0**	**–1.1**	**–0.7**	**–0.7**	**–0.7**
Primary balance	**3.3**	**1.7**	**2.5**	**2.8**	**2.6**	**2.8**	**2.6**	**2.7**
Memorandum items:								
Interest payments, total	3.9	2.8	3.7	3.9	3.7	3.4	3.3	3.3
of which: Provisions for support programmes[2]	1.3	0.3	0.5	0.8	1.1	0.6	0.7	0.7
Cost of IMSS reform[3]	0.8	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Revenue sharing	3.0	3.0	3.1	3.1	3.3	3.2	3.4	3.5

1. The budget projections for 2000, 2001 and 2002 are the approved budgets.
2. Cost of the support programmes for banks and debtors.
3. IMSS is the social security institute for private workers; the total cost of the reform includes both reduced revenues and higher expenditures.

Source: Ministry of Finance.

½ per cent of GDP higher than projected, even though privatisation proceeds fell below expectations (Table 9). At the same time, interest payments on the public debt were lower than budgeted, reflecting declining interest rates through the year.

Only part of the revenue windfall and savings from lower interest payments served to finance additional spending. Two thirds of the revenue windfall were used – as laid down in the Budget Law – to accelerate debt amortisation and to create the oil-revenue stabilisation fund.[29] The rest was allocated to additional expenditure by public enterprises, as well as to social welfare programmes (including broadening the poverty programme PROGRESA, strengthening basic education and health services), extending social security and financing higher education and highway infrastructure projects (Tables 10 and 11). Because of the legal constraints on the use of windfall revenue and the unusual front-loading of spending that year some fiscal stimulus could not be avoided.[30] The only way to dampen this impact on aggregate demand would have to have been outside the federal budget, *i.e.* through lower investment by public enterprises or fewer PIDIREGAS projects (privately-financed investment projects, which are launched under public impulse).[31] In the event, the scale of these projects was extended in 2000 by more than budgeted.

Table 9. **Federal government budget**

Per cent of GDP

	1995	1996	1997	1998	1999	2000	2001		2002
	Outturn	Outturn	Outturn	Outturn	Outturn	Outturn	Budget[1]	Outturn[2]	Budget[1]
Revenue	**15.2**	**15.5**	**16.0**	**14.2**	**14.7**	**16.0**	**15.5**	**16.3**	**16.6**
Contribution of PEMEX	3.9	4.5	4.1	2.3	2.1	4.0	3.2	3.4	2.3
Other non-tax revenue	2.0	2.1	2.1	1.3	1.2	1.3	1.5	1.6	1.3
Tax revenue	9.3	8.9	9.8	10.5	11.4	10.7	10.9	11.2	13.0
of which:									
Income tax	4.0	3.8	4.3	4.4	4.7	4.8	4.6	5.0	6.0
VAT	2.8	2.9	3.1	3.1	3.3	3.5	3.4	2.9	3.6
Excise taxes	1.3	1.2	1.4	2.0	2.3	1.5	2.0	2.8	2.9
Import duties	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.5	0.5
Expenditure	**16.1**	**16.0**	**17.4**	**15.9**	**16.5**	**17.5**	**16.9**	**17.6**	**18.0**
"Programmable"	9.5	9.3	10.4	10.2	10.3	10.8	10.5	11.1	11.4
Current expenditure	7.8	7.6	8.7	8.7	8.9	9.3	9.2	9.8	10.3
Capital expenditure	1.9	1.9	1.9	1.7	1.6	1.6	1.6	1.6	1.4
Delayed payments	–0.2	–0.2	–0.3	–0.2	–0.2	–0.1	–0.3	–0.3	–0.3
Non-programmable	6.6	6.7	7.0	5.8	6.2	6.7	6.4	6.5	6.6
Revenue sharing	2.7	2.8	3.0	3.0	3.1	3.3	3.2	3.4	3.5
Interest payments[3]	3.8	3.7	3.4	2.4	3.1	3.2	3.0	2.9	2.9
Other[4]	0.1	0.2	0.6	0.4	0.0	0.2	0.2	0.2	0.2
Financial balance	**–0.9**	**–0.5**	**–1.4**	**–1.7**	**–1.8**	**–1.5**	**–1.4**	**–1.3**	**–1.4**

1. The projections for 2001 and 2002 are the approved budgets.
2. Preliminary data.
3. Includes provisions made on account of the support programmes for banks and debtors.
4. Includes accounts payable from previous fiscal period and net expenditure of the Federal Government on behalf of state-owned enterprises.

Source: Ministry of Finance.

Table 10. **Public enterprises under budgetary control: financial accounts**[1]

Per cent of GDP

	1995	1996	1997	1998	1999	2000	2001		2002
	Outturn	Outturn	Outturn	Outturn	Outturn	Outturn	Budget[2]	Outturn[3]	Budget[2]
Revenue	**8.9**	**8.7**	**9.1**	**7.9**	**7.9**	**7.6**	**7.4**	**7.7**	**7.9**
PEMEX	2.7	2.9	2.7	2.1	2.2	2.0	2.0	1.9	2.3
Other public enterprises	4.9	4.5	4.5	4.1	4.0	3.9	3.7	4.0	3.8
Transfers received	1.4	1.2	1.9	1.8	1.7	1.7	1.7	1.8	1.8
Expenditure	**8.3**	**8.4**	**8.4**	**7.4**	**7.2**	**7.2**	**6.8**	**7.2**	**7.2**
Current expenditure	5.9	5.7	6.3	5.6	5.7	5.6	5.3	5.7	5.8
Capital expenditure	1.6	2.0	1.6	1.4	1.1	1.1	1.1	1.0	0.9
Interest payments	0.8	0.6	0.5	0.4	0.4	0.4	0.4	0.5	0.5

1. State-owned enterprises under budgetary control, excluding public financial intermediaries (development banks and development trust funds).
2. The projections for 2001 and 2002 are the approved budgets.
3. Preliminary data.

Source: Ministry of Finance.

Table 11. **Public expenditure by sector**

	1995	1996	1997	1998	1999	2000	2001[1]	2002[1]
Total[2], peso billion	290.4	403.4	528.1	600.6	711.2	864.7	937.4	1 026.8
(Percentage changes, in real terms)	(–15.6)	(6.3)	(11.2)	(–1.5)	(3.1)	(9.8)	(2.4)	(3.7)
	Per cent of total[3]							
Social development	53.4	51.9	51.5	57.9	60.9	60.1	61.8	62.5
Education	23.5	23.0	22.2	24.7	24.7	23.9	25.3	25.6
Health	14.0	12.9	13.4	14.7	15.5	14.1	14.4	13.4
Social security	8.6	8.3	8.9	10.5	13.4	14.3	13.4	14.6
Labour	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Social assistance and supply	2.2	2.6	1.7	1.6	1.4	1.3	1.4	1.6
Urban and regional development	4.7	4.7	4.9	6.0	5.7	6.2	7.0	7.0
Rural development	7.1	6.3	5.6	5.0	3.7	3.4	3.7	3.7
Environment and fishing	0.9	1.7	1.4	1.0	1.3	1.2	1.3	1.4
Communications and transport	4.8	5.5	8.3	4.0	3.4	2.7	2.4	2.7
Energy	22.1	23.1	21.0	21.5	19.4	19.9	18.9	18.1
Justice and security	7.6	8.0	7.9	5.6	5.8	6.1	5.2	5.1
Administration	4.2	3.4	4.3	5.0	5.4	6.6	6.8	6.7

1. Estimates for 2001 are preliminary; the projections for 2002 are based on the approved budget.
2. Public expenditure, excluding interest payments and revenue-sharing with state and local governments (*i.e.* "programmable" expenditure).
3. Percentages may not add up because of rounding.

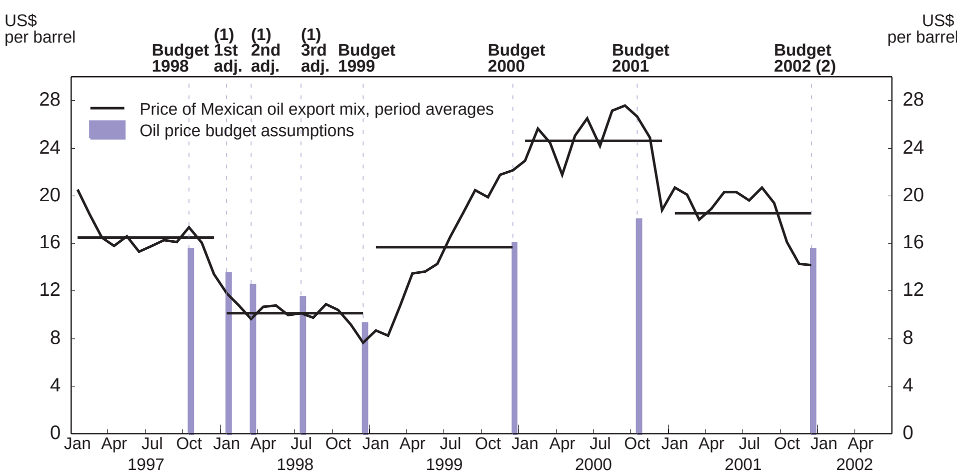
Source: Ministry of Finance.

... but the environment worsened in 2001, and the fiscal stance was tightened

Budget developments in 2001 stand in clear contrast to those a year earlier. When the budget was prepared at the end of 2000, the economic situation was already showing signs of deterioration, with major uncertainties as to the extent and likely duration of the slowdown. The budget foresaw a reduction of the financial deficit in a more adverse environment, with slower – though positive – GDP growth and a decline in oil prices (by about 6 dollars per barrel) (Figure 15). Lower budget revenue and lower spending were thus projected. In the event, economic conditions worsened by much more than anticipated. Oil receipts were hit by smaller-than-anticipated export volumes, the strength of the peso and weak domestic sales, as GDP declined.[32] Although tax income was stronger than projected – partly thanks to a tax amnesty measure –, total revenue turned out to be lower, leading the government to adjust the level of spending as required by the Budget. By September, the revenue shortfall had reached 0.3 per cent of GDP.

The adjustments – made in three steps between May and October – have mostly involved cuts in current spending, but also a freeze in capital spending. The adjustments were facilitated by the fact that the implementation of investment programmes tends to be delayed when a new administration takes over. Areas affected have included the state-owned electricity company (CFE), pro-

Figure 15. **Oil prices and budget assumptions**



1. Adjustments made to the 1998 budget assumptions.
2. According to the approved budget for 2002.
Source: Ministry of Finance; PEMEX.

grammes for agricultural development and the road annual construction programme as well as labour training. By the end of 2001 the levels of both current and investment spending were lower than budgeted, and the deficit (at 0.73 per cent of GDP) was not far from the initial projection. However, within-year adjustments to achieve a given deficit outturn are not without a potentially high social and economic cost over the medium-term, since they postpone development of physical and human capital.

Constraints on fiscal policy operation

The implementation of the budget over the past few years underscores the vulnerability of revenue to exogenous shocks and the fact that the fiscal stance tends to be pro-cyclical. Although there are no estimates of structural budget balances, it is likely that achieving the 2000 budget objective in the face of a strong acceleration of economic activity implied an easing of fiscal policy. In 2001, on the other hand, bringing down the budget deficit in line with the objective, despite the stagnation of GDP, has required a tightening of the fiscal stance. The authorities did not have much margin for manoeuvre, and the fiscal discipline that was exercised was well perceived by markets, as evidenced by the decline in interest rates during most of 2001.

The budget deficit is low relative to GDP and so is public debt both by Mexican historical standards and in comparison with other OECD countries – even adjusted for liabilities related to bank and debtors' support programmes. Nevertheless, there is no reason for complacency. The more comprehensive public sector borrowing requirement (PSBR) corrects some of the shortcomings of the traditional "financial balance", thus providing a more accurate picture of the sustainability of public finances. In particular, it excludes non-recurrent revenue from privatisation and includes spending needs related to PIDIREGAS projects. It also takes fuller account of debt servicing related to financial support programmes and it includes financial requirements of development banks. On this basis, despite a 2½ percentage points drop from the 1999 outcome, the PSBR still amounted to 3.8 per cent of GDP in 2001.

The budget for 2002 foresees further fiscal consolidation

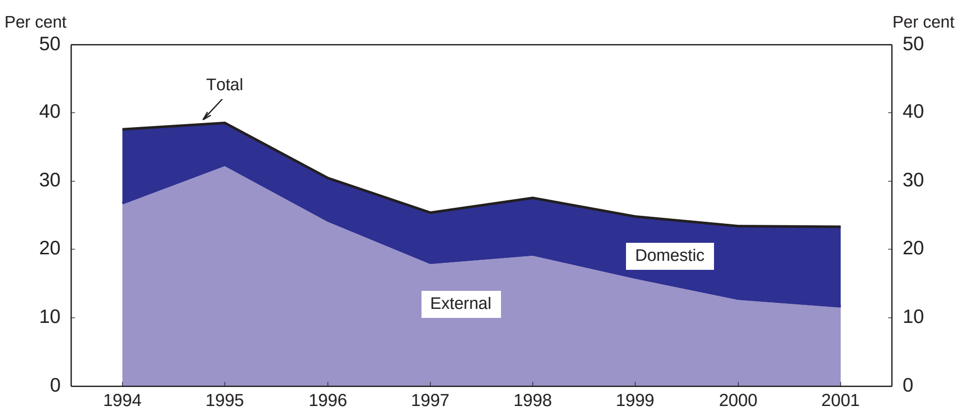
The budget for 2002 is tailored to the above-mentioned constraints and aims at maintaining a tight fiscal stance. It foresees a public sector financial deficit of 0.65 per cent of GDP in a context of low growth and great uncertainty regarding the external environment. Public sector revenues are projected to grow in real terms, based on real GDP growth of 1.7 per cent and under the assumption of an average price for the Mexican oil export mix of US$15.5 per barrel. PEMEX revenue is expected to be boosted by an expansion in export volumes and improved refinery capacity that would translate into lower imports. Tax revenue is expected to be enhanced by more than 1 per cent of GDP, as a result of the approved tax measures and improved tax collection, while non-recurrent revenue (privatisation) would fall substantially.

On the expenditure side, priority has been given to social areas (education, health, social development and security) and investment spending. The programme was designed with tight limits, but, thanks to higher tax receipts obtained through the tax reform, non-interest expenditure overall has been projected to increase slightly in real terms. As in previous years, spending adjustments are to be implemented automatically if government revenue evolves differently from projections so as to guarantee that the fiscal targets will be met.

Debt management

The strategy followed by the Mexican authorities since the peso crisis of 1994-95 has been to reduce the outstanding stock of the public debt by generating primary budget surpluses, to lower reliance on external debt and to lengthen the average maturity of debt instruments. The total net debt of the public sector (including public enterprises) fell from a little over 38 per cent of GDP in 1994 to around 23 per cent of GDP by December 2001 (Figure 16). In addition to

Figure 16. **Total net debt of the public sector**
Stocks outstanding, end of period[1]
Per cent of GDP



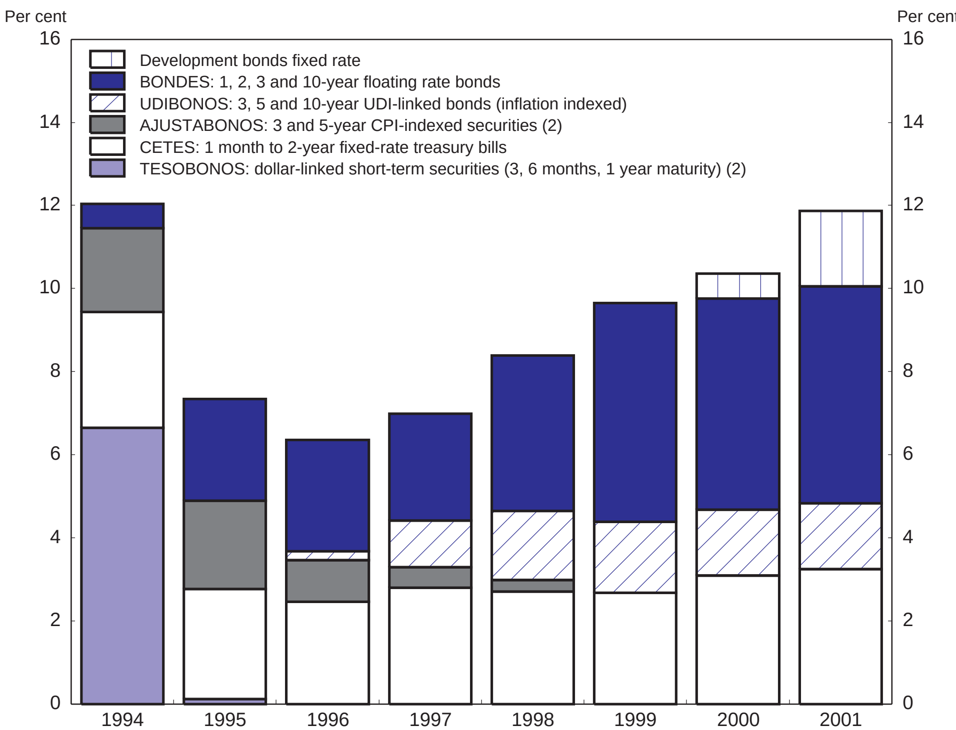
1. "Broad economic debt" according to the Ministry of Finance definition, *i.e.* total gross debt less deposits and financial assets of the public sector (comprising the Federal Government, public enterprises and development banks). Official trust funds are excluded.

Source: Ministry of Finance.

the public debt *stricto sensu*, there are liabilities arising from bank restructuring operations and debtor support programmes which are estimated at around 19 per cent of GDP.[33] Over the past five to six years the authorities have sought to replace the external debt component by domestic debt, a process which has been facilitated by the development – even if still incipient – of institutional investors.[34] In 2000, the government continued to buy back Brady bonds by exchanging them for a new instrument (a 20-year "global" bond) and cash, thus prepaying loans maturing in 2001-03. The retirement of Brady bonds through exchanges for longer maturity "global" bonds (with a 30-year maturity) continued in 2001. As a result,

Figure 17. **Public sector domestic debt**[1]

Stocks outstanding, end of period
Per cent of GDP



1. Excludes repurchase agreements and deposits with monetary regulation purposes.
2. TESOBONOS were redeemed in first quarter 1996; AJUSTABONOS by end 1999.

Source: Ministry of Finance.

the outstanding stock of Brady Bonds was cut in half during the year (reaching about US$8 billion in December 2001). At the same time, debt arising on account of PIDIREGAS schemes has been financed externally.

Substantial progress has been made in developing a domestic public debt market for longer-term instruments. As conditions on domestic financial markets improved over time, the authorities have been increasingly issuing longer-maturity bonds. This has brought the average maturity of the domestic federal debt to almost two years by September 2001, a more than two-fold increase over 5 years. Bonds issued were mostly indexed or at floating-rate until 2000, when the authorities began issuing fixed-rate bonds with 3 to 5 year-maturity (Figure 17). In 2000, the IPAB (Bank Saving Protection Institute) also began to issue bonds with similar characteristics to refinance its liabilities with market instruments (Chapter IV). Fixed-rate bonds were well accepted by market participants, so that in mid-2001, the government was able to issue a 10-year bond. This strategy has helped smooth somewhat the vulnerability of the budget to interest-rate volatility: according to Ministry of Finances estimates, a rise of domestic interest rates of one percentage point (100 basis points) increases the budget deficit by close to 0.1 percentage points of GDP. Considering domestic public debt, it would be desirable to further increase the share of longer-term, fixed-rate instruments as market conditions permit. In managing the broader public debt, including IPAB liabilities, where the Treasury and IPAB act separately, centralisation of management could produce a more efficient strategy and a narrowing of spreads.

Looking ahead: strengthening the fiscal position

Setting fiscal policy in a medium-term framework

There is a clear need for a medium-term policy framework based on fiscal policy objectives and assumptions about where the economy is heading. As argued in past OECD *Economic Surveys*, this could serve to orient and stabilise expectations of market participants, thus contributing to reducing the risk premium in interest rates. Mexico has made considerable progress in improving fiscal transparency: data are published on a regular basis and a comprehensive measure of the fiscal deficit (PSBR) is now included. But there is limited experience in publishing forward projections of the fiscal balance beyond the current budget year. The medium-term macro-economic scenario presented in 1997 (the National Programme for Financing Development, 1997-2000) and updated in 1999 did not extend beyond the year 2000, which marked the end of the Presidential "*sexenio*". It is important to find ways to provide information about key aspects of policy orientation over a period of several years, perhaps rolling over the medium-term projections and updating them regularly. This would help reduce uncertainties, in particular before the transition to a new administration. It would also allow policy decision to focus on longer-term priorities, rather than cyclical phenomena. Many OECD countries have integrated into their budget planning process forward projections, which are updated and published on a regular basis. Box 2, below reviews the experience of selected OECD countries.

Incorporating forward projections into the budget planning process for Mexico would contribute to improving the quality of decision-making both at the macroeconomic level, by indicating the fiscal position that would result from unchanged policy ("baseline" projections), and at the structural level, by helping to identify how various policy changes would help close the gap between the baseline projection and the desired fiscal projection, consistent with medium-term objectives. The National Development Plan 2001-06 goes some way in publishing medium-term goals for some fiscal variables. It would be appropriate to go further, with more formal medium-term budget planning, publishing fiscal projections for variables such as operating expenses, revenues and debt. In this context, a number of medium-term fiscal issues pertinent to Mexico would have to be addressed.

i) There are strong spending pressures related to the social security system: some are explicit and have been quantified, while others are implicit liabilities related to the public sector pension system which is still a pay-as you-go system.[35]

ii) The cost of the bank and debtor support programmes is only partly quantified and reflected in the budget.

iii) There are some uncertainties regarding the fiscal cost of PIDIREGAS schemes. Although the cost of some of these schemes is included in the PSBR, it is not always the case. Explicit future cost estimates are needed for all PIDIREGAS schemes.[36]

The budget's sensitivity to exogenous variables such as oil prices and interest rates adds to the uncertainties surrounding budget projections. It induces the government to follow a particularly prudent approach in its annual projections, which is appropriate. It would also warrant regular updates of medium-term projections. Once significant progress has been achieved in fiscal consolidation, with a stronger revenue base in place, a medium term framework would allow more flexibility for operating policy from one year to another, allowing temporary deviations. In such a context it might be appropriate to focus budget discussions more on some concept of an expenditure "norm", rather than on the actual budget balance. Prudence is also required in public sector operations which are off budget but can have a sizeable impact on aggregate demand, such as the financial intermediation of development banks or the scale of PIDIREGAS projects which are launched.

Measures to widen the tax base and improve tax collection(see below) would constitute a prerequisite for allowing some degree of flexibility to fiscal policy and would help to loosen some of the constraints under which it has been operating. At the same time, on the spending side, measures to enhance the effi-

Box 2. Medium-term budget projections in selected OECD countries

In Australia, the Principle of Budget Honesty establishes legal obligations concerning budget planning and fiscal policy. The annual budget includes fiscal projections with a 4-year horizon (this year's budget covered the period until 2004-05 fiscal year). The economic and fiscal outlook is updated at mid-year, and new estimates of the budget and medium-term forecast are provided. Short-term deviations from medium-term budget target are allowed over the cycle.

In New Zealand, the government has a legal obligation to publish a full fiscal forecast with a horizon of 3 years, and a progress outlook for major fiscal variables (operating expenses, revenue, the fiscal balance, the public debt and net worth) over a ten-year horizon. The Fiscal Responsibility Act, which came into effect in 1994, sets legislated principles of "responsible fiscal management": to maintain the debt at "prudent" levels, by running operating surpluses on average over a "reasonable period of time" (which has been interpreted as over the cycle); to achieve and maintain a "prudent" level of public net worth; to ensure that tax rates are "reasonably" stable and predictable.* The Act also establishes stringent report requirements to ensure that short- and long-term fiscal objectives are clear.

The European Union member countries publish every year a "Stability programme" (for euro area countries) or a "Convergence programme" (for countries outside the euro area) which serves to implement the Stability and Growth Pact. The "programmes" provide fiscal projections, for which several elements are published over a 4-year horizon. The medium-term objectives agreed under the Pact include a ceiling for the budget deficit (3 per cent of GDP), with the aim of reaching budget balance or surplus to provide room for letting automatic stabilisers work, and a cap on public debt of 60 per cent of GDP.

In the United Kingdom, every year, with the draft budget, the government provides medium-term projections with a 5-year horizon. It is committed, since 1997, to respect the "golden rule" – over the economic cycle, the government will borrow only to invest and not to fund current spending; and the "sustainable investment rule" – the public sector net debt as a proportion of GDP will be held over the cycle at a "stable" and "prudent" level, which in practice is interpreted as below 40 per cent of GDP.

In the United States, both the administration and the Congress provide 10-year rolling budget estimates. The estimates are produced at a greater level of detail up to 5 years ahead. The projections of the Congressional Budget Office fulfill the legal obligation to provide five-year baseline projections of the federal budget, based on objective and impartial analysis.

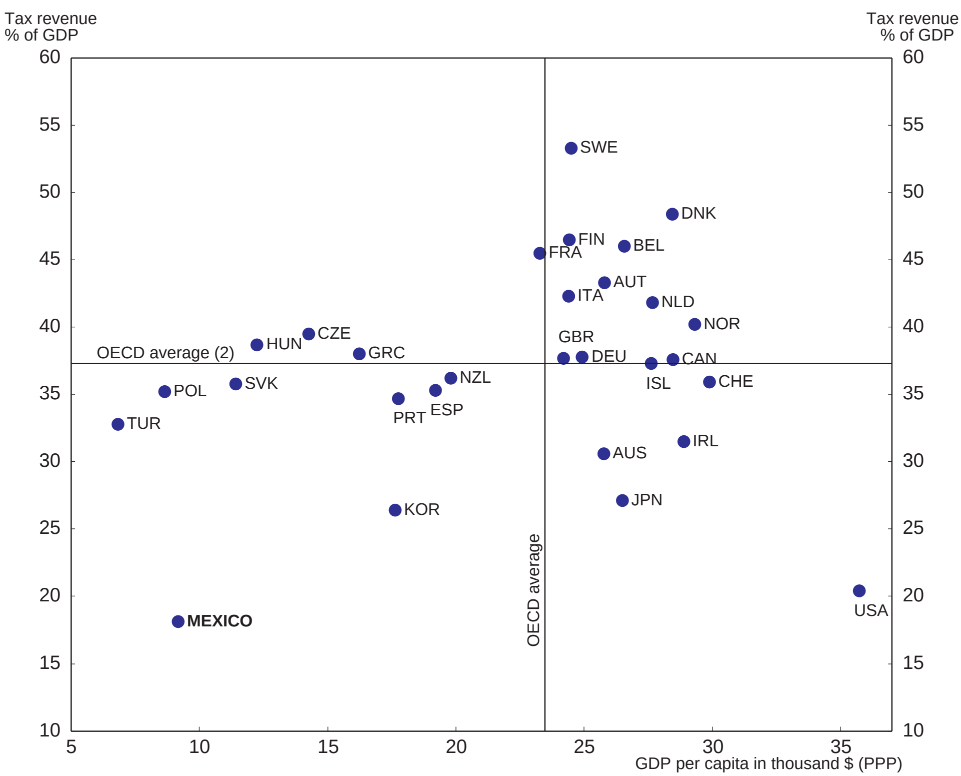
* The Act does not define "prudent" or "reasonable". These are left to the government to interpret. New Zealand's fiscal management is discussed in some details in the OECD *Economic Surveys* of New Zealand (1996 and forthcoming).

ciency of public spending, discussed in the 2000 OECD *Economic Survey*, need to be continued, so as to improve conditions for strong and sustainable growth of output and employment over the longer run.

The tax reform

A wide-ranging tax reform would substantially help consolidate public finances by reducing reliance on oil revenue and making room for additional spending. Compared with the situation in other OECD countries and in Latin America, public expenditures are very low in Mexico in proportion to GDP (Figure 18). Moreover they are volatile, because they are largely financed by oil-

Figure 18. **Tax revenue and the level of income in OECD countries**[1]



1. 2000 or nearest year available.
2. Unweighted average.
Source: OECD, *Revenue Statistics* 1965-2000; OECD, *National Accounts*.

related revenue, while the tax base is narrow. Freezing or cutting public spending as currently practised to ensure budget discipline in the face of revenue shocks is costly in the longer run. There are also pressures on spending over the medium term, related to liabilities while privatisation proceeds will dry up. At the same time, an increase in tax revenue would permit financing additional investment in human and physical capital, which is important for long-term growth. The proposal sent to Congress at the beginning of 2001 was expected to increase tax revenue substantially; it was structured with a view to improving income distribution and enhancing the simplicity and transparency of the tax system, by getting rid of special regimes and exemptions.

The tax reform which was approved by Congress in December 2001 differs in some important aspects from the proposal, most notably on indirect taxes. Regarding direct taxes, the approved measures retain most of the fundamental features of the proposal, eliminating various preferential regimes both for corporate and individual tax payers. The top marginal rate of individual income tax is reduced (as well as the number of brackets), and the income from all sources will now be subject to the same tax rate. On indirect taxation, on the other hand, the proposal to widen the VAT tax base was not approved; to compensate the revenue shortfall, excise taxes were increased, including a surcharge on luxury items and a special tax on telecommunications. The major planks of the approved reform are reviewed in Box 3.

The new tax initiatives are officially estimated to bring in additional revenue of around 1 percentage point of GDP in 2002. This increase is not negligible, but it is still short of what would be required to reduce the budget deficit, while financing longer-term spending needs. According to the 2000 OECD *Economic Survey*, an increase in tax revenue of some 3 percentage points of GDP would seem to be a reasonable benchmark for Mexico in the medium term. In addition to the set of approved tax changes, improvements in tax administration and compliance are estimated to bring in extra revenue of some 0.6 per cent of GDP in 2002. The introduction of the various special taxes together with the fact that the VAT regime remains unchanged, with numerous exemptions and zero-rate goods and services, will tend to increase administrative costs. However, moving from an accrual to a cash-flow basis for both income and indirect taxation will result in substantial simplification, which should improve tax compliance. Furthermore, the elimination of some exemptions and special regimes on the income tax side will reduce the scope for tax fraud.

A major step has been accomplished with the recently approved package; but tax reform will have to be put on the policy agenda again in the years ahead, regarding indirect taxation in particular, where changes are needed to further strengthen tax revenue while reducing distortions. Discussions around the tax reform proposal were focused to a large extent on how the proposed changes

Box 3. Tax measures approved

Corporate income tax

– The tax rate is to be lowered by 1 percentage point a year, from 35 per cent in 2002 to 32 per cent in 2005. The special tax rate for retained earnings, which was 30 per cent, is eliminated – This change is estimated to be the most important for revenue increase in 2002.[1]
– Immediate deduction of investment carried out outside the three largest metropolitan areas (Mexico City, Monterey and Guadalaraja), to be implemented as from 2003 only, so as not to affect revenue this year (no estimate of the revenue impact is available).[2]
– Payment of a 3 per cent tax on payroll or transferring to enterprises the payment of the "salary credit" that the government was granting wage earners (up to an amount equivalent to 3 per cent of the payroll) – This measure is the second most important in terms of revenue increase.
– Contributions to social security (IMSS), individual retirement savings account (administered by AFORES) and the housing fund (INFONAVIT) made by firms on behalf of their employeesbecome deductible for income tax purpose – implying a substantial revenue loss.[3]

Individual income tax

– The top marginal tax rate is reduced from 40 to 35 per cent in 2002 and gradually down to 32 per cent by 2005 (it will thus be aligned with the corporate tax rate).
– Persons will record income from all sources for tax filing purposes – a measure meant to subject all income to the same tax rates, which will also facilitate tax control.
– The scope of tax expenditures is broadened: real interest payments on mortgages and medical insurance premia become deductible from the tax base.
– Fringe benefits (social security benefits, overtime...) remain exempt from income tax.

Special taxes have been created[4]

– *Special tax on telecommunications, on mobile phone services in particular* – at a 10 per cent rate (except for calls with prepaid cards under a certain threshold). Local fixed line calls and long distance calls are not included.
– *Special tax on soft drinks*: a tax of 20 per cent levied on those that use fructose as sweetener .
– *Sales tax on luxury goods and services* – at a rate of 5 per cent.

Box 3. Tax measures approved (*cont.*)

Changes to special regimes on income tax:[5]

- T*he simplified regime* for certain sectors (agriculture, livestock, forestry, fishery and land transportation) is based on cash flow, with a view to reduce tax avoidance; the special regime for publishing will be phased out by 2006.
- T*he regime for small tax payers*:[6] the threshold is lowered (1.5 million pesos annual income). There will be one single rate at of 1 per cent applied to gross income. Earnings up to three minimum wages are exempt from the taxable base (previously there were several rates, including a zero-rate, for various income brackets).

Value added tax

- VAT will now be charged on a cash flow basis, rather than an accrued basis.[7]
- No changes to the VAT regime (various rates, wide zero rating and exemptions remain in place).

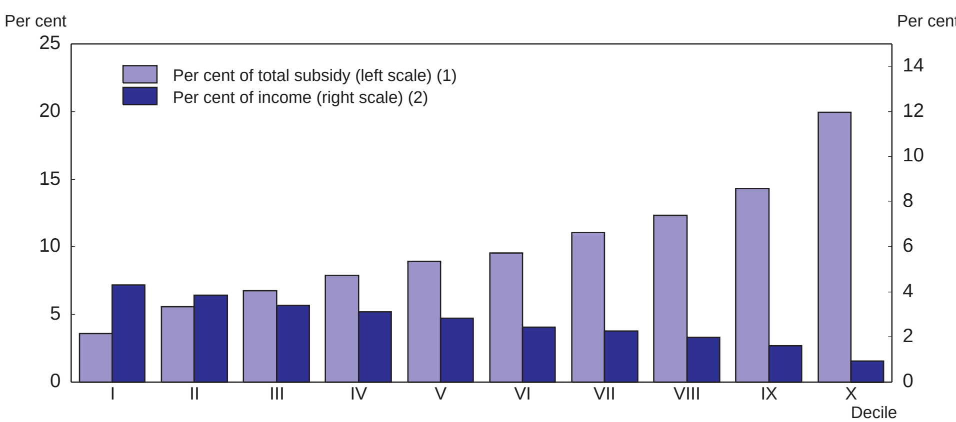
Fiscal federalism:

- States are allowed to charge up to an additional 3 per cent rate as a final sales tax.
- States can impose up to an additional 2 per cent rate on tax income of individuals under the regime for small tax payers (and up to an additional 5 per cent rate for individuals with commercial activities in an the intermediate situation).
- Any revenue raised by States under the above mechanisms is not shared with the federal government.

1. The set of new tax measures is estimated to bring in additional resources for an amount of 61 billion pesos in 2002: more than a third of this (24 billion pesos) comes from this change ; another 23 billion should come from the "payroll tax" (official estimates).
2. The deduction will also be applicable in the three major cities in the case of enterprises which are labour intensive, use non-polluting technology and do not make intensive use of water.
3. This measure is estimated to cost 15 billion pesos of lost revenue.
4. These taxes are estimated to bring 14 billion pesos (the telecom tax: 3.8 billion, the luxury tax: 8.8 billion).
5. The two measures are estimated to enhance revenue by 10.5 billion pesos.
6. This regime applies to individuals with commercial activities. An intermediate regime has also been introduced for those with annual income below 4 million pesos.
7. *i.e.* VAT will be paid when the disbursement takes place. The new rule, which is generally applied to retailers in most European countries with a VAT system, helps the entrepreneurial sector, which otherwise often faces liquidity problems.

would affect revenue raising capacity and the progressivity of the tax system. The highly unequal income distribution in Mexico limits the base for individual income taxation[37]. Out of a population of 95 million people, in recent years there were only 15 million individual tax payers, of which only 4 to 5 million paid income tax. About 70 per cent of wage earners in the formal sector did not pay income tax at all, but rather received tax payments from the "salary" tax credit. Abolishing some of the exemptions related to the taxation of interest income and capital gains, as was just approved, goes some way towards taxing the affluent more. This should be complemented, however, with a greater effort by local governments in the area of property taxes – taxation of (large) real estate holdings in particular – that could well be increased, primarily by making more adequate valuations. This would enhance the overall revenue base of local governments and it would probably be relatively progressive in its overall incidence. More importantly, reducing the preferential treatment of consumption by eliminating massive zero rating and exemptions under VAT, as initially proposed, would be a way of taxing the most affluent households at higher effective rates. According to official estimates and considering the distribution by income deciles, the highest two deciles would be bearing half of the burden of additional taxation from a tax base widening, while the lowest two deciles would only pay 3.1 per cent of the additional burden. High-income categories are actually heavily subsidised by the non-taxation of con-

Figure 19. **Distribution of implicit VAT "subsidy", 2000**



1. The implicit VAT subsidy at each income decile is estimated by the corresponding expenditure on food multiplied by the standard VAT rate of 15 per cent.
2. The consumption of food and household income per decile (referring to total income) are based on the INEGI 2000 Household Survey.

Source: INEGI, "Encuesta nacional de ingresos y gastos de los hogares 2000"; OECD calculations.

sumption goods. The distribution by income deciles for 2000 shows that the highest two deciles together capture close to 35 per cent of the value of the implicit subsidy, while the lowest two receive less than 10 per cent (Figure 19). It would be possible to compensate for the impact of the VAT changes on low-income groups through a number of specific measures, including increasing wage credits for low-wage tax payers and various transfer mechanisms for poor families, including those who are not employed in the formal sector.[38] The widening of the tax base on the VAT would have a high impact in terms of revenue raising, even after compensation for low income families. This could bring tax revenue close to what is needed to consolidate public finances and to meet longer-term spending needs.

III. Structural reform for sustainable and balanced growth

Introduction

In 2000, the Mexican economy was in the fifth year of the cycle of expansion that followed the peso crisis, with annual growth averaging about 5 per cent since 1995. In the second half of the 1990s, progress continued to be made on the path of structural reform, in line with the OECD's recommendations in recent surveys, but major initiatives still need to be taken and ongoing reforms to be completed. The worsening in the macroeconomic climate that accompanied developments in the United States in 2001 must not slow the pace of reform. On the contrary, it is important to overcome resistance to reform. The new administration must spell out more clearly its medium-term reform strategy, and progress in implementing policies that have already been announced. The recent tax reform is a step in the right direction, although further measures will be necessary, as indicated in the previous chapter. Also, in its National Development Plan for 2001-06, the new government emphasises the need to continue action on a wide front, in order to foster private investment and the creation of productive jobs. Particular emphasis is given to regional development strategy.

This chapter starts by reviewing Mexico's economic performance. While highlighting the progress made, it underlines the persisting problem of poverty and the marked regional disparities in income levels and economic structures. It then reviews a few of the main areas in which vigorous action would make possible a lasting improvement in the well-being of the population, including that of the most disadvantaged groups: enhancement of human capital and improved labour market performance, putting in place conditions conducive to the adoption of new technologies and to the dynamism of small enterprises, and strengthening competition in product markets. Box 4 at the end of the chapter recapitulates the OECD's main recommendations for further structural reforms, including in areas dealt with in more depth in previous surveys which are not addressed in this survey.

Mexico's long-term performance

Overall performance has improved…

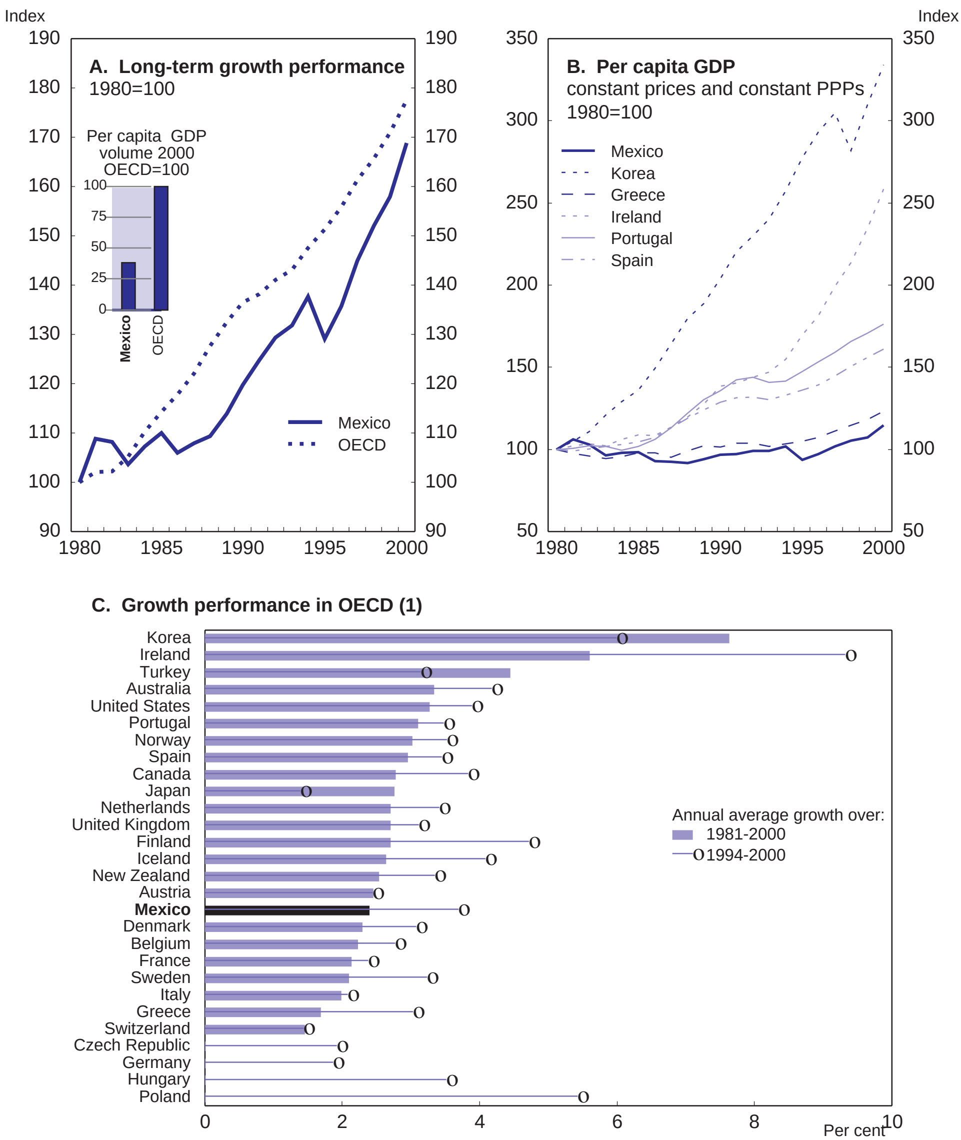
In the past twenty years, Mexico has experienced fairly contrasting cycles of activity, with phases of dynamic growth interrupted by economic crises and deep recessions (1982-83 debt crisis, 1994-95 peso crisis). All told, real GDP grew by about 2 per cent a year between 1981 and 2000, barely keeping pace with the growth of the population. As a result, the standard of living was flat, whereas it grew by 2 per cent on average in the OECD area (Figure 20).[39] Performance has improved however in the past decade. Thanks to a sustained recovery, annual GDP growth averaged around 3½ per cent between 1994 and 2000, offsetting the impact of the peso crisis and raising the standard of living slightly over the period.[40] Employment grew by an average annual rate of 3 per cent over the same period (for dependent workers according to the national accounts). The deterioration in the current account balance remained limited. Inflation fell to below 5 per cent by the end of 2001. One of the factors that contributed to Mexico's improved performance overall was the deepening of the process of trade liberalisation, with the coming into force of the NAFTA in 1994. The implementation of prudent macroeconomic policies also helped to improve Mexico's performance, while the floating exchange rate regime adopted after the 1994 crisis facilitated adjustment to exogenous shocks. Furthermore, the structural reforms launched on a wide front starting over ten years ago, including an ambitious privatisation programme, at last seem to be starting to bear fruit.

... but labour productivity has risen only slightly

Despite the progress made, the modernisation of the Mexican economy is incomplete. Labour productivity, measured as GDP per person employed, has risen only very slightly since 1990. It is estimated that Mexican labour productivity in 1999 was slightly less than a third of productivity in the United States.[41] In the OECD, only Turkey and the former centrally-planned economies (Hungary, Poland and the Czech Republic) have comparable levels of productivity, while most of the other countries have levels between 70 and 80 per cent that of the United States. The increase in per capita GDP is mainly due to a greater utilisation of labour (measured by an increase in the employment/population ratio). In Mexico, where the working-age population is increasing rapidly, a large (and growing) proportion of the population is employed in agriculture or in the informal sector in urban areas, which are activities with very low productivity levels. If one considers just dependent employment in non-agricultural sectors, productivity gains have been more marked than in the economy as a whole; thus, in manufacturing, the sector most exposed to competition, annual productivity gains averaged 5 per cent during the period 1994-2000 (Figure 21). Despite the steep growth in employment and investment in manufacturing and services, job creation in the formal sector has, all told, been insufficient to provide new entrants with productive jobs and to reduce significantly the size of the informal sector.[42] In addition, some regions seem to have missed out on the development process and, as will be seen below, poverty is still a serious endemic problem.

Figure 20. **Mexico's growth performance in comparison**

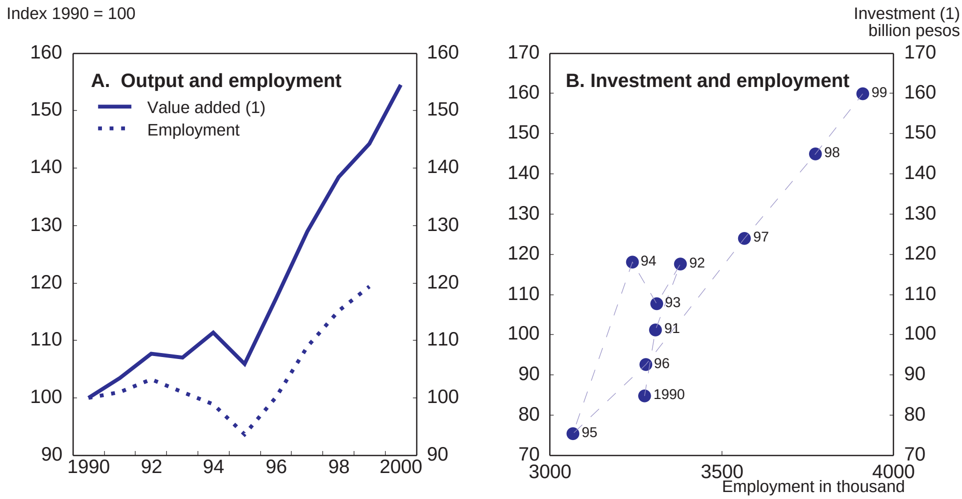
Measured by the real GDP



1. The series for the Czech Republic, Germany (due to unification), Hungary and Poland are incomplete before 1991. These countries are ranked according to alphabetical order.

Source: OECD, *Main Economic Indicators*; OECD, *National Accounts*.

Figure 21. **Manufacturing employment, output and investment**



1. At 1993 constant price levels.
Source: INEGI; OECD, *Quarterly National Accounts*.

The impact of trade liberalisation has varied widely across regions...

The coming into force of the NAFTA in 1994 crowned a process of trade liberalisation begun ten years earlier. A close correlation can be established between export growth and foreign direct investment (FDI) flows.[43] In the northern States, where many of the activities geared to exports are located, including most of the *maquiladoras* (in-bond enterprises), per capita real GDP has grown at an annual rate of about 1 per cent since 1993.[44] In contrast, the southern States, which were already among the poorest, saw their annual per capita GDP fall by 1 per cent on average over the period (Table 12 and Figure 22).[45] For the more industrialised regions in the North and Centre, the geographical advantage of being close to potential markets was compounded by a favourable distribution of public infrastructure expenditure over several decades.[46] In these regions, enterprises had the size and capacity to modernise and innovate required to adapt to the new conditions imposed by trade integration. The South, in contrast, was traditionally specialised in basic agricultural commodities, exports of which grew only slightly.[47] In this region, the manufacturing base traditionally consisted of small enterprises, while the number of industrial clusters and export-oriented large enterprises remained limited. Inadequate transport and communications infrastructure no doubt also contributed to isolate the region, preventing it from sharing in full in

Table 12. **Regional indicators**

	North[1]		South[2]	
	1993[3]	2000[3]	1993[3]	2000[3]
Population (thousands)	9 336	11 402	8 850	10 439
GDP per capita[4]	3 493	3 719	2 534	2 532
Manufacturing				
Employment (thousands)	677	987	65	93
Productivity (North = 100)	100	100	87	70
Private sector				
Insured workers (thousands)[5]	1 678	2 295	276	321
Average wage (North = 100)[6]	100	100	85	77

1. Nuevo Leon, Sonora, Coahuila, Chihuahua.
2. Oaxaca, Guerrero, Chiapas.
3. 1993 or nearest year available: population based on 1990 census. Insured workers for 1994. End period is 2000 except for GDP per capita (1999) and employment in manufacturing (1998).
4. Real GDP per capita, in US$ 2000.
5. Workers registered at social security institute IMSS.
6. Based on wages declared to IMSS per insured workers.

Source: IMSS; INEGI.

the gains resulting from trade opening – inward investment flows and technology transfers *via* joint ventures with foreign enterprises.

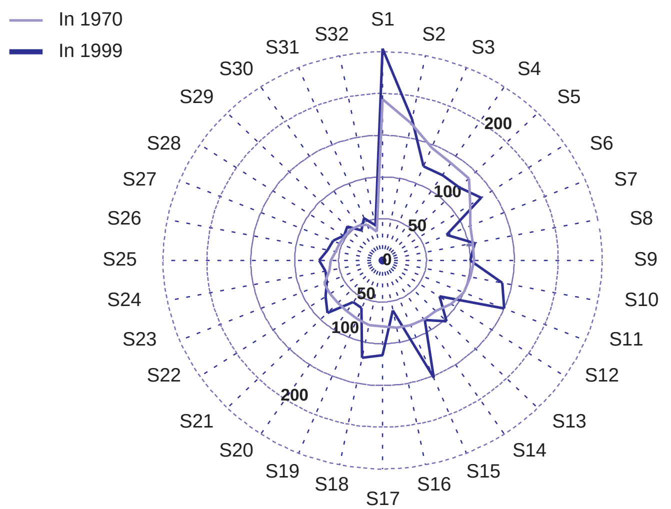
... and poverty is still widespread

A large proportion of the population lives in conditions of absolute poverty. It is estimated that, in 1998, 23 per cent of the population lived on less than 2 dollars a day (*i.e.* less than 4 dollars in PPP terms).[48] By way of comparison, the poverty line in the United States is 24 dollars a day for a single person;[49] in 2000, about 11 per cent of the US population was below the poverty line. In a country like Mexico where poverty is absolute, an economic crisis on a scale as in 1995 results in a fall in the living standards of the population as a whole and a dramatic increase in the number of people living in a state of poverty. There is still both widespread poverty and large income inequalities.[50] Extreme poverty, reflected in nutritional problems and very limited access to health care and education, is an essentially rural phenomenon concentrated in the States in the south, though not only, and affecting mostly indigenous communities. It affects about 10 per cent of the population. In urban areas, poverty is most often associated with precarious activities in the informal sector.

Extreme poverty calls for emergency measures which have a virtually immediate impact: distribution of food, temporary job creation for highly vulnerable groups. More moderate poverty requires long-term measures that go beyond

Figure 22. **Per capita GDP in Mexican States**

Mexico = 100



Key:

S1 : Distrito Federal	S9 : Jalisco	S17 : Aguascalientes	S25 : San Luis Potosí
S2 : Nuevo León	S10 : Chihuahua	S18 : Querétaro	S26 : Hidalgo
S3 : Baja California	S11 : Quintana Roo	S19 : Nayarit	S27 : Michoacán
S4 : Baja California Sur	S12 : Sinaloa	S20 : Tabasco	S28 : Guerrero
S5 : Sonora	S13 : Colima	S21 : Durango	S29 : Zacatecas
S6 : Coahuila	S14 : Morelos	S22 : Yucatán	S30 : Chiapas
S7 : México State	S15 : Campeche	S23 : Guanajuato	S31 : Tlaxcala
S8 : Tamaulipas	S16 : Veracruz	S24 : Puebla	S32 : Oaxaca

Source: INEGI.

income support. A strategy to lift the population out of poverty on a lasting basis aims to encourage the expansion of productive jobs and to improve skills. Effective measures were put in place in the mid-1990s. The new administration has reinforced these measures.[51] Besides targeted measures, recent governments have stressed the importance of a development strategy to increase labour productivity.

In the past, growth strategy was largely based on the use of plentiful low-skilled, low-paid labour resources in the traded goods and services sectors. In the past ten years, this strategy has to a large extent been redrawn. The new administration is pursuing a strategy designed to make the Mexican economy more competitive by promoting the integration of all sectors and regions. The 2000-06 National Development Plan focuses on horizontal measures conducive to private investment and job creation. Several broad thrusts of the Plan are in keeping with the preliminary findings of the OECD's study of the main factors in growth.[52] Among these, increased labour participation in productive activities coupled with an improvement in labour skills; large-scale capital accumulation permitting better diffusion of innovation and technology; a business climate conducive to entrepreneurship; active competition in product markets and improved transport and communications infrastructure, are among the elements that could produce a lasting improvement in the standard of living in Mexico.

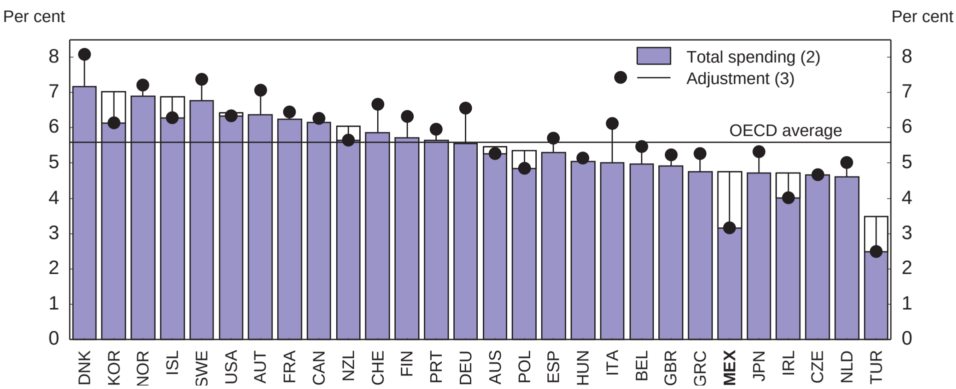
Human capital and labour market policies

Enhance the labour force's skills and qualifications

The level of education of the population as a whole is still extremely low: despite recent improvements, 40 per cent of the 25-64 year-old population did not complete compulsory secondary schooling (junior secondary); 80 per cent did not complete full secondary schooling, compared with the OECD average of less than 50 per cent.[53] Mexico currently devotes about 6 per cent of its GDP to education expenditure, which, adjusted for the country's demographic structure (over half of the population is under 25), remains well below the OECD average (Figure 23). Furthermore, given the rapid growth of the population reaching working age (3 per cent, or one million people per year), a major effort will still be needed to facilitate the transition from school to work – *inter alia*, by offering a range of technical and vocational qualifications for young people leaving secondary school or higher education.

The intensive process of modernising and restructuring the economy, and the labour displacement that accompanies it, make necessary a major effort on the vocational training front. The modernisation of the training system by the introduction of a national system of standards and certification drawn up in collaboration with the business sector is a major step forward. The new system, which is just becoming operational, if it reflects properly the needs of the productive sector, should facilitate labour mobility. Private training initiatives are generally limited to the largest enterprises in the economy's modern sector, while the smallest, which are the most in need of better skills, do not respect statutory training obligations. Two main public training programmes are in operation: one provides financial support for a brief period to workers who have been displaced or lost their jobs; the other is aimed at small enterprises, and provides financial and technical support for short periods to help them improve the skills of their work-

Figure 23. **Expenditure on education**[1]
Per cent of GDP



1. In 1999 or nearest year available. Countries are ranked according to total spending in that year
2. Public and private spending.
3. Adjustment to take into account the difference in the proportion of population aged 5 to 29 of each country relative to the OECD average.

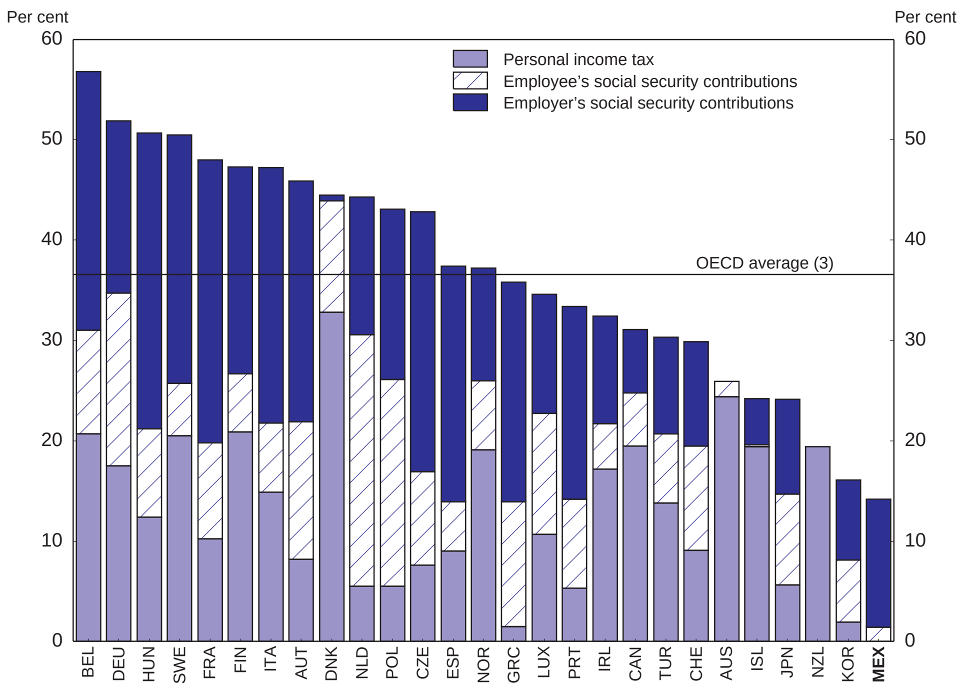
Source: OECD, *Education at a Glance*, 2001.

ers.[54] However, despite steady expansion, the resources devoted to active policy measures remain very small by international standards.

Facilitate job creation in the formal sector

In the past, the labour market has exhibited a large degree of *de facto* flexibility, which facilitated adjustment to adverse shocks: real wages have shown a high degree of flexibility during slowdowns (these episodes usually being accompanied by an unanticipated surge in prices); the minimum wage has fallen considerably relative to the average wage; the tax wedge is not high by international standards (Figure 24).[55] Admittedly, redundancy payments are relatively costly, but in the absence of any unemployment insurance system, to some extent they may be regarded as substitutes for unemployment benefits. All told, open unemployment is very low, while there is still a large informal sector where legislation and regulations are difficult to enforce.[56] Certain policies and institutional provisions may have contributed to this situation by creating impediments to job creation in the formal sector. Taken individually, institutions and legal requirements that may discourage hiring in the formal sector are unlikely to have a strong impact, but together they may be an obstacle to employment opportunities for low-skilled workers, by pricing them out of the formal sector.

Figure 24. **Tax wedge on labour**[1]
Per cent of gross labour costs[2]



1. In 2000. For a single individual at the income level of the average production worker. Data for 2000 are based on estimated wage levels of the average production worker.
2. Gross wage plus employer's contributions.
3. Unweighted average.

Source: OECD, *Taxing wages*, 2001.

In the long term, the best chances of increasing employment and incomes, and by the same token alleviating poverty, lie in enhancing human capital, notably by reducing regional and socio-economic inequalities in access to education and training. At the same time, it is necessary to take steps to make activities in the formal sector more attractive. In several cases, institutional arrangements and labour market regulations should be brought into line with practices. In 1996 the social partners signed an agreement setting out the principles of a "new work culture". This agreement was to pave the way for a rethink of institutional arrangements, while underlining employers' obligations, notably with regard to training. Since then, however, there has been so significant progress on labour market reform. The 1997 OECD *Economic Survey*, which contained an in-depth analysis of the question, put forward a number of specific recommendations which are still relevant. The main ones are reproduced in Box 4, below. Measures that aim at widening the scope for short-term contracts as well as authorising probationary periods for long-term contracts can favour the expansion of the formal economy. Some easing of employment protection regulations should also be considered; however, since there is no unemployment insurance, it would have to go hand in hand with the creation of some form of temporary income support. Options will have to be carefully evaluated to avoid disincentives to work, as other OECD country experience has shown.

Fostering entrepreneurship in the formal sector

The formal sector co-exists with a large informal sector in which firms, especially the small ones, do not comply with most of the regulations. Measures to encourage the shift of activities from the informal sector to the formal sector would enable workers to obtain at least minimum social cover. It is necessary to take a wide range of actions, including the provision of services in the formal sector to make these jobs more attractive (work-related social benefits, adequate social insurance, compliance with the law, etc.). At the same time, checks on the enforcement of tax obligations and social protection should be stepped up.[57] Easing labour market regulations as noted above, revising the tax and transfers regime, and simplifying administrative formalities form part of the range of actions that could be propitious for an expansion of formal activities.

To foster entrepreneurship, the authorities increasingly prefer an indirect approach, focusing on improving the conditions for private investment rather than on direct intervention as in the past. Admittedly, programmes to assist entrepreneurship are no substitute for properly functioning markets, and strengthening competition in product markets forms part of the conditions required by creating opportunities for entrepreneurial activity. These conditions encompass human resource skills, labour market flexibility and the capacity to absorb new technologies; in addition, to encourage activity in the formal sector, the compliance cost of regulations should not be dissuasive, and financing should be facilitated. Most countries have put in place a wide range of initiatives for helping enterprises: some programmes are targeted at specific types of enterprises (*e.g.* small enterprises or high-technology enterprises); others address their specific needs (funding, innovation, information, development of managerial skills). Better communication and the sharing of information between the various levels of government (the regions, States and municipalities) and greater participation by private agents (business or trade union representatives) are among the factors identified by the OECD as being essential for making policies to promote entrepreneurship more effective.[58] Three particularly promising initiatives are discussed below.

Easing the burden of administrative constraints and increasing transparency

There are various public initiatives that can foster entrepreneurship at low cost. For example, the authorities can facilitate the dissemination of information about the formalities for setting up a business or the funding available. The growing use of the Internet by government agencies ensures more effective dissemination of information, and makes public action more integrated and transparent; the web site, SIEM (Mexican Business Information System) is an example, as is the publication of information concerning government contracts on the Internet.[59] The impact in terms of efficiency gains is potentially high. Although Mexico has made significant progress in cutting red tape, business surveys conducted in 1999 showed that red tape was still often perceived by enterprises as an obstacle to their expansion.[60] In this connection, the development of one-stop shops which provide information and sometimes also manage administrative formalities is promising.

Helping small enterprises[61]

The new government attaches particular importance in its strategy to measures in favour of small enterprises. One of the main objectives of the strategy spelled out in the 2001-2006 National Development Plan (NDP) is to improve productivity in that sector of activity so as to provide the poorest members of the population with opportunities for better paid jobs, thereby promoting better balanced social and regional development.[62] As in a number of other OECD countries, SMEs play an important role in net job creation and, by incorporating technological innovation, they can also help to improve the competitiveness of the productive system. Small firms (including those with fewer than 10 employees) are the main employers, particularly in the regions that are less developed, the bulk of these being in the southern part of the country. In 1998, SMEs accounted for over 60 per cent of total employment, with most of them in distribution and services, where informal activities are extensive, and to a lesser degree in manufacturing.

The example of the OECD countries shows that SMEs are generally faced with financing difficulties that can curb their dynamism and prevent the development of start-ups. In Mexico this constraint was already severe for the smallest firms, unable to provide collateral or the financial information required, and it has worsened since the 1994-95 crisis.[63] According to central bank surveys, less than 30 per cent of small firms have access to bank loans (those that are export-oriented being in a more favourable position than the others), while for large firms the figure is over 60 per cent. The micro-credit market has a role to play in a country like Mexico, but is insufficiently developed. The present government has taken measures to strengthen the microfinance sector (known as "social banking") and ensure that institutions operate within a sound regulatory framework and under supervision by the financial authorities (Annex III). There are also programmes providing aid for SME financing, *via* the development banks (NAFIN in particular, and BANCOMEXT for exporters), but the role of these institutions and the criteria they apply need to be clarified. More generally, and as observed in Chapter IV, a healthier and consolidated banking system can also help to improve the conditions governing firms' financing, including SMEs. All in all, SMEs rely mostly on self financing.

There are many federal programmes designed to help SMEs (aid for training and management advice, technological modernisation, advice on quality improvements and technical assistance). More and more frequently, as elsewhere in the OECD, government action consists of being an adviser and facilitator. The dissemination of information is particularly important outside the major urban areas. Measures to improve the competitiveness of SMEs tie in with social and regional development policies, and a great many ministries and government agencies are involved in their implementation. The institutional framework was altered a few years ago and new structures were set up in order to better co-ordinate the action taken by the main entities concerned. There are also a number of consultative mechanisms for programme monitoring, but in the main there is no systematic evaluation of results. Some countries have set up independent central agencies for co-ordinating and assessing initiatives, examples being the Small Business Administration in the United States and the more recent A*gence pour les* PME in France. In Mexico, however, even if the first steps towards global evaluation have been put in place, information concerning the results of the programmes under way is altogether insufficient. The National Development Plan stresses the importance of structural and organisational reforms in order better to monitor and verify results. It is planned to set up a "national system of indicators" for this purpose.

Enterprise networks and regional development

The traditional forms of regional development policy, subsidising enterprise creation in depressed areas, have been abandoned in most OECD countries in favour of an indirect approach. Increasingly, the authorities are looking to encourage enterprise creation at local level by ensuring that the basic infrastructure and transport and communications are adequate, and by helping with human resource upskilling. In particular, they are promoting the establishment of clusters of industries. It has been observed in a number of countries that the success of enterprise groupings depends on a complex set of factors.[64] In the majority of cases, industrial clusters have developed without any specific measures being taken beforehand, and it is not advisable for a government to try to form industrial clusters out of nothing. The authorities have mainly to act as a catalyst; their role is to ease the obstacles to the formation of networks, to disseminate information and to encourage interaction between firms. Amongst the countries that have used such an approach are the United States, Spain, Italy, Austria and New Zealand. Other countries have looked more to encourage links between local companies and foreign investors, examples being some of the states of Mexico, and also Ireland, Scotland, Wales and Malaysia. In every case, the regions in which industrial clusters prospered already had a solid economic base and adequate institutional capacity.

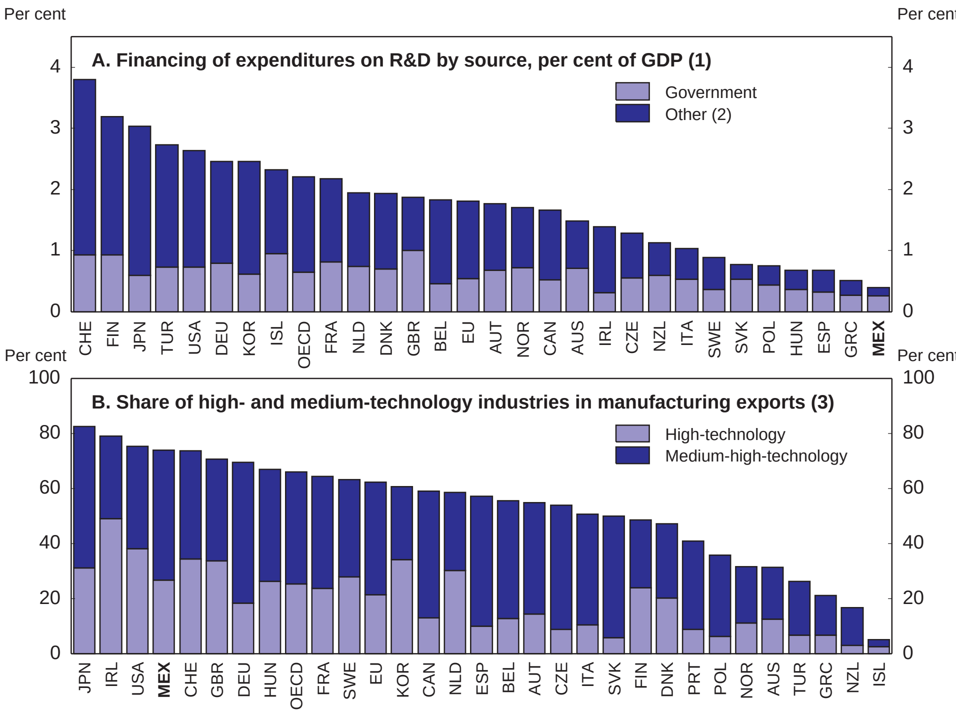
The strategy of the new government gives special consideration to regional development, which has to be solidly based on greater SME dynamism. Co-ordinated schemes are planned to strengthen the comparative advantages enjoyed by the southern states, and thereby further the expansion of SMEs in the region and hence the creation of productive employment for disadvantaged families. The new administration has launched a permanent process of regional planning. It is based on a new system of intergovernmental relations designed to co-ordinate the different planning mechanisms that already existed at the various levels of government (federal, states and municipalities), but that had not previously been formally linked with one another. There are obvious advantages in actions being better co-ordinated to ensure a global vision over the longer term, that encompasses both national and local priorities, but also to avoid overlaps, draw synergies at the local level and monitor results.

Encouraging a knowledge-based economy

By international standards, Mexico's technological infrastructure lags a long way behind, as attested by the small volume of R&D expenditure as a percentage of GDP (Figure 25). As in the less advanced OECD countries, R&D activities are concentrated in higher education institutions and the public sector, the business sector spending little on R&D. However, Mexico's trade specialisation in medium and high-technology manufactures is relatively advanced (Table 13). The diversification of its export base partly reflects the growing importance of the subsidiaries of foreign firms, which has encouraged the diffusion of innovation. In addition, large enterprises have had to modernise their production processes and technology in response to growing competitive pressures. The situation is very different in SMEs, most of which have limited access to information on technologies and markets. To encourage small firms to modernise their technology and in the process enhance their management skills and production practices, since 1995 the authorities have been providing information and support for upgrading technology, in particular via greater use of information and communications technologies (ICT).[65]

The priority objective is to enhance the awareness of industrial firms, irrespective of size, of the benefits of ICT and to develop their capacity to continually update their technological base. Studies done for several countries show that the

Figure 25. **Science and technology indicators**
Per cent



1. 2000 or latest year available.
2. Business enterprise, other national sources and abroad.
3. 1999.

Source: OECD, *Science, Technology and Industry Scoreboard*, 2001.

development of industrial clusters (regional or sectoral) can facilitate technology transfers from large enterprises to the networks of SMEs that are their suppliers. Accordingly, programmes have been launched to provide specific technological support with the integration of ever-more complex production networks. Other policies can promote technological modernisation: the growing application of quality standards in small enterprises; the diffusion of technology benchmarks; the creation of conditions conducive to technology transfers from abroad. In Mexico, there are several schemes designed to give SMEs more access to the financial resources needed for technological modernisation. As in most other OECD countries, tax incentives are provided; NAFIN, the development bank,

Table 13. **Change in the trade specialisation of Mexico**

SITC – 3 code	Main comparative advantages	RCA[1] 2000	Share of exports[2] 2000	RCA[1] 1990	Share of exports[2] 1990
33	Petroleum, petroleum products and related materials	8.91	9.04	33.01	35.87
78	Road vehicles	7.03	16.97	8.58	11.51
76	Telecommunication and sound recording apparatus	5.72	11.65	–4.50	0.19
75	Office machines and automatic data processing machines	3.81	7.12	–0.42	2.09
84	Articles of apparel and clothing accessories	3.12	5.23	–0.88	0.33
05	Vegetables and fruits	1.44	1.97	4.11	5.44
82	Furniture and parts thereof	1.38	2.01	–0.27	0.17
11	Beverages	0.81	0.92	0.64	1.01
81	Prefabricated buildings, sanitary, heating and lighting	0.42	0.59	0.04	0.18
03	Fish, crustaceans, molluscs and preparations thereof	0.36	0.42	1.13	1.26
07	Coffee, tea, cocoa, spices and manuf thereof	0.35	0.49	1.23	1.50
66	Non metallic mineral manufactures, n.e.s.	0.14	1.11	0.71	1.66
85	Footwear	0.13	0.24	0.00	0.31
00	Live animals other than animals of division 03	0.11	0.25	0.97	1.30
79	Other transport equipment	0.11	0.55	–1.21	0.64
06	Sugar, sugar preparations and honey	0.10	0.20	–1.68	0.23
83	Travel goods, handbags, etc.	0.05	0.14	–0.04	0.06
55	Essential oils for perfume and cleaning preparations	0.05	0.48	–0.26	0.22

1. RCA: Revealed comparative advantage indicator (Xi/X – Mi/M)*100.
2. As a percentage of total exports in 1990 and 2000 respectively.

n.e.s. = not elsewhere specified.

Source: OECD.

which works primarily with SMEs, also provides aids; consultancy services have been set up (at federal level and in some States). All in all, policies in Mexico should emphasise the diffusion (and importation) of existing technologies rather than the creation of new technology.

Developing infrastructure and stepping up competition

Transport and communications infrastructure and the energy sector suffered for a long time from insufficient investment, the result being inadequate capacity, lack of maintenance and costly inefficiencies.[66] During the first round of structural reforms, which ended some ten years ago, the strategy consisted of reducing the role of government in the production of goods and services by means of an ambitious privatisation programme. Private investment was supposed to take over from public investment in a number of areas. More recently, the reform process has been taken further with the partial liberalisation of certain public services and the development of the regulatory framework needed to strengthen competition in those sectors where there are monopolies. The efforts to enhance competition on product markets constitute one of the prime courses of action aimed at creating conditions conducive to strong and sustainable growth. By aligning prices more closely on marginal costs, competitive markets result in a larger volume of output and one that better satisfies consumer tastes. There exists a large body of research showing that competitive markets also generally lead to faster growth of output through their impact on incentives to innovate, to manage and to encourage optimum resource allocation (Ahn, 2002). The degree of competition in the Mexican economy was reviewed in the OECD's *Regulatory Reform in Mexico* (1999) which concluded that, despite the numerous reforms carried out, "sustained attention is needed now to complete and implement reforms to establish conditions for vigorous market competition and entry".

The main recent stages in the process of liberalising public services and network industries are shown in Table 14. Indicators of the system of ownership in services show that in Mexico the share of public capital is now very small. However, reforms which involve revising the Constitution have for the most part met with opposition in Parliament. Furthermore, since the 1994-95 crisis, companies which had been privatised (airlines) or which were operating with concessions (toll roads) have been re-nationalised. In the energy sector, the public sector share remains predominant. Private capital predominates in other sectors: railways and telecommunications in particular, but even in these sectors competition is still sometimes insufficiently developed.

Relative success in opening up the telecommunications sector

Mexico's telecommunications sector has been liberalised and a great many new operators have penetrated the local and long-distance telephony market. However, Telmex, privatised nearly ten years ago, retained its dominant position, as in several other OECD countries. In practice, Telmex is the owner of all fixed-line connections and of all long-distance lines outside the biggest towns; it has two-thirds of the market for mobile telephony. New entrants on the local telephony market have been slow to expand their market share. The fixed-line network is not sufficiently extensive and charges are relatively high. The recent agreement that Telmex and the new operators reached foresees a decline in interconnection tariffs for the year 2002. However, there is room for tariffs to come down further and this would enhance competition. The regulatory framework was put in place in 1996: COFETEL, which comes under the aegis of the Transport and Communications Ministry, is responsible for regulation while, as in the other sectors, it is the Federal Competition Commission that is responsible for determining whether a company has a dominant position. In practice, COFETEL has a lot of difficulty regulating Telmex and there has been much controversy and legal proceedings. COFETEL does not have the desired degree of independence and its procedures are not very transparent; nor does it have the authority to obtain from firms it regulates all the information it needs.

Table 14. **Recent steps in the liberalisation of public services**[1]

	Petrochemicals and natural gas	Electricity	Seaports, highways, railroads	Air transportation	Telecommunications
1995	Sale of PEMEX petrochemicals division announced. Plans scaled back due to political opposition	Establishment of an independent regulatory agency	Bail-out of toll road operators. Re-nationalisation of highways	Re-nationalisation of AeroMexico, Mexicana and two smaller airlines, consolidated under a single holding company (CINTRA). New Civil Aviation Law liberalising rate-setting	Federal Telecommunications Law establishes new regulatory regime
1996			Restructuring of railroads, splitting the national railway in five regional companies		Establishment of the regulatory agency (COFETEL)
1997	Regulatory and legal framework for the private distribution of natural gas. Sale of concessions (1997-99)		Privatisation of railroad starts (1997-99)		Expiry of Telmex fixed-line monopoly. Privatisation of satellite-fixed services
1998			Privatisation of most ports (1998-99)		Auctioning of bands for local services
1999	Auction of petrochemical plants attracts no bidders	Liberalisation proposals stall, due to political opposition		Sale of concessions for the operation of airports (1998-2000)	Entry of new operators on local services
2000				Regulation on air transportation revised to facilitate action against anti-competitive practices	
2001					

1. Prior to 1995, the public telecommunication monopoly, Telmex, was privatised, as well as AeroMexico and Mexicana (1989-91). Toll roads were built by the private sector (1989-95). Reforms of the Electricity law opened up generators to private initiatives (1992-94).

Source: OECD.

The Competition Commission found in 1997 that Telmex enjoyed a dominant position on five markets, enabling COFETEL to intervene by drawing up specific rules for Telmex. Following a series of legal battles initiated by Telmex, it was not until September 2000 that the specific obligations concerning interconnection tariffs, quality of service and the requirement to provide consumers with more transparent information were published in the official journal. Telmex is fighting the decision and has again engaged in a legal battle, which jeopardises the application of specified obligations. In the meantime, In early 2001, an agreement was signed between Telmex and two private telephone operators, aimed at resolving a number of differences between them. This should have the effect of increasing and improving services on the local telephony market in which the two operators do business. To achieve the objectives of universal service and a greater degree of penetration, it would be wise to set up a universal service fund that could subsidise network expansion with all operators being required to contribute to the fund. No progress has been made in this direction; before introducing a mechanism of this type, it is intended to modify the Federal Law on telecommunications and a proposal should be submitted to Congress early in 2002.

Insufficient progress in the energy sector

The energy sector remains one of the most highly regulated in Mexico. The state-owned company PEMEX has a monopoly for the generation, distribution and import of petroleum products. The "secondary" petrochemicals division was meant to be partially privatised, with minority participation in existing plants and the authorisation for private and foreign investment in new capacity. In practice, however, since liberalisation was only partial and concerned downstream petrochemical activities, private investors showed no interest. In the short term, to bolster the activities of existing capacity, the new administration has entered into negotiations at the local level with the object of establishing "strategic alliances", without going any further with the sale of assets.[67] The question of when and how the petrochemical sector will be restructured to be subsequently privatised remains open.

Reform in the electricity sector should not be delayed. According to official estimates, demand for electric power is expected to increase by 6 per cent per year over the period 2001-2006. To guarantee supplies, generating capacity will need to be increased by over 30 per cent and transmission and distribution systems modernised, failing which bottlenecks will soon appear. In the present context of severe budgetary constraints, the need for substantial investment can only be met through greater private sector participation. Investment by private enterprises over the past few years, prompted by the public sector (PIDIREGAS), will not remedy the situation for any length of time since it is creating future liabilities for the state. The two state-owned enterprises, the *Comision Federal de Electricidad* (CFE) and *Luz y Fuerza del Centro* (LFC) for the Mexico City area, share the market for transmission and distribution. Since generation was opened up to private investors, a few power stations have been built – mostly for self-consumption by the industries that set them up. However, independent generation still accounts for only a negligible share of the total (3.3 per cent). Legally, the CFE and the LFC are the only purchasers of privately generated electricity and there is no real market on which to sell any surpluses. The experience of the other OECD countries shows that reforms in this sector are difficult.[68] So when privatising natural monopolies, technically complex regulatory problems have to be addressed in order to prevent that dominant position hamper competition.

For liberalisation to have its maximum beneficial impact, privatisation should be preceded by competition enhancing restructuring and adoption of a clear regulatory regime, including the strengthening of the regulatory body. In undertaking the restructuring, policy makers should give careful consideration to adopting each of the following competition facilitating measures: separate the potentially competitive (*e.g.* generating and electricity supply, for instance, metering and billing.) and natural monopoly segments (*e.g.* long distance transmission and local distribution) of the industry; separate the potentially competitive segment into a number of competing companies each under separate ownership; and put the local distribution networks under separate ownership, giving the regulator the power to insist that each adopt standardised accounting so as to facilitate comparing costs and tariffs (*i.e.* to facilitate "yardstick" regulation).

The proposal to reform the electricity sector in depth, submitted to Congress by the previous government in 1999, was not approved. The present administration is considering tabling a new proposal which is not aimed at privatising assets and does not therefore involve amending the Constitution.[69] In the absence of legal reform, the restructuring of the CFE has started. The company has been split into several specialised units which are not independent: seven generating companies; a network management unit; a transmission company; thirteen regional distribution companies. The restructuring process is looked upon as a stage in preparing the company to cope with competition once the legal framework has been changed to allow full participation by private investors.

To sum up, Mexico is in an intermediate position amongst OECD countries as regards the size and relative scope of the public sector. Following rapid initial progress towards liberalising network industries, the process has suffered delays and reforms have sometimes even gone backwards. On some markets, such as local telecommunications services, progress in stepping up competition has been slow. In the electricity sector, the basic essentials have still to be addressed. Box 4 below summarises the OECD's recommendations in the area of structural reform, including in areas dealt with in detail in earlier Surveys. Tax reform is discussed in the previous chapter, while the recommendations specific to the financial sector are set out in Box 10 in the next chapter.

Box 4. A review of progress in structural reform

Proposal[1]	Recent action taken	OECD assessment/ recommendations
Enhance human capital		
– Raise educational attainment of population	Increased funding to extend capacity; modernisation of school curricula	Continue to increase capacity and upgrade teachers skills
– Facilitate the transition from school to work	Business sector more closely involved in design of vocational training and technical education	Further strengthen vocational technical education
– Improve job training	System of skill standardisation and certification developed	Continue these efforts, monitor and assess results
Increase the flexibility of employment regulations		
– 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.
– Broaden scope for using short-term contracts	No action	
– Allow probationary periods so as to facilitate job creation through long-term contracts	No action	
Addressing social safety net needs		
– Continue the integral programme, PROGRESA, for the poorest	Extension of PROGRESA, including in urban areas, after adjustments to maintain work incentives	Continue implementation
– Continue efforts to provide basic health care to all	Extension of the basic health package	Continue implementation
– Advance in the reform of public sector retirement funds	No action	Make progress
Making product markets more competitive		
– *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

Box 4. A review of progress in structural reform (*cont.*)

Proposal[1]	Recent action taken	OECD assessment/ recommendations
– *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
– *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
– *Telecommunications*: impose additional regulations on the incumbent (Telmex).	Obligations on incumbent regarding fees service quality and information have been published. Agreement reached between Telmex and two private operators on contentious issues between them	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
Use market-based mechanism to ensure universal service	No action	Proceed with reform

Note: The government's tax reform and its assessment are included in the previous chapter (see Box 3 in particular), while recommendations for further reform in the financial sector are shown in Box 10 of Chapter IV.

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

IV. Challenges in the financial sector

The Mexican financial sector has been confronted with a series of challenges in the past decade. In the first half of the 1990s, liberalisation was followed by a boom and bust cycle culminating with the banking crisis of 1994/95 and necessitating a major government rescue operation – estimated to have cost about 20 per cent of GDP. A systemic crisis was avoided and measures were taken to prevent the balance sheet problem of banks becoming an obstacle to near term recovery prospects. However, political uncertainties and other shortcomings slowed the adjustment of the banking system until the late 1990s, when the approval of reforms improved the regulatory framework and created a stronger basis for a sustainable recovery. Since 1998/99, further financial sector reforms have been implemented and the performance of the Mexican financial system has markedly improved, as shown by indicators of the solidity and profitability of the banking sector. This has also been helped by a large infusion of foreign capital, as international banks entered the Mexican market through mergers and/or acquisitions.

Nevertheless, several challenges remain. The banking sector is still relatively inefficient and the level of non-performing loans, though fully provisioned, remains quite high by international standards. The state-owned financial intermediaries, either in the form of development banks or trust funds, still play a large role, overlapping with commercial banks in some parts of the market. The regulatory framework is often complex and characterised by a high cost of compliance. All these factors imply that the financial system is not fully playing its role in stimulating growth through better allocation of capital (Leahy *et al.*, 2000). Indeed, commercial bank lending to the private sector has been slow to recover, and at about 18 per cent of GDP in 2000, it remained among the lowest in the OECD.

The chapter starts with a description of the aftermath of the peso crisis in the second half of the 1990s, before discussing recent reform initiatives in the second section. The third section presents a series of indicators of performance, showing that the Mexican financial system has finally recovered from the peso crisis. The chapter concludes with a discussion of the challenges ahead, arguing for further measures to create the conditions for an increase in commercial bank lending to the private sector within a sound and competitive system.

The aftermath of the peso crisis

The Mexican financial system was shaped until the mid-1990s by an ambitious liberalisation programme that lifted restrictions on the operation of financial markets, eliminating some distortions on the allocation of credit.[70] State-led consolidation resulted in a banking system composed of medium-sized institutions, several of which with nation-wide operations.[71] Liberalisation also had the desired effect of increasing competition and boosting financial depth indicators, including through a sharp increase in bank lending.

The success was short-lived, however. Financial sector liberalisation was followed by a boom-bust cycle characterised by a deterioration of credit quality and bank failures. This mirrors the experience of several other OECD countries, where inappropriate post-liberalisation policies led to banking crises.[72] In Mexico, this was caused by a combination of two factors. First, the explosive expansion of credit, which was associated with a sharp drop in saving ratios, was not counteracted by authorities. Second, supervision authorities were unable to prevent excessive risk-taking by banks. This second factor was of particular importance in Mexico, because ineffective prudential oversight and the poor regulatory/supervision framework were compounded by inadequate accounting standards and a lack of transparency, hiding the true financial situation of banks, as well as problems at the level of bank management. Indeed, the sharp expansion of lending was undertaken with inappropriate levels of human expertise to evaluate risk and allocate credit, while problems also existed in managing credit collection and raising guarantees. The exclusion of foreign participants at the time of privatisation, by preventing the transfer of management expertise, was unfortunate in this regard.

As a result of these policy failures, the banking system became increasingly fragile, with a growing share of past-due loans putting pressure on profitability. These problems came to a head in the 1994-95 peso crisis, which hit the banking sector through four main channels: currency depreciation, a liquidity crunch in foreign currency, a sharp contraction in economic activity resulting from policy tightening, and a large jump in interest rates. These factors increased the cost of funds available to banks, increased banks' liabilities (banks had borrowed heavily in foreign currency), and reduced borrowers' capacity to repay loans. Meanwhile, weak bankruptcy laws made collection of bad loans more difficult. By 1995, the banking system was on the brink of collapse.

The imminence of a systemic crisis led the then incoming administration to launch a series of programmes to support the banking system. The financial authorities' response avoided a crisis of larger proportions. Several debtor support programmes were designed, mainly involving incentives for debt restructuring; loan maturities were lengthened and the real interest rate was fixed through an indexation mechanism based on CPI inflation. Also, several banks were taken over by the government and then either liquidated or sold. Finally, capitalisation programmes injected capital into the banking system either in the form of temporary loans or through the purchase of banks' loan portfolio.[73] These different programmes succeeded in rescuing the banking sector, but at a significant cost to the public treasury. It is estimated that in the 1995-97 period alone, the various programmes involved nearly twice the banking system's pre-crisis equity and a quarter of its outstanding loans. The latest official estimate, published in June 1999, puts the net fiscal cost of these various support programmes at almost 20 per cent of GDP, half of which deriving from the take-over of banks.[74]

Even though a systemic crisis was avoided, several factors delayed the adjustment of the financial sector until late in the 1990s. An important impediment was the remaining restrictions on foreign investment. With the entry into force of NAFTA in 1994, financial institutions established in Canada and the US were granted national treatment. This also applied to the NAFTA subsidiaries of non-NAFTA parent companies; hence, European and Japanese financial institutions for instance, could enter the Mexican market through their North American subsidiaries. However, strict limits on market share were maintained, both by institution and for foreign investment in aggregate. Substantial easing took place in February 1995, in the aftermath of the peso crisis and in view of the pressing re-capitalisation needs of the banking system. But in practice, some restrictions remained until January 1999.[75] Most important of those was the prohibition of controlling foreign stakes in banks whose capital exceeded 6 per cent of the total net capital of the banking system, which applied in practice to the three largest Mexican banks.

Political uncertainties concerning the support package also played a role in preventing the banking system from recovering faster. Bank intervention and re-capitalisation programmes involved the issuance of 10-year floating rate government notes. But interest on these notes was capitalised and Congress questioned future budgetary allocations for their payment. As a result, no secondary market for these notes existed.

These uncertainties and restrictions weighed heavily on the financial system until 1999. First, liabilities arising from the rescue package continued to grow, peaking at 20 per cent of commercial banks' total assets. Rescue-related government bonds were not traded, hindering liquidity management by banks. Second, asset recovery was hampered by legal challenges, increasing the cost of the package. Third, consolidation and re-capitalisation were slowed by restrictions on foreign ownership.[76] Finally, past-due loans remained large, even as several debtor support programmes were launched in succession, with a total cost equivalent to 3.3 per cent of GDP. As a result of these problems, banks remained fragile for several years, with the third largest bank put under state administration as late as mid-1999.

The financial system today

Recent reform initiatives improving the framework

In 1998/99, a far-reaching package of financial reforms was approved (Box 5).[77] The package included the elimination of the blanket coverage on bank deposits and its replacement by a limited deposit guarantee scheme, whose cap started to be reduced. A new institute was created to manage the deposit insurance scheme, as well as the support programmes, including the sale of assets inherited from the rescue package. The reform package also clarified the legal status of the liabilities arising from the rescue package, which received full government backing and started to be replaced by tradable securities. Finally, remaining barriers to foreign ownership in the financial sector were eased, to the effect that foreign investors gained the right to acquire equity holdings in the three largest commercial banks.

These measures were followed by the approval of new bankruptcy and secured lending legislation in April 2000. Previously, ineffective legislation had encouraged a culture of non-payment and had been one of the main obstacles for the resumption of lending to the private sector, especially SMEs and households. The new "foreclosure and guarantees law" clarified the legal procedures for the recovery of bad loans and provided lenders with tighter loan guarantees. The new law was complemented by a "last chance" programme for debtors to regularise their loan payments. Through the "Punto Final" programme, available to the agricultural and fisheries sectors, small and medium enterprises and housing mortgage holders, 1.1 million debtors have restructured their loans, with over 800 000 pre-paying their outstanding debt.[78]

Another important recent measure was the gradual strengthening of the supervision and regulatory framework. Accounting standards have been updated and disclosure rules broadened, bringing Mexican rules closer to international norms. For instance, the whole amount of past-due loans are now recorded as such – previously only the unpaid portion of the loan had to be declared as non-performing. New capital adequacy requirements also started to be phased in, leading to a gradual upgrade in the required capitalisation of credit institutions including stricter rules concerning the treatment of deferred taxes. Full implementation is pencilled in for 2003. At present, the majority of banks already comply with the new requirements. Finally, new portfolio rating and provisioning requirements have been introduced.

Complementary measures were introduced in 2001, as part of an effort to modernise certain practices in the financial system.[79] This included an upgrade of the corporate governance regime applying to the sector, with the goal of making practices more transparent. In that context, progress has been achieved in tightening codes of conduct and improving the protection of minority shareholders.[80] The

Box 5. The Institute for the Protection of Bank Savings (IPAB)

The Institute for the Protection of Bank Savings (*Instituto para la Protección al Ahorro Bancário*, IPAB) became operational in May 1999. Its original role was to manage the deposit insurance scheme, but its mandate was broadened to include the administration of the various financial support programmes and the assets and liabilities deriving from them. This involves servicing these liabilities and implementing programmes to maximise the recovery value of assets, by their disposal and/or by the collection of overdue loans. IPAB is also in charge of resolving bank failures.

Until the creation of IPAB, direct asset sales had been slow and interest on rescue-related debt was often capitalised.[1] Since mid-1999, IPAB has succeeded in selling the collection rights to several loan packages through public bidding processes, and asset sales have been speeded-up, including through the re-privatisation of several banks that had been under intervention. IPAB has also started to refinance rescue-related liabilities, mostly through the issuance of 3 and 5-year tradable bonds indexed to the 28-day Cetes.[2] Refinancing has also been achieved by borrowing from financial institutions, restructuring the liabilities of re-privatised banks, and re-financing higher-yielding obligations. This strategy has been successful, to the extent that IPAB debt has fallen from 13.7 per cent of GDP in mid-1999 to an estimated 12.6 per cent of GDP at the end of 2001. At the same time, its maturity profile has improved considerably, with expected outflows in the peak years of 2005/06 falling by a third.

Although much progress has been made and IPAB has been fulfilling its role remarkably well, some challenges remain. In 2001, direct budget transfers are expected to provide only 19 per cent of IPAB's funding, compared with 62 per cent from bond issuance, 15 per cent from asset sales and 4 per cent from deposit-insurance fees. But proceeds from asset sales are likely to decline gradually and deposit-insurance fees are already among the highest in the OECD. Moreover, the pace of new bond issuance is in large part determined by market conditions and cannot be easily speeded-up. This is especially the case if IPAB issuance is seen in the aggregate context of the amount of domestic debt issued by the public sector, including the Treasury and the Central Bank. These factors imply that direct budget transfers will need to be stepped-up significantly in the next few years, even if IPAB is to follow the minimalist strategy of keeping its debt constant in real terms.

1. Until the creation of IPAB, direct asset sales had been slow, in part because transactions focused on selling banks as a whole. Also, until 1997/98, several legal obstacles, including tax-related issues, hampered asset sales.
2. The 3-year *Bonos de la Protección al Ahorro* (BPA) started to be auctioned in March 2000 and their 5-year equivalent in August. In mid-2001, these bonds were trading at around 60 basis points above Cetes, down from 150 basis points at the peak.

role of the National Banking and Security Commission (*Comisión Nacional Bancária y de Valores*, CNBV) was also reinforced, both in terms of its powers to prosecute the abuse of privileged information and market manipulation, and in relation to prudential regulation practices, including controls on related credits and internal controls. Finally, regulations concerning investment and mutual funds have been modernised, to allow managers greater flexibility and to widen the asset classes in which they may invest.

Size and structure of the banking system

Private banks

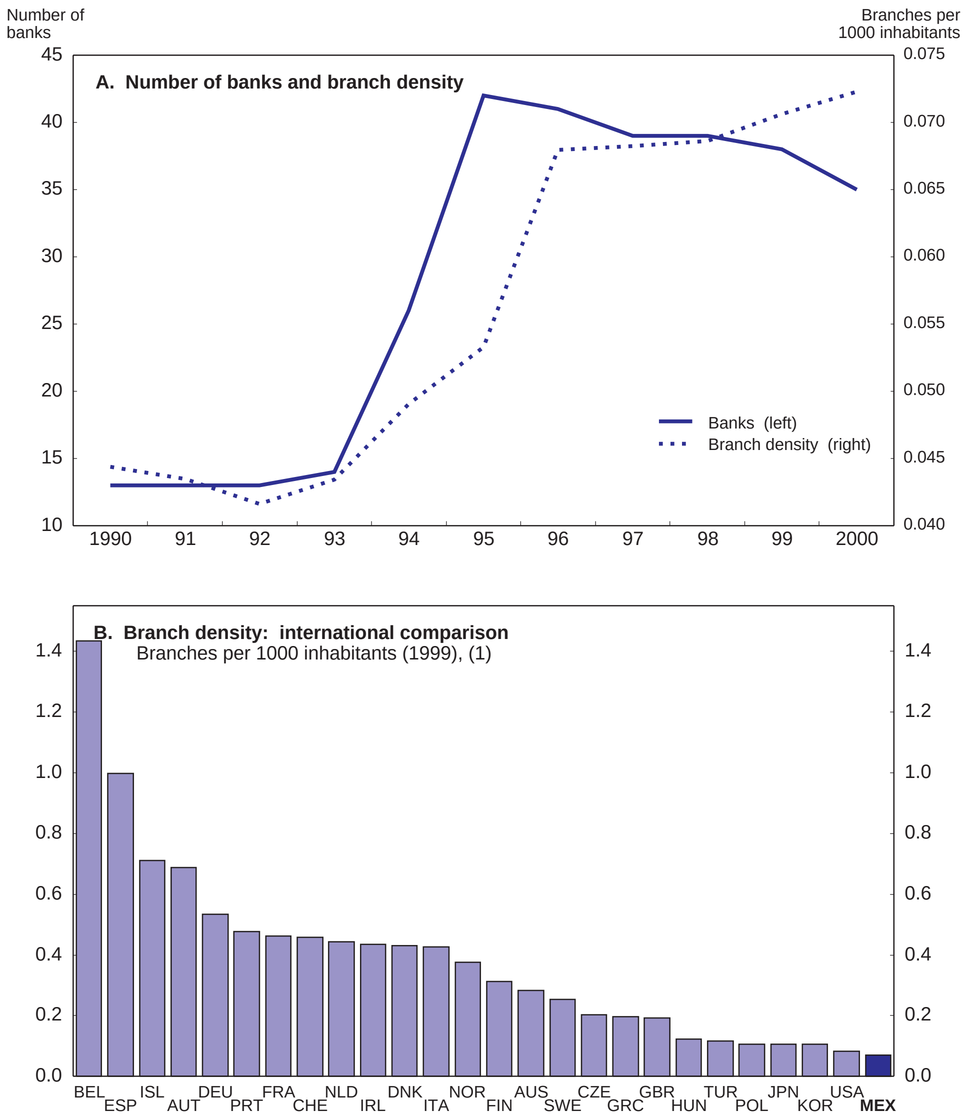
By removing constraints on the supply of financial services, deregulation led to a temporary jump in the size of the banking system in most OECD countries. Often, an initial increase in the number of banks was followed by a process of consolidation, as less competitive institutions were driven out of the market. This process has also been evident in Mexico: at the onset of the privatisation process in the late 1980s, there were 18 private commercial banks operating in the country.[81] In 1995, this number peaked at 42. After that, the trend was reversed, with the peso crisis being one of the factors that triggered a process of consolidation (Figure 26).[82] The role of foreign investment in this consolidation has also been significant. Contributing to this has been the gradual liberalisation of rules governing FDI in the sector, following the entry into force of NAFTA. Consolidation was particularly swift after 1998, when foreign stakes in the three largest banks were allowed. In the 1980s, only one foreign institution had (relatively minor) banking operations in Mexico. As restrictions were partly eased, the share of commercial banks with a significant (20 per cent or above) foreign stake increased to about a quarter of banking assets in 1998. With full liberalisation, this jumped again to more than three quarters in 2001 (Figure 27). By mid-2001, the three largest commercial banks, representing about half of total assets in the system, were under the control of foreign shareholders.[83]

The level of financial intermediation is often positively correlated with economic growth, but can also be influenced by structural reforms. Indeed, the importance of financial intermediation increased significantly in most OECD countries following liberalisation. In Mexico, domestic credit to the private sector grew sharply as a percentage of GDP between 1989 and 1994, but it has since declined steadily, even after the approval of reforms in 1998/99. Despite a brief recovery, in mid 2001, domestic credit had fallen to below 20 per cent of GDP and other indicators of financial deepening, such as the ratio of banking assets and monetary aggregates to GDP, were among the lowest in the OECD (Figure 28).

Development banks

As with commercial banks, dis-intermediation has also been evident in the development bank sub-sector, which has traditionally played a significant role in Mexico's financial system (Box 6). The sub-sector was badly hit by the peso

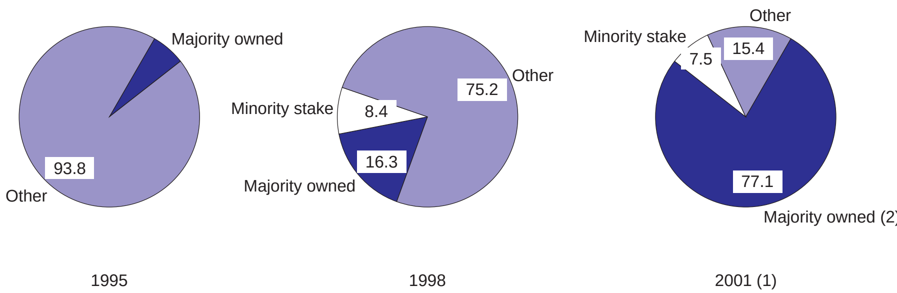
Figure 26. **The size of the banking system**



1. 1998 for Austria, Finland, Greece, Ireland and the Netherlands. All banks except for the following: commercial banks for Greece, Hungary, Japan, Mexico, Portugal, Turkey and United Kingdom; commercial banks and foreign commercial banks for Korea; commercial banks and savings banks for Iceland and the United States; commercial banks, foreign commercial banks and savings banks for Sweden.

Source: OECD, *Bank Profitability – Financial Statements of Banks* (2001); National Banking and Security Commission (CNBV).

Figure 27. **Market share of foreign-controlled banks**
Per cent of total assets

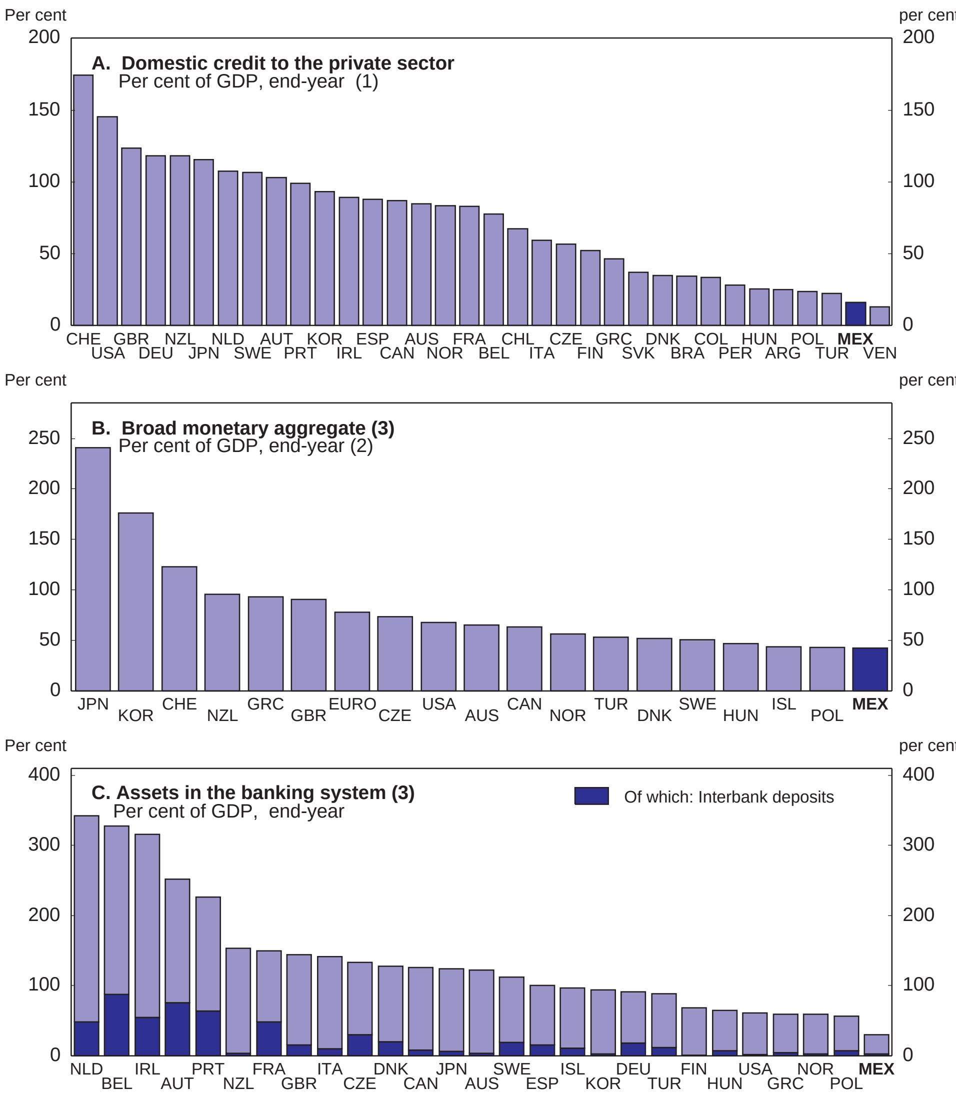


1. September 2001.
2. Includes Bancomer, which is controlled by BBVA (holding 48.5% of total capital).
Source: CNBV.

crisis and was re-capitalised through the transferring of bad loans to a specialised trust fund, FIDELIQ.[84] Since then, development banks have curtailed lending even more sharply than commercial banks, with the sub-sector experiencing a net dis-intermediation every year since 1995.[85] By early 2001, development banks accounted for only a third of total assets in the banking system and less than 10 per cent of total direct lending to the non-bank private sector. In spite of repeated re-capitalisation exercises, some development banks are still loss-making. The fact that such losses are not just a transitory phenomenon, but continue throughout the business cycle, points to a subsidy element in the operation of these institutions. This may have created distortions and hampered the development of the private credit market. Indeed, the one important challenge facing state-owned financial institutions derives from the overlapping among some public sector institutions, as well as between state-owned and private sector intermediaries. For instance, several trust funds target the agricultural sector (Fira, composed of four different funds), but so does the national bank for the agricultural sector (Banrural). Also, the national bank for foreign trade (Bancomext) finances some construction and tourism infrastructure, in spite of the existence of a national bank that supports capital investment (Nafin) and of a trust fund for the promotion of tourism (Fonatur). The problem is exacerbated by the

Figure 28. **Indicators of financial intermediation**

1999



1. Refers to financial resources provided to the private sector that establish a claim for repayment.
2. Defined as M4 (or related aggregates) for Belgium, Brazil, Greece, Japan, Mexico and United Kingdom; M2 for Poland, Czech Republic, Norway and Denmark; M3 (or related aggregates) for other countries.
3. Commercial banks. Latest year available: 1998 for Australia, Austria, Finland, Ireland and the Netherlands.

Source: OECD, *Bank Profitability – Financial Statements of Banks* (2001); World Bank, *World Development Indicators 2001*.

Box 6. **Mexican development banks**

In mid-2001 there were five development banks in Mexico: Nafin (*Nacional Financiera*), which is in charge of supporting capital investment and providing development finance; Bancomext (*Banco Nacional de Comércio Exterior*), providing credit and guarantees for foreign trade operations and export-oriented projects; Banobras (*Banco Nacional de Obras y Servicios Públicos*), responsible for financing the development of public works, including infrastructure and urban equipment; Banrural (*Banco Nacional de Crédito Rural*), in charge of financing rural projects; and Banjército (*Banco Nacional del Ejército, Fuerza Aérea y Armada*), which provides financial support for the members of the armed forces. Nafin is by far the largest of the five development banks in terms of assets, accounting for about 45 per cent of the total in mid-2001. Banobras and Bancomext accounted for about 25 and 17 per cent respectively, with the much smaller Banrural and Banjército sharing the rest.

Two more development banks were created in mid-2001. PAHNAL, the national savings trust (PAHNAL, Patronato del Ahorro Nacional) was a publicly-owned savings institution that channelled small deposits into government securities. It was transformed into Bansefi (*Banco del Ahorro Nacional y Servicios Financieros*), which will promote small savings through the savings and loan network. Fovi, the housing trust fund, and a newly created mortgage institution (*Hipotecaria federal*) were transformed into a development bank (Nacional Hipotecaria) to guarantee low-income residential mortgage lending, modelled loosely on the US Fannie-Mae.

fact that trust funds are generally managed separately, by different ministries, or even by the Central Bank. This overlapping leads to efficiency losses and lack of transparency.

Alternative sources of finance

It is important to notice however, that the decline in lending by both commercial and development banks has been partly offset by increased lending from sources other than domestic banks, including foreign bank credit, credit granted by non-bank financial intermediaries, and suppliers' credit. Credit granted to the private sector by these lenders has grown from 14 to 17 per cent of GDP in the past four years, reaching almost 50 per cent of total lending in 2000, up from about a quarter in 1994 (Box 7). The bulk of credit outstanding from these alternative sources are in commercial loans, but lending related to consumer credit and housing have also been increasing steadily (Figure 29).

Box 7. Non-bank financial intermediaries

Non-bank intermediaries are an increasingly important source of financing to the private sector in Mexico. Together with suppliers' credit, non-bank financial intermediaries provide the bulk of lending to small and medium-sized enterprises (SMEs). Foreign bank lending, on the other hand, is available mainly to larger enterprises. Non-bank intermediaries can take different forms:

– Limited purpose financial companies (*Sociedades Financieras de Objeto Limitado*, SOFOLES) are specialised institutions that do not take deposits and that concentrate either on a given type of lending (mortgage, consumer credit) or on a particular sector (automobile, construction). They can either be part of a financial conglomerate or be fully independent. In either case, they are subject to regulation by the Ministry of Finance, dispositions issued by the Bank of Mexico and supervision by the CNBV. At the end of 2001, there were 34 SOFOLES operating in Mexico.

– Savings and loan and credit union institutions can receive deposits and generally engage in consumer and commercial loans. The legal status of these institutions varies from that of banks both in terms of prudential and regulatory frameworks. In some cases, such as credit co-operatives, institutions had until recently escaped effective supervision. The newly created BANSEFI is expected to play a leading role in re-organising this sector.[1]

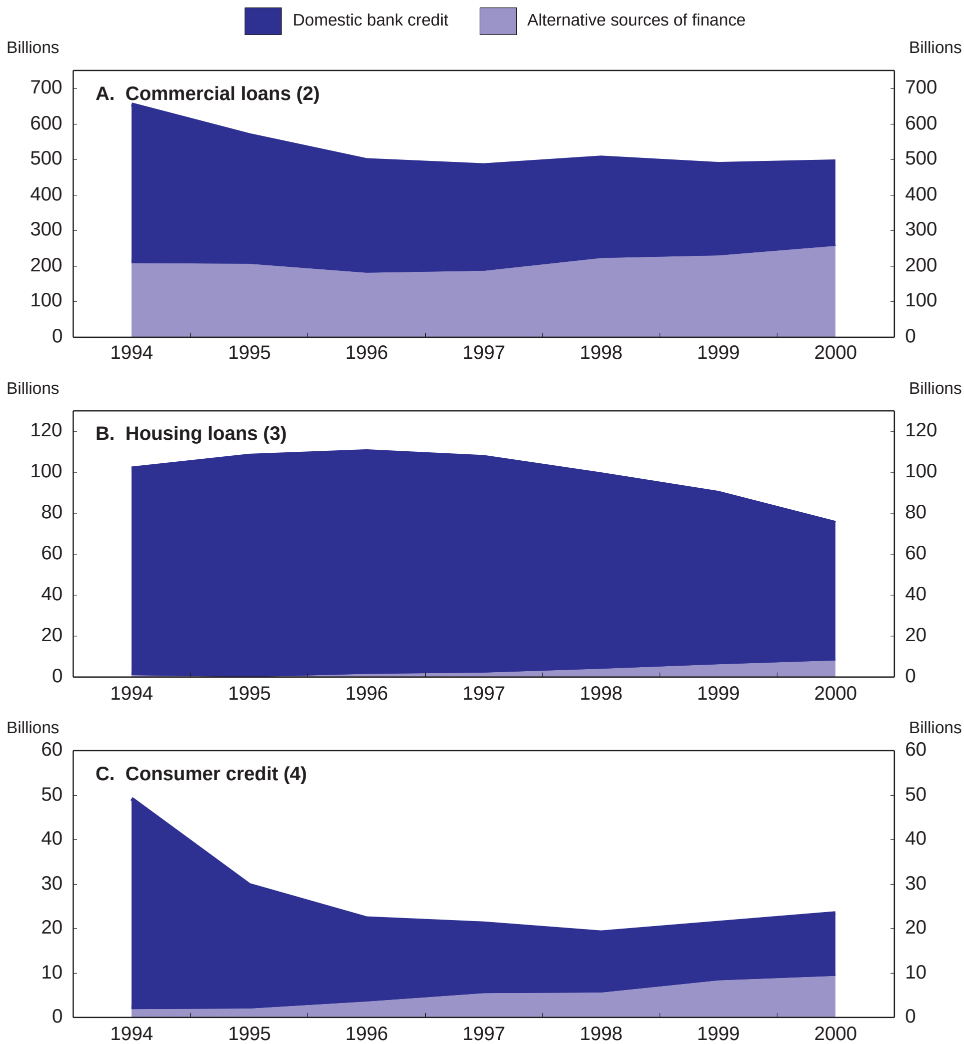
– FIDEICOMISOS are government trust funds, directly financed by the budget, which were created to support certain sectors or activities, often through subsidised loans. They can be linked to and managed by particular government ministries, or in some cases, the Bank of Mexico. FIDEICOMISOS may also engage in second-tier lending, operating through banks or SOFOLES.[2]

– INFONAVIT (National Employees' Housing Fund) is an autonomous entity that manages workers' funds and that operates mainly in the housing market.

1. Since June 2001, a new law provides a regulatory framework that requires *inter alia*, that these entities should be transformed into co-operatives or corporations. The new law puts CNBV in charge of supervision, with the support of federations (under a delegated supervision scheme). See Annex III.
2. Among the most important funds are Fovi (Fund for Low-income Housing), Fonatur (National Fund for Tourism Activities) and Fira (Fund for the Agricultural Sector).

Non-bank financial intermediaries, although their role is increasing, are unlikely to represent a long-term solution to the low levels of overall lending. As seen above, these intermediaries have been an important source of new financing to the private sector. By mid-2001, the total amount of credit granted by alternative sources of finance was at a comparable level to that lent by domestic commercial banks (Figure 30). Most of this was represented by foreign bank lending.

Figure 29. **Lending to the private sector**[1]
Stocks in billions of 1994 pesos, end of period

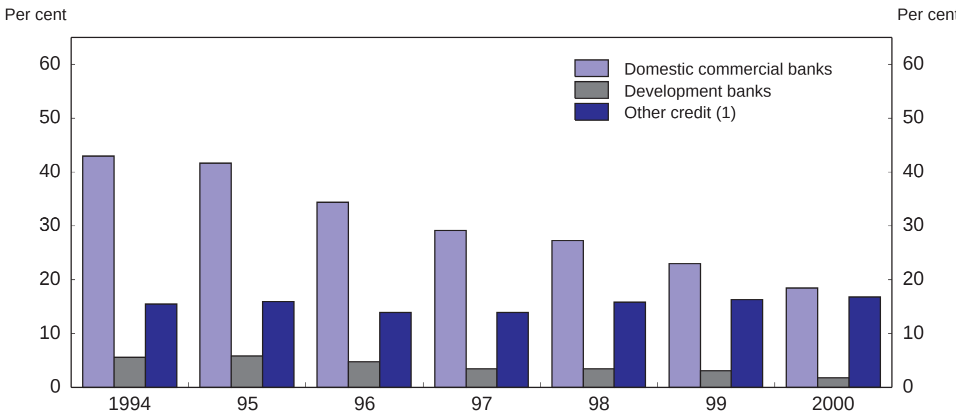


1. Sources of finance to the non-bank private sector.
2. Alternative sources of finance include mainly lending through supplier credit, commercial paper and other securities, Sofoles, foreign banks, credit unions and leasing, factoring and insurance companies.
3. Alternative sources of finance include mainly lending by savings and loans institutions, Sofoles and insurance companies.
4. Alternative sources of finance include mainly credit obtained through department stores' credit cards.

Source: Bank of Mexico.

Figure 30. **Credit to the private sector**

Per cent of GDP, end-year



1. Includes credit obtained through department stores' credit cards, lending by savings and loans institutions, Sofoles, supplier credit, commercial paper and other securities, foreign banks, credit unions and leasing, factoring and insurance companies.

Source: Bank of Mexico.

Among the non-bank intermediaries, SOFOLES, which cannot receive deposits, presented the highest rate of growth. SOFOLES finance their operations by placing securities or borrowing, either from private banks or from the public sector. For instance, in the case of mortgage lending and the financing of construction activity, it is common for SOFOLES to serve as agents for the granting of subsidised loans from the public sector, either through development banks or through Trust Funds, such as Fovi. As such, SOFOLES can only have an indirect impact on overall lending, either through increased competition in financial intermediation or through their role in financial deepening.

Indicators of performance: emerging from the crisis

The financial sector has responded rapidly to recent reforms, mostly through an increase in efficiency and profitability, a system-wide re-capitalisation and an overall clean-up of balance sheets. This in turn has put institutions in a better position to face a more stringent supervision and regulatory framework, which included an upgrade of capitalisation and provisioning requirements and stricter rules for overall risk-management. Today, the Mexican banking system is increasingly solid and as profitable as its OECD counterparts; and the supervision and regulatory framework, including, importantly, disclosure requirements, are close to the standards of more advanced countries. Overall, it can be ascertained by several performance indicators that the Mexican financial sector has recovered from the 1994-1995 peso crisis.

Solvency and profitability of the financial system

In the years preceding the peso crisis, Mexican commercial banks were already suffering from a decline in income (both interest and non-interest), a deterioration in the quality of their loan portfolio (reflected in an increase in non-performing loans) and a consequent drop in profitability and solvency indicators.[86] The peso crisis and its aftermath made matters significantly worse, with the effect that by 1996, interest income had fallen to about half of pre-crisis levels and non-performing loans had reached 13 per cent of the credit portfolio.[87] Not even a sharp reduction in operating expenses was sufficient to prevent significant losses in the banking system as a whole.

Since 1997, profitability has recovered rapidly. First, gross income has grown significantly, pushed by non-interest income such as fees and commissions, which jumped from 0.9 to 1.4 per cent of total assets in the three years to December 2000 (Table 15). This is in part derived from earnings on non-core activities, such as those related to the management of the retirement funds (see below) and "bancassurance". Interest income on the other hand has failed to recover consistently, in part as a result of the low levels of lending. Second, the non-performing loan portfolio has declined considerably – reaching less than 6 per cent of the total credit portfolio in early 2001 – in part as a result of P*unto* F*inal*. This has allowed banks to reduce provisions without jeopardising solvency ratios. Third, consolidation has translated into increased labour efficiency, with the number of staff being reduced by more than 10 per cent between 1997 and 2000.[88] In sum, overall profitability trends have been positive and banks seem increasingly well positioned to face fiercer competition in credit markets.

Indicators of the solidity of the banking system have also improved consistently, as banks have been re-capitalised, partly with foreign entry. The gearing ratio for the system as a whole (capital and reserves as a percentage of total balance sheet) is now higher than the OECD average. Although capitalisation ratios in the Mexican banking system are sufficient to comply with present prudential requirements, the quality of banks' capital is sometimes inadequate. For a few banks, a proportion of Tier 1 capital is backed up by deferred taxes and convertible subordinated debentures (within the limits established by Basel rules), whereas fixed assets can be overvalued. This situation should change in the next few years, however, as new rules mentioned above concerning capitalisation and provisions come gradually into effect.

The profitability of Mexican banks' is now as high as in other OECD countries, but this reflects relatively high financial margins, fees and commissions,

Table 15. **Commercial banks' income statement**
Percentage of average total assets

	1993	1994	1995	1996	1997	1998	1999	2000	2001[1]
Net interest income	6.37	5.07	5.33	3.35	3.77	5.15	5.41	5.19	5.01
Non-interest income (net)	2.05	1.40	2.04	2.69	2.26	1.46	3.30	2.05	1.81
Net profits or loss on financial operations	1.39	0.77	1.10	2.12	0.87	0.49	1.69	..	..
Gross income	8.42	6.47	7.37	6.04	6.03	6.61	8.71	7.24	6.82
Operating expenses	4.65	4.15	3.93	3.85	4.42	5.02	5.25	5.15	4.71
Staff costs	2.30	1.99	1.59	1.50	1.93	2.07	2.05	2.36	..
Property costs	2.20	1.92	2.12	2.13	2.25	2.57	2.81	2.79	..
Net income	3.77	2.32	3.44	2.20	1.61	1.59	3.46	2.09	2.10
Provisions on loans	1.49	1.55	2.95	2.83	1.48	1.44	2.51	0.96	1.09
Profit before tax	2.28	0.76	0.49	–0.63	0.13	0.15	0.95	1.13	1.01
Profit after tax	1.82	0.59	0.40	–0.69	0.07	0.57	0.71	0.94	0.80
Memorandum item:									
Assets (billions of pesos)	463	619	837	1 061	1 112	1 150	1 314	1 438	1 521
Solvency, capitalisation									
Capitalisation ratio[2]	..	9.8	12.4	13.2	13.8	14.4	16.2	13.8	14.9
Capital/total assets	..	5.5	6.8	6.0	8.5	8.4	10.5	..	..
Non-performing loans/total loans[3]	..	7.3	6.9	5.9	11.1	11.4	9.7	5.8	5.3
Provisions/non-performing loans	..	48.6	72.6	119.9	62.8[4]	66.0	107.8	115.3	119.8
Current assets/current liabilities	..	1.07	1.08	1.02	1.06	1.09	1.09	1.11	1.11

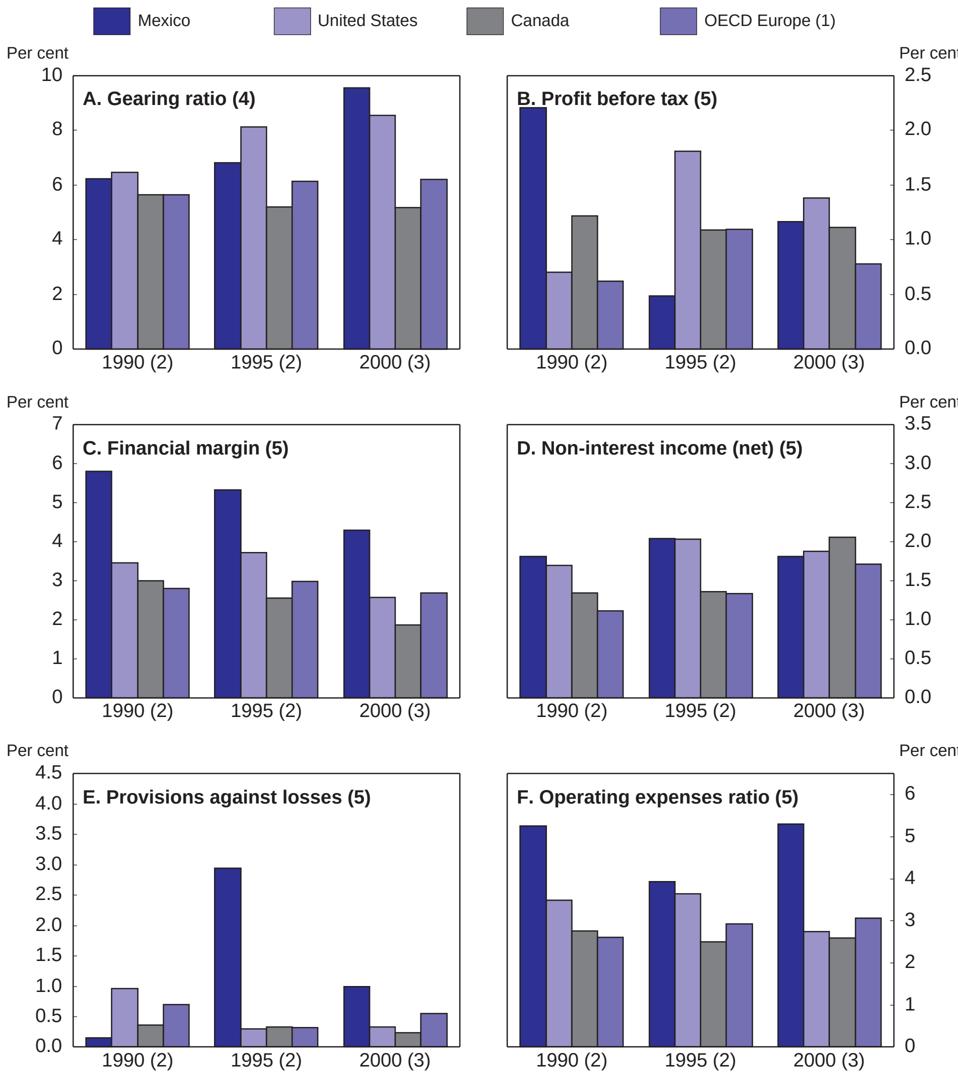
1. Third quarter data.
2. Net capital over risk-weighted assets. Since December 1997, this ratio also includes market risk.
3. Including IPAB notes.
4. Break in data, reflecting the transition to the new accounting system (based on internationally-accepted accounting principles since 1997).

Source: Comisión Nacional Bancaria y de Valores (CNBV); OECD, *Bank Profitability-Financial Statements of Banks*.

offset by above-average operating expenses and a high level of provisions against losses (Figure 31). This indicates that, although the profitability of the system is at a reasonable level, the burden of bad loans has been significant and banks remain relatively inefficient, with negative spill-over effects on the rest of the economy. Staff and property costs are significantly heavier in Mexico than in other OECD countries (as a percentage of balance sheet total), in spite of the relatively low branch density. Concerning past-due loans, these have been on a declining trend, especially since the implementation of the *Punto Final* programme. In spite of this, though, they still represented 5.3 per cent of the total loan portfolio in September 2001. When measured as a percentage of total balance sheet, provisions in the Mexican commercial banking system were among the highest in the OECD (Figure 32). These results should be interpreted with caution however, since Mexican banks have in recent years increased the proportion of their operations off-balance sheet.

Figure 31. **Income statement of the financial system**

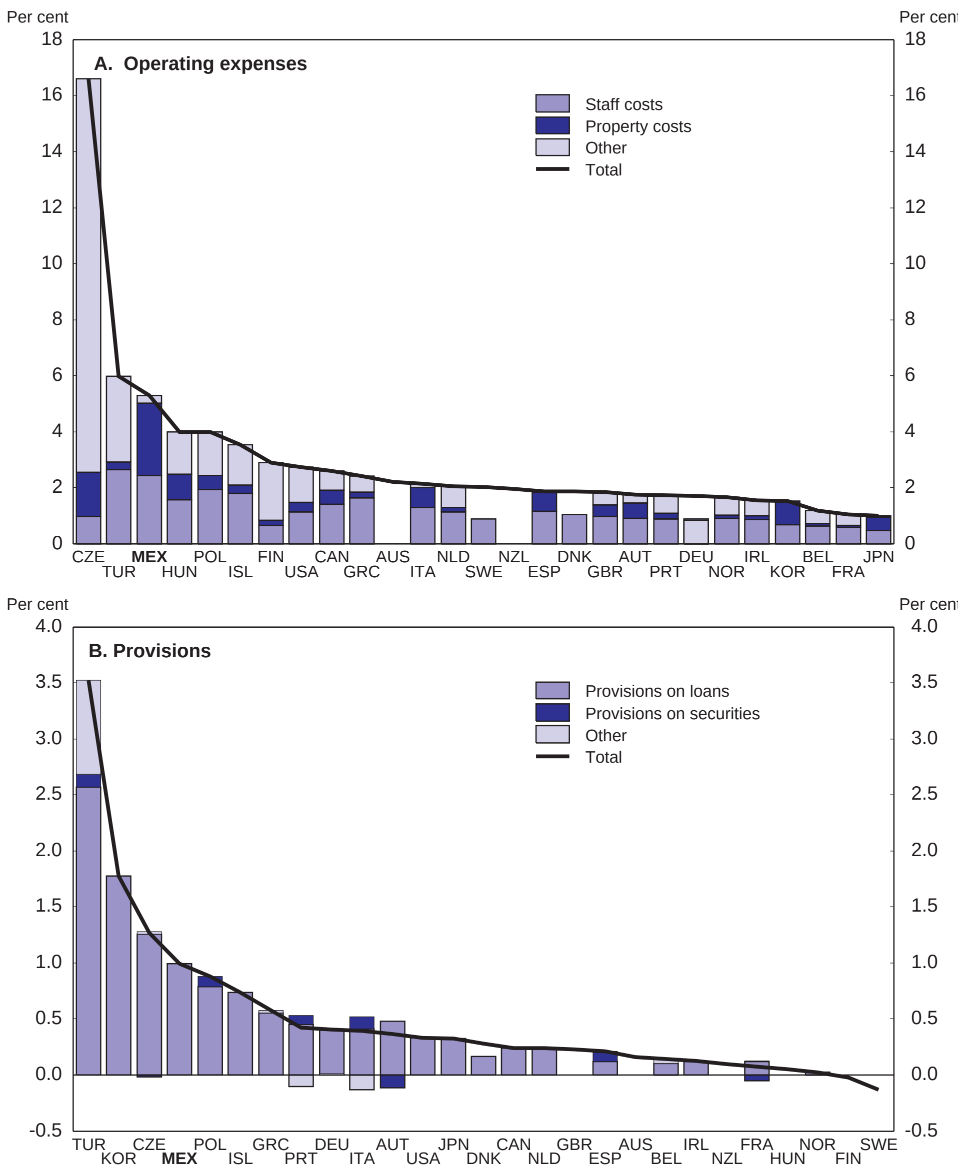
Commercial banks



1. Unweighted average of countries for which data are available.
2. The data for Mexico are not strictly comparable before 1997 as a result of different accounting standards.
3. 1999 for Canada; 1998 for OECD Europe.
4. Capital and reserves as a percentage of year-end balance sheet total.
5. As a percentage of average balance sheet total.

Source: Bank of Mexico; OECD, *Bank Profitability – Financial Statements of Banks* (2001).

Figure 32. **Operating costs and provisions**
Per cent of average balance sheet total



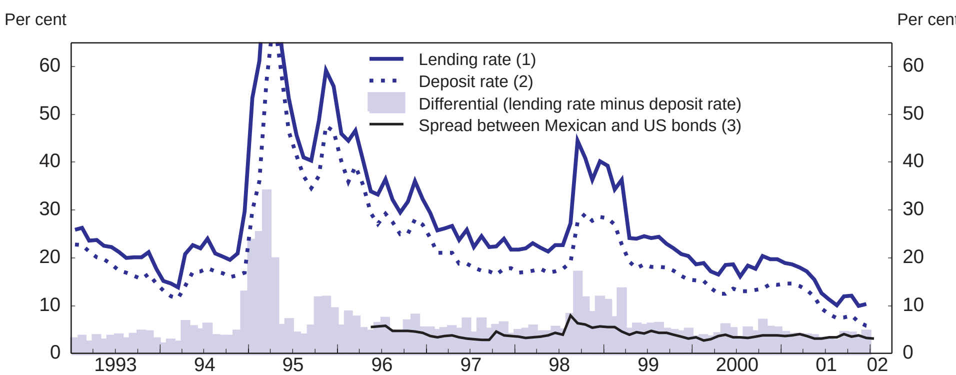
1. 2000 or latest year available.
Source: CNBV; OECD, *Bank Profitability – Financial Statements of Banks* (2001).

Efficiency of intermediation

The collective experience of OECD countries shows that financial sector liberalisation affects allocative efficiency in the economy through its impact on financial intermediation.[89] Liberalisation also has a direct effect on the operation of financial markets, as an environment of increased competition generally leads to more efficient institutions. One measure of this internal efficiency is the differential between lending and deposit rates in the banking system. The smaller this differential, the more efficient is financial intermediation, since savers receive higher returns and investors pay lower capital costs. Using this yardstick, the impact of the initial bout of reforms (in the late 1980s and early 1990s) on the efficiency of the Mexican financial system was initially positive, before the banking sector was derailed by the peso crisis. Interest rates differentials remained high through most of the second half of the 1990s, closely mirroring the behaviour of Mexican sovereign spreads. More recently, further efforts at liberalisation were met with a gradual narrowing of the spread between lending and deposit rates (Table 16). Although higher than the OECD average, the spread in mid 2001 had dropped to the lowest level since the peso crisis (Figure 33). The contrast is particularly sharp if compared with 1998, when the index was affected by the turbulence in emerging markets.

Alternative productivity and efficiency indicators also suggest rapid improvement until 1994 and decline or stagnation during the crisis and its after-

Figure 33. **Lending and deposit rates**
Per cent

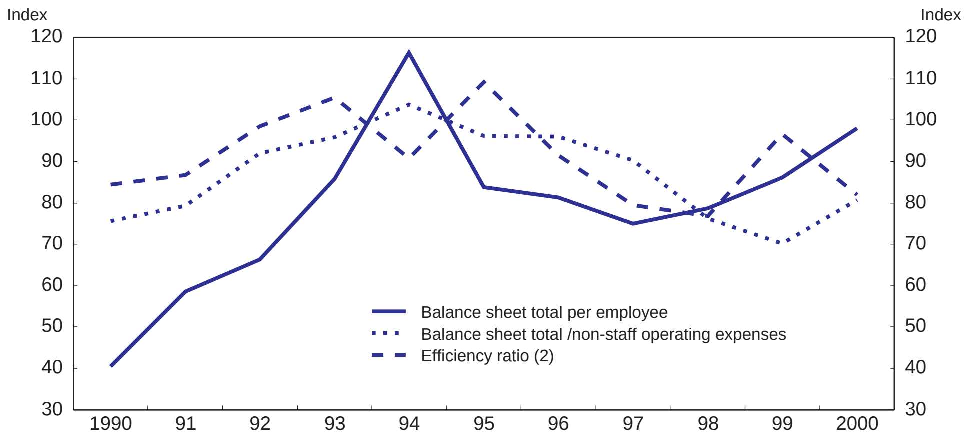


1. The commercial paper rate is used as a proxy for the lending rate. In March and April 1995 it reached respectively 91 and 90 per cent.
2. In April 1995, the deposit rate (Costo de captacion'') reached 70.26 per cent.
3. Spread between Mexican Brady 30-year bonds and US 30-year Treasury bonds.

Source: Bank of Mexico; International Monetary Fund, *International Financial Statistics*.

Figure 34. **Productivity and efficiency indicators in the banking sector**[1]

Average 1994/95 =100



1. Commercial banks.
2. Net interest income plus fee and commissions income divided by operating expenses.

Source: Bank of Mexico; OECD, *Bank Profitability – Financial Statements of Banks* (2001).

math. However, only one measure shows gradual recovery after 1998/99 (Figure 34). Overall, productivity (balance sheet per employee and per non-staff operating expenses) and efficiency ratios (net interest income plus fee and commissions income divided by operating expenses) remain similar to the levels attained in other emerging market economies, which means that there remains much scope to catch up with the more advanced OECD countries (Figure 35).

Securitisation

Financial market liberalisation has led to the increased use of securities across the OECD area ("securitisation"), which has often implied the emergence of (non-bank) institutional investors as important financial intermediaries. This process has not yet been evident in Mexico, where banks still retain the bulk of financial intermediation, with approximately three-quarters of total assets at the end of 2000. This compares with about half in Canada and most of OECD Europe and less than 20 per cent in the US, where institutional investors such as pension and mutual funds and insurance companies hold a larger share of total assets (Figure 36). Assets held by institutional investors in Mexico have expanded rapidly in the past three years, but these remains at one of the lowest levels among OECD countries (Figure 37).

Table 16. **Interest rate differentials**

Bank's lending rates less money market rates, year average[1]

	1993	1994	1995	1996	1997	1998	1999	2000
United States	3.0	2.9	3.3	3.3	3.4	3.6	3.4	3.4
Japan	2.0	1.9	2.2	2.1	1.9	1.6	1.9	1.8
Germany	5.6	6.1	6.4	5.5	4.2	3.2	2.7	2.2
France	0.3	2.0	1.5	2.8	2.9	3.0	3.4	2.3
Italy	3.7	2.7	2.0	3.2	2.9	2.9	2.6	1.9
United Kingdom	..	..	1.8	1.5	1.4	1.9	2.0	1.8
Canada	1.0	1.2	1.4	1.7	1.3	1.6	1.5	1.6
Australia	4.6	3.9	3.4	3.8	3.9	3.0	2.5	2.6
Belgium	3.6	3.7	3.6	3.9	3.6	3.7	3.7	3.6
Mexico	**7.1**	**6.3**	**10.1**	**5.5**	**4.7**	**3.9**	**4.5**	**3.0**
Netherlands	3.5	3.1	2.8	2.9	2.8	3.0	0.5	0.4
Portugal	na	4.3	4.1	4.5	3.6	..	2.2	..
Spain	1.1	0.9	3.5	4.1	3.4	2.8	2.6	1.9
Memorandum item:								
Euro area	..	..	..	4.0	3.3	2.9	2.7	2.2

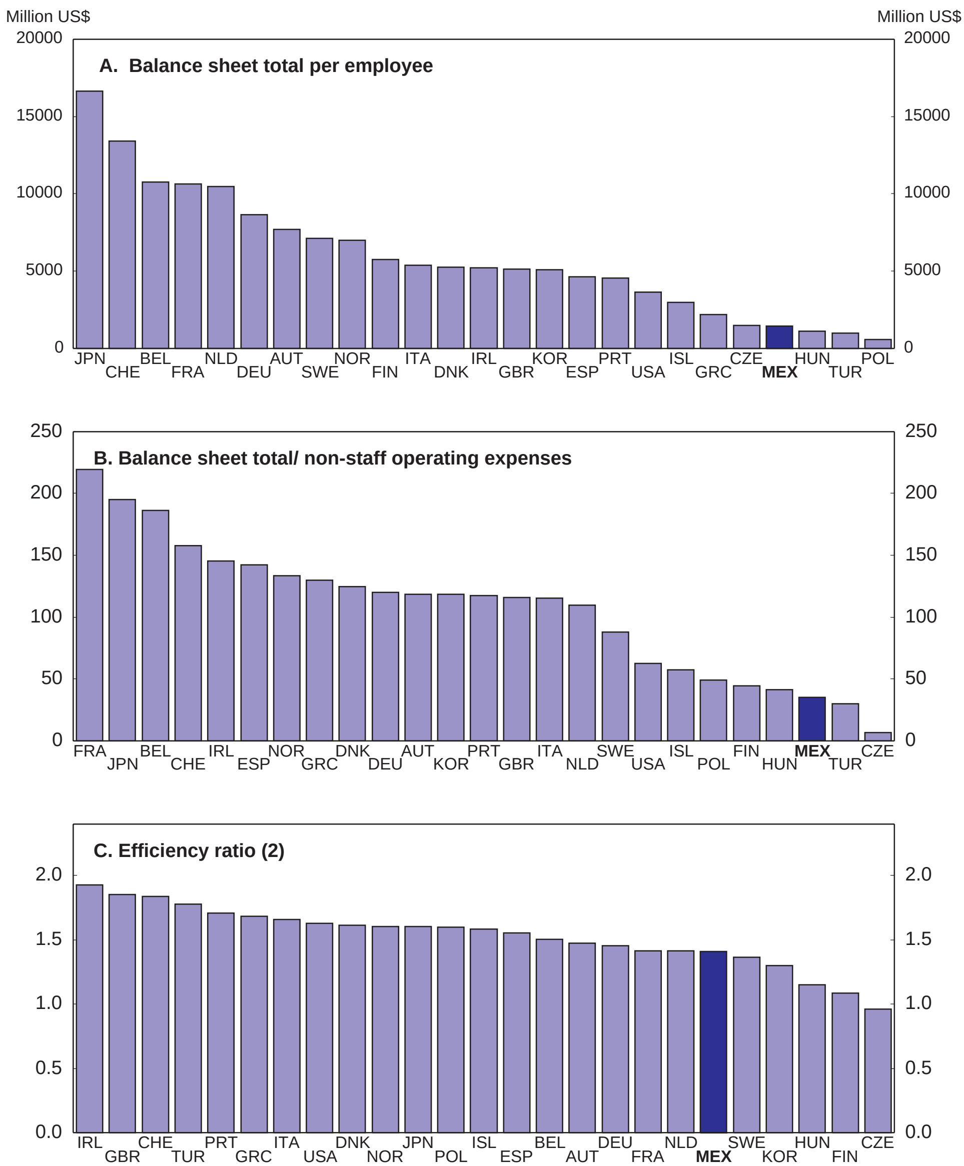
1. United States: Base rates charged by banks on short-term business loans less 3-month Treasury bill rate.
   Japan: Weighted average of contracted interest rates charged by all banks on both short- and long-term loans, discounts and overdrafts, less 3-month certificates of deposit.
   Germany: Until 1995 rate on current-account credit thereafter credit to enterprises up to one year less until 1998 3-month Fibor, thereafter 3-month Euribor.
   France: Banks' prime lending rate less until 1996 3-month Pibor, thereafter 3-month Euribor.
   Italy: Rate on short-term bank loans less until 1998 3-month interbank rate, thereafter 3-month Euribor.
   United Kingdom: Building Societies's mortgage basic rates less 3-month Treasury bill rate.
   Canada: Rate from chartered bank on large business loans less 3-month Treasury bill rate.
   Australia: Rate charged by banks on loans to small and large business less 90 days buying rates for commercial bills.
   Belgium: Rate for liquidity credit charged by the four major banks less 3-month Treasury Certificate (tender rate).
   Mexico: Weighted average of amounts placed on securities exchange at various terms with the yield curve calculated on 28-day commercial paper of qualified companies less 3-month Cetes.
   Netherlands: Mid-point rate charged on current account advances less until 1998 3-month Aibor, thereafter 3-month Euribor.
   Portugal: Average rate charged by deposit money banks on 91to 180-day loans and advances to non-financial enterprises less until 1998 3-month Treasury bill rates, thereafter 3-months Euribor.
   Spain: Rates on 3-month credit (variable rate) less until 1998 3-month interbank rate; thereafter 3-month Euribor.
2. Weighted average Euro area retail bank lending rate for loans to enterprises up to one year less 3-month Euribor.

Source: IMF, *International Financial Statistics*; OECD, *Main Economic Indicators*.

Institutional investors

Pension funds (*Sociedades de Inversión Especializadas en Fondos para el Retiro*, SIEFORES) are the most dynamic among Mexican institutional investors, holding the equivalent of 9 per cent of total financial savings.[90] These funds have expanded quickly after mid-1997, when social security reforms introduced a fully-funded capitalisation pension scheme for private sector employees, to replace the previous pay-as-you-go (PAYG) system (see previous *Economic Surveys* of Mexico). The

Figure 35. **Productivity and efficiency indicators: international comparison**[1]

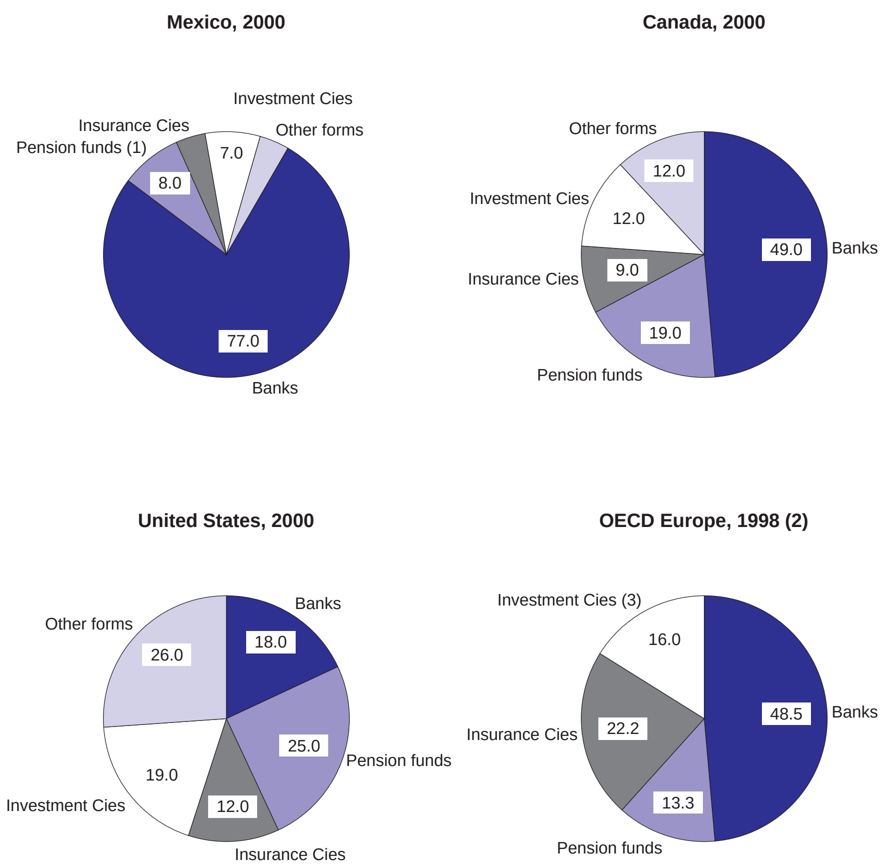


1. Commercial banks. 2000 or latest year available.
2. Net interest income plus fee and commissions income divided by operating expenses.

Source: CNBV; OECD, *Bank Profitability – Financial Statements of Banks* (2001).

Figure 36. **Composition of financial assets**

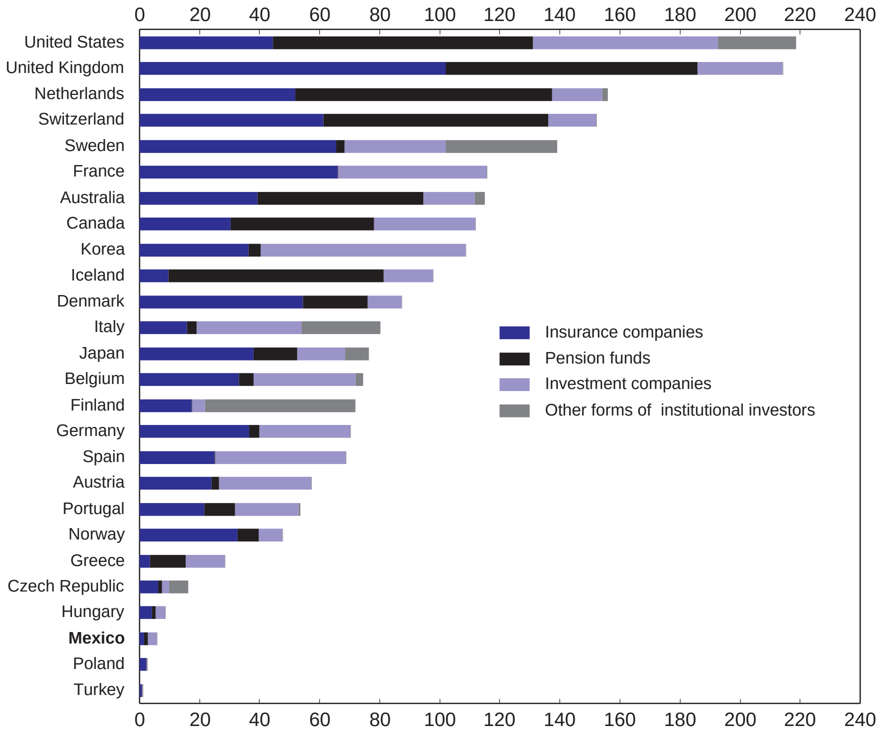
Per cent of total financial assets



1. Includes SIEFORES.
2. Unweighted average of following countries: Germany, France, Italy, United Kingdom, Belgium, Netherlands, Sweden and Switzerland.
3. Including other forms of institutional investor.

Source: Bank of Mexico; OECD, *Institutional Investors, Statistical Yearbook*, 2000 Edition.

Figure 37. **Vehicles for savings**[1]
Per cent of GDP



1. Financial assets of institutional investors in 1998; 1996 for Switzerland and Greece; 1997 for Belgium, the Czech Republic, Poland, Portugal, Sweden and Turkey.

Source: OECD, *Institutional Investors, Statistical Yearbook*, 2000 Edition.

scheme operates through individual pension accounts, with private administrators competing to attract funds. These administrators, known as AFORES, are often subsidiaries of a bank-led financial conglomerate. Four large firms, which held about 60 per cent of the market in December 2000, dominate the sector. Competition has been increasing gradually however, mostly through new entry. Concentration ratios have been falling steadily since 1997 and no firm now holds more than a 20 per cent market share.[91] Although pension contributions are mandatory, in practice the scheme reaches only 18.5 million workers, about half of the labour force (as of March 2001). Generally excluded from the scheme are workers in the large informal sector as well as public sector employees, which have their own (defined benefit, PAYG) pension schemes. Participants in the scheme can also make voluntary deposits into their accounts in addition to the required contribution. These voluntary contributions have grown rapidly in the past few years (albeit from a very low base) and by mid-2001 were equivalent to 0.3 per cent of total deposits in the banking system. Contrary to the experience of other countries until now, the growth of Mexican pension funds has not directly led to increased lending to households or enterprises, since these funds invest the bulk of their portfolio in government securities rather than in private sector debt or equity. This is mostly as a result of their regulatory regime, as present requirements encourage the purchase of inflation-indexed instruments (of which the public sector is the only issuer) and high-rated debt (which excludes most of the private sector).[92]

Capital markets

Mexican capital markets boomed in the late 1980s and early 1990s, boosted by macroeconomic stability, trade and investment liberalisation, strong capital inflows and an ambitious privatisation programme. Mirroring developments in other parts of the financial sector however, the peso crisis led to a plunge in market capitalisation and turnover indicators. More recently, boosted by the return of macroeconomic stability and the growth of pension funds and insurance companies, capital markets have started to recover (Table 17). However, most of the savings captured by institutional investors have been channelled towards government securities, with very little spill-over to the corporate bond sector or the stock market. At the end of 2000, the value of private corporate debt outstanding was equivalent to 2 per cent of GDP. This is significantly smaller than domestic government debt outstanding (10 per cent of GDP), even excluding non-tradable instruments such as those related to the bank rescue package. Within the corporate debt market, commercial paper (with terms of less than one year) accounts for about a third of outstanding liabilities, long-term financing (over three years) is largely unavailable and liquidity in secondary markets is low. The same is true for

Table 17. **Capital market indicators**

	1995	1996	1997	1998	1999	2000
Number of listed companies	185	193	198	195	190	177
Stock Market Capitalisation (% of GDP)	38.0	33.1	39.7	23.6	31.8	22.2
Turnover (% of GDP)						
Stock market	11.3	10.9	12.1	7.1	7.2	7.2
Fixed income market	2.72	0.84	0.24	0.23	0.08	0.09
Money market	251	395	240	299	456	719

Source: Bolsa Mexicana de Valores (BMV).

the stock market, which remains relatively thin. This suggests that unlike the situation in many other OECD countries, capital markets are not yet playing an important role as financial intermediaries to the corporate sector. In fact, larger Mexican companies are more likely to access US than Mexican financial markets. Since 1999 however, new physical and regulatory infrastructures have been introduced, laying the ground for the development of domestic capital markets.[93]

The challenges ahead

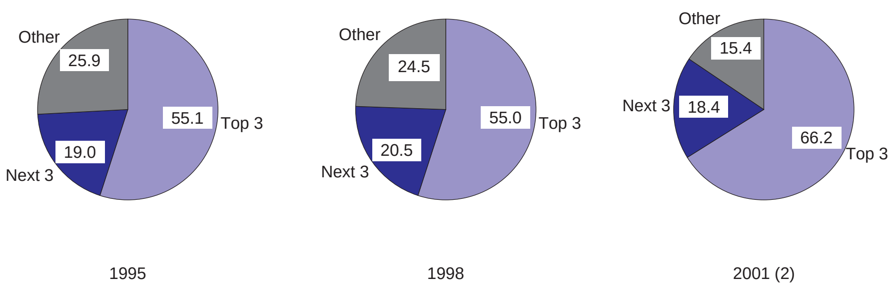
With the progress made in recent years, the Mexican financial system is now broadly in good shape. Some challenges remain, however. First, the banking system is relatively inefficient, with productivity and efficiency indicators lagging behind those of most other OECD countries, and past-due loans are still relatively high, although fully covered by provision. Second, the role of development banks remains significant, sometimes, creating distortions and interfering with the operation of commercial banks. Third, the regulatory and supervision arrangement is complex and its implementation fragmented, increasing the cost of compliance and often reducing efficiency. Finally, and most importantly, lending to the private sector has continued to decline. As capital market financing of the private sector is also weak, this implies that the overall level of financial intermediation is low, suggesting that a constraint on economic growth might exist.

The efficiency of the banking industry: challenges related to consolidation

The consolidation of the banking industry, which started in the mid-1990s, but has accelerated since full liberalisation of FDI rules in 1998, has had an impact on concentration ratios. The six largest banks' share of total assets rose from 75 per cent in 1998 to 85 per cent in June 2001, one of the highest ratios among OECD countries (Figure 38). In spite of this trend, competition in the banking system does not seem to have been negatively affected.

Authorities have been monitoring the consolidation of the banking industry closely. The Federal Competition Commission (FCC) has reviewed several acquisitions and mergers in the financial system, including those involving foreign investors.[94] It has also been careful to define the relevant product market as encompassing the whole range of banking and credit services offered by the financial conglomerate, which is important in a country with a universal banking model such as in Mexico. Indeed, some recent mergers have been conditioned by the FCC to prevent them from having an adverse impact on the AFORES market, as well as on the commercial banking market *per se*. The competition authorities generally found that foreign acquisitions increased competition in the industry, to the extent that capital injections into ailing banks served to increase their capacity to compete effectively in the market. In these cases, the strengthening of the financial system and the stability of the banking sector were compatible with – and

Figure 38. **Concentration ratios**
Market share of the six largest banks[1]



1. As a percentage of total assets.
2. September 2001.
Source: CNBV .

actually supported – the development of a more competitive market. In recent years, the FCC has intervened in two cases involving the financial sector, related to horizontal agreements among banks affecting the credit card and the government debt markets.[95]

Consolidation in the financial sector is likely to continue, since some banks remain to be sold or closed down by IPAB and some smaller banks may have difficulties meeting new capitalisation requirements (to come fully into effect as of 2003). The benign effects of consolidation on competition observed so far, are likely to be less intense in the future, as the banking system is now largely re-capitalised and relatively more solid. Instead, it is possible that further mergers, if occurring between two of the remaining six largest banks, may have anti-competitive effects. As a result, continued vigilance on the part of competition authorities is required.

As seen above, the consolidation process has already had an impact on the performance of the financial system, but efficiency and productivity levels still lag those of other OECD countries, in large part because of high operating costs and provisions.[96] This relative inefficiency constitutes a cost to the economy as a whole, reducing the return to savers and increasing the costs to those who invest. The reduction of operating costs is expected to be achieved in part through increased competition in the industry. Policies that increase labour market flexibility and improve the operation of real estate markets can also have an impact on banks' expenditures as it may lead to lower staff and property costs. Efficiency would also be enhanced by policy action to deal with the persistent problem of loan defaults. The level of non-performing loans in an economy can be influenced by the adequacy of bankruptcy and loan recovery legislation and the efficiency and transparency of the legal system. A new legal framework for bankruptcy and credit guarantees came into effect in May 2000, shortening and simplifying the process of bank foreclosure and increasing the legal certainty of lending operations. But bankruptcy proceedings were yet to be tested by the banking system in late 2001 and the exercise of credit guarantees still faced high legal costs, slow proceedings and poor enforcement at local level. An efficient judicial system is thus crucial for the effective implementation of the new laws, suggesting the need to modernise processes and increase resources available to judiciary authorities. In that regard, the option of creating separate commercial courts, to hear and settle disputes concerning the financial sector, should be considered.

Default rates could also be reduced (and overall lending increased) by better credit information sharing systems.[97] But the density of the Mexican credit history system, at 5 million consultations in 2000, remains significantly below that of other OECD countries. Although recent regulatory changes have gone in the right direction, some problems remain.[98] The monopoly position of the dominant credit reporting firm, and the fact that it is owned by banks, raises some moral hazard issues, including some potential conflicts of interest. This leads to reluctance among non-bank intermediaries and utility companies to share credit information. The lack of integration between credit files generated by banks and by other sources is a major source of inefficiency in the system.

Development banks and government trust funds: the need to rationalise

Recent government proposals for the development bank sector, sent to Congress in April 2001, are two-pronged: to re-think the role of each bank and to upgrade two existing institutions, transforming them into banks. The first part of the proposal, still under examination by Congress, is to be welcomed and should be considered in the wider context of the role of the public sector in financial intermediation. As such, the exercise should not be limited to development banks, but would also need to involve a re-thinking of the activities and management of the various trust funds. Ideally, this would lead to a process of rationalisation, in which the existence of each state-owned financial institution will need to be questioned. A standard claim for the existence of development banks or trust funds is that they provide public goods or that they correct market failures. For instance, it is often pointed out that these institutions operate in markets in which private banks do not find it profitable to lend. But the very existence of publicly-supported financial institutions may have prevented the development of private lending, although this hypothesis is difficult to verify. In the case of Mexico, market failures seem to exist, in particular in the rural sector, but this does not necessarily justify the existence of numerous publicly-owned financial institutions. In that regard, consideration should be given to transforming some development banks into non-financial development agencies, which would for instance, preclude borrowing from financial markets. In that context, the second part of the government's proposal for upgrading two existing institutions, recently approved by Congress, needs to be implemented carefully. Authorities should ensure that development banks engage exclusively in second-tier lending, to avoid overlapping and the crowding out of the private financial sector. There have already been significant efforts made in that regard.[99]

Reducing the weight and enhancing the efficiency of the regulatory framework

Significant steps have been taken in recent years to upgrade the regulatory framework for the operation of the financial system. Some issues remain, however, related to the implementation and enforcement of these new regulations, which will require some capacity building, as well as financial and human resources. There also remains a fundamental challenge related to the cost and complexity of the regulatory and supervisory framework. The problem is more strongly felt in two areas: the inefficiencies related to the fragmentation of supervision, exemplified by the large number of agencies with authority over the financial system, and the cost of the deposit insurance scheme:

- Mexico's fragmented regulatory model in the financial sector (Box 8) is not a problem *per se*, and it is followed successfully by several other OECD countries. The problem resides instead in the inadequate co-ordination between different agencies, the overlapping of their responsibilities and their sometimes insufficient level of autonomy.
- The deposit insurance fund being phased in is financed by insurance quotas paid by commercial banks. The funded system replaces blank coverage of deposits and as such, it is expected to induce more prudent behaviour by depositors and lead to better financial management practices by banks.[100] But the insurance quotas are quite high by international standards, denting bank profitability and increasing the cost to borrowers. The high cost of the scheme is related to the need to finance IPAB operations. Indeed, three-quarters of funds collected from these levies will be used to help pay for the fiscal cost of the post-1995 rescue package, with the remaining amount being accumulated in a contingency fund for future rescue operations.

The simplification of the regulatory framework could lower the cost of compliance and lead to lower interest rate spreads. Deposit insurance premia

Box 8. Financial sector regulation and supervision

Financial sector regulation and supervision is rather fragmented in Mexico. The Bank of Mexico regulates the financial system from a more "systemic" viewpoint of the functioning of the different markets, such as the money and the foreign exchange market as well as the payment system. It also regulates and supervises some financial operations. The role of regulating and supervising individual financial institutions falls under the Ministry of Finance (*Secretaria de Hacienda y Crédito Público*, SHCP), either directly or through the functioning of the different agencies linked to it. SHCP is directly in charge of licensing, merger approval and general regulation affecting the banking system as a whole, such as the establishment of minimum capital requirements and risk rating. Other, more specific, roles are assigned to SHCP agencies with authority over the financial system.

– The Banking and Securities Commission (*Comisión Nacional Bancária y de Valores*, CNBV) is the agency in charge of the regulation and supervision of financial sector institutions in the banking (including development banks) and securities sectors, as well as those engaged in factoring, financial leasing and custody operations. It also has responsibility over money exchange houses, credit unions and savings and loan associations.

– The Insurance Commission (*Comisión Nacional de Seguros y Fianzas*, CNSF) regulates and supervises the insurance sector, as well as institutions offering surety bonding (*fianzas*).

– The Retirement Fund Commission (*Comisión Nacional del Sistema de Ahorro para el Retiro*, CONSAR) is in charge of overseeing pension funds (SIEFORES) and regulating and supervising pension fund administrators (AFORES).

Other agencies, not linked to the SHCP include:

– The Institute for the Protection of Bank Savings (*Instituto para la Protección del Ahorro Bancário*, IPAB) has the role of managing the deposit insurance scheme and is also in charge of the resolution of bank failures.

– The Protection Agency for Users of Financial Services (*Comisión Nacional para la Protección y Defensa de los Usuários de Servicios Financieros*, CONDUSEF) has an advisory role to users of financial services and provides legal help in case of conflict with financial institutions.

could be reduced and applied only to insured assets, with the impact on IPAB's revenues offset by an increase in direct budget transfers. Concomitantly, a differentiation of premia by the level of risk, already foreseen in law but not yet applied, should be introduced. Moreover, the fragmented responsibility model should be revised and the co-ordination between the different agencies better institutionalised, perhaps through the creation of an "umbrella" institution. For instance, the banking and securities commission could be better integrated with other specialised agencies in view of the need to supervise integrated financial groups. This would also facilitate the elimination of present inconsistencies in the regulatory treatment of different types of financial institutions. The bank failure resolution system should also be re-visited, especially in the context of the gradual reduction in the coverage of the deposit insurance scheme.[101] Overall, the autonomy of the various agencies should be reinforced, perhaps through the severing of institutional links with the Ministry of Finance. This would be of particularly importance for instance, to maintain the effective regulation of development banks and trust funds controlled by the Ministry of Finance. The appointment of agencies' boards for a fixed term, as in the case of the Bank of Mexico, should be considered. Measures towards increased autonomy would also need to involve the access to a secured source of financing. Authorities are examining these issues and should come up with concrete proposals in the next few months.

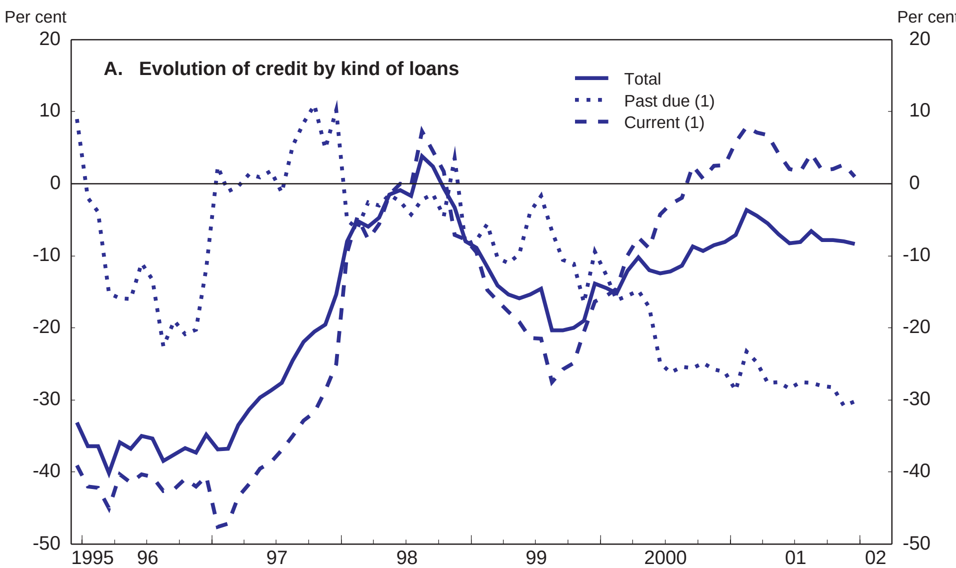
Creating conditions for an increase in credit to the private sector

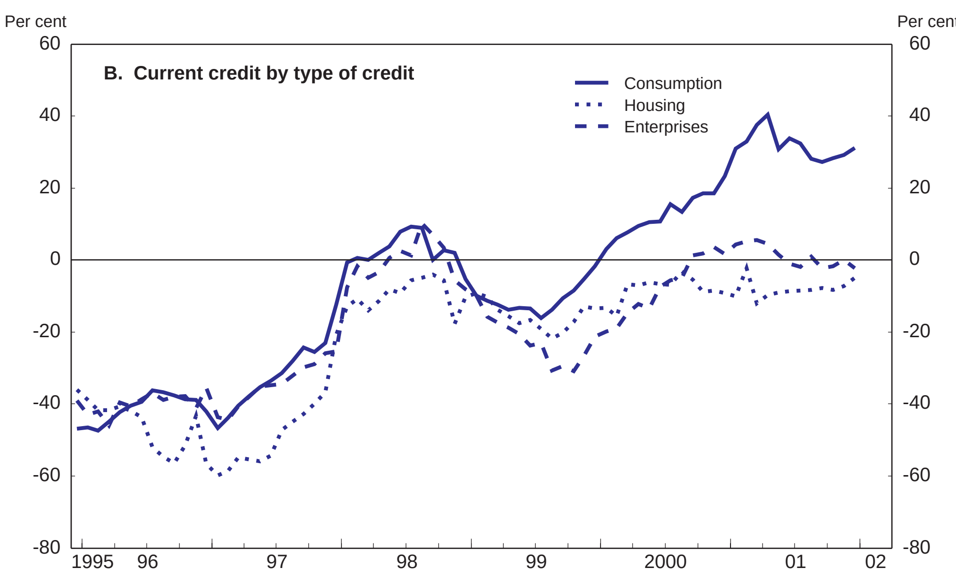
Although the challenges described above will require attention from the authorities, the most important concern remains by far the low level of credit to the private sector, including both bank lending and other sources of finance. Some components of domestic credit started to pick up in late 2000 (especially when adjusted for the decline in non-performing loans), but there are still no clear signs of a sustained revival of credit to the private sector (Figure 39).[102] The problem is felt more severely by small and medium-sized enterprises (SMEs), since larger companies can often access foreign borrowing. Such asymmetries are probably inevitable, given the intrinsic higher risk of lending to smaller enterprises. However, governments should continue to implement measures to ensure a level playing field by eliminating barriers to lending with an asymmetrical effect. More active policies that do not create distortions could also be envisaged to help smaller firms (Box 9).

A broader question refers to how financial intermediation is likely to develop in Mexico. Access to foreign sources of finance is to a large degree part of a global trend towards increased internationalisation of financial markets and should not be countered by policy action. To the contrary, the tax and regulatory treatment of domestic and foreign investment should be harmonised, so as to level the playing field and allow domestic capital markets to become more integrated with their foreign counterparts. It is likely that globalisation will lead to a certain division of labour between various international markets. Domestically-based financial institutions, to the extent that they have superior knowledge of local borrowers and local conditions, are likely to keep a comparative advantage in lending to small-and medium-size enterprises.

The low level of bank lending is in part related to the small amount of deposits in the banking system. These have been declining steadily from about

Figure 39. **Recent trends in domestic credit to the private sector**[1]
Year-on-year percentage change in real terms





1. Direct credit by commercial banks.
Source: Bank of Mexico.

Box 9. Increasing credit to SMEs

The financing of entrepreneurial activity in Mexico has been characterised in recent years by its duality. Larger companies in the tradeable sector have access to foreign sources of borrowing or to the shrinking pool of domestic bank loans, whereas small and medium-sized enterprises (SMEs) have had to rely on development banks or less traditional sources – especially suppliers' credit.

Some of the factors that have prevented a revival of bank lending to the private sector, as described above, affect SMEs more strongly than larger firms. Factors with an asymmetrical effect have included weak bankruptcy and credit guarantee laws, costly and cumbersome judicial procedures and the lack of adequate credit risk assessment. The recent correction of some of these inadequacies will go some way to level the playing field between enterprises of different sizes, although further measures may be required.

Other policies, directed specifically to the needs of SMEs, could also be envisaged. In many OECD countries, funding for smaller firms is also relatively scarcer, as the inherent high risk of SMEs make them less attractive to the banking sector. As a result, many governments have been focusing on improving access to venture capital and other types of private financing. This has been done through many channels, including the development of secondary stock markets that allow easy and less costly entry and exit to venture investors, and the easing of conditions for riskier investments by pension funds and other institutional investors. "Business angel" networks, which bring together small companies and wealthy investors, have also been tried successfully in the United States, Austria, Sweden and Germany. Finally, some OECD governments still play a more direct role in helping SMEs, by guaranteeing or providing venture capital. However, this support is likely to be costly and may create distortions, so the scope of these programmes is likely to diminish relative to measures described above, which focus on the better functioning of private markets.*

* OECD *Small and Medium Enterprise Outlook*, 2000; and see Annex III below.

25 per cent of GDP in 1998 to less than 20 per cent in late 2000. Part of the reason is the increasing competition from investment funds, which generally offer higher returns. Purchases of government securities by the general public have also been increasing.[103] Increased competition among banks, by boosting returns on bank deposits, is expected to partly remedy this situation. Overall however, the decline in deposits, when it derives from the enhanced competition between banks on one hand and non-bank financial intermediaries on the other, is part of a natural "securitisation" process, also experienced by other OECD countries, and should not be countered by policy action.

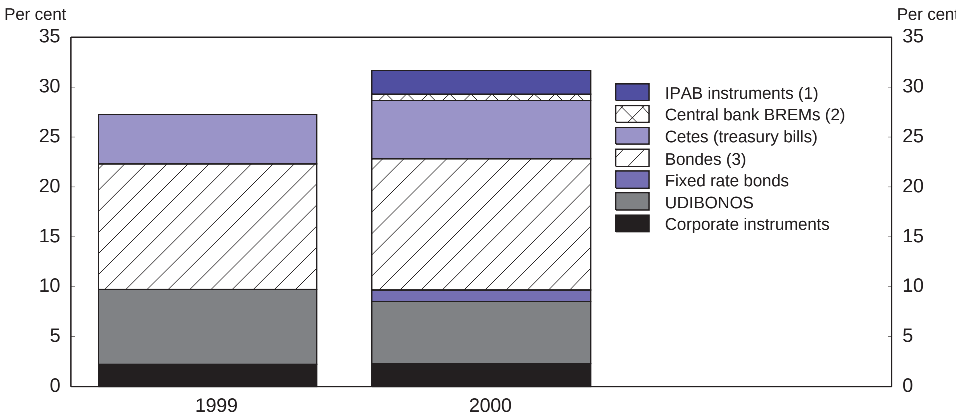
The size of the deposit base is also affected by the insufficient level of domestic saving. The recent reform of the social security system could continue to play a positive role in this regard, especially if it is extended to public sector employees, as proposed by the government.[104] The action of PAHNAL and the savings and loan sub-sector, by capturing small deposits (a segment not generally targeted by commercial banks), could also lead to an increase in aggregate saving. In Mexico, only a small percentage of the population has access to bank accounts, which reduces the available pool of potential savers, while raising issues of equity. Increased access to financial services from viable and safe intermediaries can helpfully increase overall savings. In a country with a relatively young population and a skewed distribution of income like Mexico, however, this is unlikely to have a major macroeconomic impact in the short or medium run.[105]

More importantly, private lending has been to a large extent crowded out by the public sector. Mexico's public sector net debt, at about 40 per cent of GDP (including financial rescue-related debt) is not unduly large when compared with most other OECD countries. However, the domestic component of this debt, at around 25 per cent of GDP, is large relative to the stock of private domestic financial assets and thus for the absorption capacity of the domestic financial market. Indeed, domestic public debt accounted for about 60 per cent of M4 at the end of 2000, which is very high by international standards.[106] Accordingly, public sector debt accounts for 60 per cent of commercial banks' total assets, either in the form of notes related to the financial rescue package, direct lending or through the purchase of government securities. Once unproductive and fixed assets are deducted, about 30 per cent of banks' total portfolio is composed of private sector loans, against more than 50 per cent in most other OECD countries.[107] This situation is replicated in other markets. Government paper accounted for 92 per cent of the balance of money market instruments outstanding at the end of 2000 (Figure 40). Hence, private sector debt, mostly in the form of commercial paper, is insignificant, at slightly above 2 per cent of GDP. Finally, in the insurance and pension fund (AFORES) markets, government debt also accounts for an overwhelming share of total assets, especially when compared with other countries that have introduced fully-funded first-pillar systems, such as Argentina, Chile and Poland (Table 18).

This crowding out needs to be reduced for private sector credit to pick up. Fiscal consolidation has already led to a significant drop in debt levels since 1994 (abstracting from the cost of the banking sector bail-out). Further efforts at reducing net public sector borrowing requirements could lead to a faster decline in debt. It would also take pressure off monetary authorities in achieving further disinflation, reducing the need for high real interest rates and lowering lending rates. Other reforms that could be beneficial are further measures to liberalise legislation on investment by AFORES, in line with government proposals contained in

Figure 40. **Money market instruments**

Per cent of GDP, end-year



1. IPAB instruments: Bonds for Savings Protection (BPAs).
2. Central bank instruments: Bonds for Monetary Regulation (BREMs).
3. Treasury bonds, regrouping 28-day maturity, 91-day maturity and 182-day maturity Bondes, and quarterly payment Bondes.

Source: Bolsa Mexicana de Valores (BMV).

the April 2001 package of financial sector reforms (but still awaiting Congressional approval). Indeed, pension funds at present under-invest in private securities, even when compared to the maximum amounts allowed under prudential rules. But the fact that these rules are relatively stringent and biased towards

Table 18. **Pension fund asset allocation**[1]

Per cent

	Mexico	Poland	Argentina	Chile
Public sector debt	92.6	58.4	56.0	35.7
Non-financial private sector debt	5.4	0.3	2.8	4.0
Financial sector debt	2.0	31.4	15.6	35.1
Stocks	0.0	5.7	12.3	11.6
Mutual and investment funds	0.0	0.0	8.2	2.4
Foreign assets	0.0	0.0	4.5	10.9
Other	0.0	4.2	0.6	0.2
Memorandum item:				
Total assets under management (% of GDP)	3.0	2.0	7.0	60.0

1. As of December 2000. Figures expressed as percentage of total.

Source: Estudio Comparativo sobre Prácticas Internacionales en Gestión de Activos Financieros Previsionales, Conference proceedings, by Julio Bustamante Jeraldo (July 2000).

government debt is one of the factors explaining the lack of offers from private sector issuers in the first place. Measures recently approved, including the modernisation of legislation concerning capital markets, are expected to have a positive impact on credit to the private sector. By tackling issues related to corporate governance and by improving the regulatory framework, this is likely to have a beneficial impact on the efficiency and transparency of the system, leading to a gradual deepening of markets.

The reduction of crowding out would also require changes to public debt management. Domestic debt issued by the Treasury rose from less than 6 per cent of GDP in 1996 to 10.5 per cent of GDP in 2000. At the same time both IPAB and the Central Bank have started to issue new instruments in the domestic debt market. By the end of 2000, these were already equivalent to more than 3 per cent of GDP. Debt management is fragmented, with the Treasury and IPAB acting separately. The recent practice has been to allow each institution to operate in a different segment of the market, so as to avoid direct competition between instruments. But these markets are fungible and a certain degree of substitution is unavoidable. In that regard, the centralisation of debt management could produce a more efficient strategy, an overall narrowing of spreads and a reduction in the crowding out of private lending.

Concluding remarks

The accomplishments of the past 3 to 4 years have been impressive and the 1994-95 banking crisis is increasingly a thing of the past. Two main challenges facing the financial sector remain however: to ensure that the banking system becomes more efficient and to create the conditions for lending to pick up on a sustainable basis. This chapter argued that, in spite of the significant progress made, policy action is warranted on both counts. This would allow authorities to build on earlier successes and correct some remaining distortions and inefficiencies. Box 10 lists the main recommendations for enhancing the efficiency of financial intermediation and helping lending to the private sector to increase on a sustainable basis.[108] These challenges are to a large extent inter-connected. For instance, well-designed responses to banking consolidation will tend to increase the efficiency of financial intermediation. These would include the efficient conduct of competition policy, actions to reduce non-performing loans, rationalisation of the state-owned financial sector and efforts at regulatory simplification. These moves would in turn be likely to lead to more lending by commercial banks. Conversely, actions that might increase lending to households and enterprises, such as removing obstacles to domestic saving and reducing crowding out by the public sector would encourage the development of financial intermediation within the private sector, increasing economies of scale and scope and leading to improved efficiency of financial institutions.

Box 10. Main recommendations concerning the financial sector

a) The consolidation of the banking industry

– *Implement measures to help banks reduce staff and property costs.* Reforms that would increase labour market flexibility and improve the operation of real estate markets would be helpful in that regard.

– *Deal with the problem of loan defaults.* Consider the option of creating separate commercial courts to settle disputes regarding the financial sector. Increase resources available to judicial authorities.

– *Improve credit information exchange systems.* Introduce new legislation to prevent moral hazard issues related to bank ownership of the dominant credit reporting firm.

b) Development banks and government trust funds

– *Rationalise the operation of state-owned financial intermediaries.* Rethink the role of development banks and trust funds, some of which should be merged to avoid overlapping. Rationalisation should aim at ensuring efficiency gains and increasing operational transparency of the sub-sector. Consideration should be given to creating development agencies to replace development banks.

– *Engage exclusively on second-tier operations.* Lending should take place in partnership with the private sector, which should remain solely responsible for first-tier lending. Contracts between the public and private financial sectors should be transparent and ensure a clear assignment of risk in case of default.

– *Avoid crowding out private sector financial institutions.* Development banks should not be used as substitutes for private sector lending. A sharp increase in financial intermediation by the public sector could exacerbate distortions in the economy and lead to long-term pressures on public finances.

c) The weight and efficiency of the regulatory framework

– *Improve co-ordination and revise the role of agencies responsible for the financial sector.* Consider creating an umbrella organisation to institutionalise co-ordination between different agencies. The bank failure resolution system should be redesigned to allow financial authorities to act more expeditiously with problem banks.

– *Increase autonomy of regulatory agencies.* The autonomy of the various agencies should be reinforced, perhaps through the severing of institutional links with the Ministry of Finance. Governing boards should be appointed for a fixed term. Agencies should have access to a secured source of financing.

– *Revise the deposit insurance scheme.* Deposit insurance premia should be reduced and applied only to insured assets. The differentiation of premia by risk should be introduced.

Box 10. **Main recommendations concerning the financial sector** (*cont.*)

***d*) Increasing lending to the private sector**

- *Eliminate barriers to domestic savings.* Actions to provide small depositors with secured access to savings instruments and other financial services, as well as measures to extend the reach of social security reform to government employees would be beneficial in that regard.
- *Reduce crowding out by the public sector.* Maintain fiscal prudence in order to reduce debt levels further. Rethink the public debt strategy for the Treasury and IPAB, centralising management to reduce spreads.
- *Revise some regulations affecting the financial sector.* Liberalise investment rules governing pension funds, to allow them to diversify away from government instruments.

The reform measures set out above would be important in facilitating lending to the private sector and increasing the efficiency of financial intermediation. In that regard, they would complement the already impressive body of reforms implemented in the past 3 years. The effects of these reforms will only be fully felt in the medium-term however, as financial institutions adjust and macroeconomic stability becomes further ingrained. Indeed, the decline in interest rates of recent months may be more important in addressing the challenges described above than any reform measure taken in isolation. What should not be forgotten, however, is that the decline in interest rates is in itself a reflection of the prudence of macroeconomic policies and advances in structural reforms, including those concerning the financial sector. This indicates the need for further efforts on both the macroeconomic and structural reform fronts, as argued in this *Economic Survey*. It also means resisting the urge for more interventionist and hasty measures to increase financial intermediation, and in particular avoiding the use of the development banks as a substitute for the lack of commercial bank lending to the private sector. Although well-designed government action can help correct market failures and help reach equity objectives, these goals are seldom best served by development bank lending. A sharp increase in financial intermediation by the public sector would exacerbate distortions in the economy and lead to longer-term pressures on public finances. It could also potentially jeopardise the hard-won credibility earned over the past few years.

Notes

1. Developments reviewed in the following paragraphs refer to quarterly national accounts data, seasonally adjusted by the OECD. Unless otherwise specified, the discussion is based on changes from one period to the next (at annual rates).
2. Banco de México's monthly Survey of expectations about the business climate 6 months ahead remained quite positive until the end of 2000, but deteriorated in early 2001.
3. In the first nine months of 2001, positive output growth was also recorded in the utilities sector, where electricity production is an indirect measure of economic activity in a broader sense, *i.e.* including the informal sector.
4. Real compensation per employee in the manufacturing industry increased by a little more than 6 per cent in the twelve months to September 2001, while the number of insured workers in the sector fell by 10 per cent, resulting in a decrease in real terms of the wage bill in that sector – often considered as an indirect measure of household disposable income, in the absence of a detailed appropriation account. Overall the wage bill probably did not fall as much in real terms in other sectors of activity.
5. Banco de México's Survey on credit conditions show that supplier credit accounts for almost two-thirds of financing of small firms, whereas "triple A" companies and large firms rely more on commercial bank credit (domestic and foreign).
6. See Chapter II for details on the implementation of the 2001 budget.
7. Part of the increase in private saving in the late 1990s is the counterpart of the lower public saving after the 1997 pension reform. As experienced in other countries, the introduction of a fully-funded capitalisation scheme induces an immediate shift from public saving to private saving, as government revenue finances the transition cost from a pay-as-you-go to a capitalisation system.
8. Alternative measures of unemployment came down in 2000, together with open unemployment, reaching a low in the last quarter. According to information gathered from firms, the labour market became increasingly tight in the latter part of 2000. At that point, survey results showed an increase in the number of workers resigning from one firm to be hired by another, and firms reported that it was increasingly difficult to hire skilled labour in production, administration and sales activities.
9. The registers of the private sector social security institute, IMSS, provide the best measure of formal activities in Mexico. Employment Surveys are conducted only annually, whereas the IMSS records monthly data. Unemployment data for urban areas are available monthly.
10. This index excludes prices of agricultural and livestock products, tuition fees and prices controlled or agreed in concert with the public sector.

11. There has traditionally been a close relationship between exchange rate movements and inflation in Mexico. In the past, nominal devaluations tended to be perceived as permanent, while appreciations were seen as temporary. Thus, agents incorporated expectations of exchange rate depreciations in their pricing decisions, while adjustments to prices were limited in response to appreciations, inducing some asymmetry. More recently, however, the relationship may have weakened, as confidence in the authorities has strengthened and the peso moved in both directions.
12. Within manufacturing, real wage gains were somewhat stronger in the *maquiladora* sector than in the other manufacturing sectors, thus contributing to some further convergence in levels between these sectors. Nevertheless, real wages in the *maquiladoras* (in-bond industries) continue to remain much lower than in the non-*maquiladoras*, in part because of the lower qualifications of the workforce. This gap results in part from the specificity of jobs in in-bond industries which mostly require only low skills.
13. Mexico's oil exports in recent years have amounted to less than 10 per cent of total merchandise exports, broadly equivalent to 2 per cent of GDP. In 2000, they reached a higher point, because of high world prices and strong demand from the United States.
14. The broader metal products and machine and equipment category, which includes cars and ICT goods, accounts for nearly 80 per cent of Mexico's manufacturing exports. A measure of Mexico's export market growth for manufacturing goods, taking into account the specific product mix of Mexico's exports, weighted by the share of each product, shows a very close relationship between export growth and that of the "weighted" market growth. Market growth, based on this indicator, was stronger in 2000 than the "standard" measure; the slowdown from the last quarter of 2000 and into 2001 was also much sharper (as documented in internal research at the Banco de México).
15. For example, in the auto industry and home appliance sectors, firms have rationalised production lines in the United States and Mexico, producing certain models only in one or the other of the two countries. In the textiles industry as well, specific stages of the production process are located in one country and other stages in the other.
16. Because of the deep structural changes in the exporting sector, as a result of trade liberalisation, measures of price and income elasticities of trade are only indicative. Estimates show that manufacturing exports are more sensitive to demand from abroad than to real exchange rates, this feature being particularly clear in the case of *maquiladoras* (estimates by the Ministry of Finance and by the OECD).
17. The transaction will be reflected in FDI inflows of US$12.4 billion in 2001.
18. The ongoing downturn in Mexico is amplified by the oil price fall in 2001, which has induced a procyclical response from fiscal policy (discussed in Chapter III). For the United States, on the other hand, the oil price fall constitutes to some degree a positive supply shock that smoothes the cycle. The heightened interdependence between national cycles in the OECD is documented in *Economic Outlook* No. 70, Preliminary edition (November 2001) Box I.1.
19. Consumer price inflation in Mexico's main trading partner, the United States, is projected by the OECD to decelerate from 1.8 per cent in 2001 to 1.4 per cent in 2003 (*Economic Outlook* No. 70). If this projection was used as a benchmark, the present operational definition of inflation in the main trading partners chosen by the Banco de México (3 per cent) may look too high. However, note that this projection for the United States refers to the private consumption deflator rather than the CPI measure and that it reflects the current slowdown of activity and may be lower than a long-term

inflation forecast. Furthermore, in the "catching-up" with the United States, it may be expected that the differential in productivity developments, given current levels of productivity in the non tradeable sector, may lead to higher inflation in Mexico (Balassa-Samuelson effect).

20. The Banco de México announces a target for the sum of the accumulated balances of all current accounts held by credit institutions at the Banco de México. Targeting a negative accumulated balance ("corto") signals the Bank's intention not to provide credit institutions with sufficient resources at market rates. This tends to put upward pressure on market interest rates. For details of the monetary policy operating procedures see *e.g.* Yacamán (1999) and Box 1 of the OECD *Economic Survey of Mexico* in 2000.

21. Direct bank credit to the private sector had just recovered and from September 2000 to August 2001 it recorded positive growth in real terms at an average rate of more than 4 per cent, year on year. The main source of credit growth during that period was consumer credit.

22. While the peso appreciation has supported the disinflation process, it should be noted that the central bank as a general rule does not provide indications or signals regarding the desired level of the exchange rate. It has intervened in currency markets, essentially through pre-determined rules, to smooth volatility and to accumulate foreign exchange reserves. Some of these operations have contributed to sizeable purchases of foreign currency in the past few years.

23. As standard historical averages are heavily influenced by the few episodes of very high and volatile interest rates, the average calculated here is based only on interest rates during "normal" times, while filtering out "exceptionally" high rates. To identify periods of "normal" and "exceptionally high" rates, a simple two-state Markov-regime-switching method model was constructed. The method considers any month's real interest rate as drawn from one of two regimes, periods of either "exceptionally high" rates or of "normal" rates. Based on this assumption it estimates the characteristics of the two regimes, *e.g.* the respective means, and the law governing the transition between them. The estimated parameter estimates can then be used to infer which regime the process was in at any historical date. Figure 13 shows the estimated probability that the real rate is drawn from the "normal" regime, estimated to have a mean of 3.5 per cent.

24. For example, the Bundesbank of Germany, which has managed to build an exceptionally good inflation track record, has actually used its monetary policy framework in a quite flexible manner. In particular, the monetary authorities have missed their targets on average almost every second year. However, when the authorities did miss the targets, the reasons were well explained (Issing, 1997).

25. The cost of the transition from the old pay-as-you-go (PAYG) pension system to the new scheme is officially estimated at 0.7 to 1 per cent of GDP annually over the next two decades or so, gradually falling below ½ per cent over the longer run. The reform of the health fund of the Mexican Social Security Institute (IMSS) imposes an additional cost on the budget.

26. Total liabilities related to the scheme amount to some 20 per cent of GDP, of which one fifth has already been provisioned. Only the real component of the debt servicing cost is recorded in the budget; adjustment for the nominal component is made for a more comprehensive measure (see below). Some of the schemes do not have an impact on the budget. Chapter IV provides details on the financial sector support programmes.

27. With the increased decentralisation, federal resources have been under pressure from revenue-sharing obligations with States and Municipalities. These obligations amount to more than 3 per cent of GDP annually in the recent years and are expected to continue to be high. Although such transfers from one level of government to another would not affect a consolidated general government account, they affect the budget data, which refer to federal government and public enterprises under budget control, but do not include state and local governments.
28. First, the amount put in the stabilisation fund is relatively small, and it can be argued that large amounts should not be accumulated in this fund, considering the urgent spending needs to enhance human capital and fight poverty. Second, there are strict rules for using the fund: for instance funds were not drawn in 2001 because the oil-revenue shortfall was not due to lower-than-assumed oil prices but to lower volumes sold.
29. The 2000 budget established that higher-than-budgeted revenue of the federal government (from oil or other sources) up to a certain threshold, set at 0.9 per cent of initial projections, would have to be spent. Above that threshold, 60 per cent of the windfall was to be used to amortise debt obligations, and 40 per cent to create a stabilisation fund. Some 9.1 billion pesos (about US$1 billion) were put in the revenue stabilisation fund that year, while 13.7 billion pesos were used to cover the fiscal cost of the debtors' support programmes, as authorised by the Budget Decree. By redeeming part of the debt, the government has alleviated some of the pressure on the budget expected over the years 2003 to 2006.
30. Automatically, when federal tax revenue is larger than budgeted, part of the extra resources go into increased transfers to the states on account of revenue sharing. In addition, two non-recurrent factors boosted spending in the first half of 2000: the general census of the population and activities related to the elections.
31. The PIDIREGAS schemes are "long-term projects for productive infrastructure with differed impact in recording of expenditure". The private sector builds and finances infrastructure for the public sector. The public sector pays contracted obligations after completion of the projects; it bears the commercial and market risks. More than half of investment done by the two main public enterprises (the oil company PEMEX and electricity company CFE) is carried out through such schemes.
32. The price of the Mexican oil mix had reached US$24.6 on average in 2000, compared with a budget assumption of US$16. The assumption set in the budget for 2001 was US$18 per barrel. Changes in the peso exchange rate also affect oil revenue: an appreciation of the peso relative to budget assumptions lowers oil-related revenue – this unfavourable impact on the budget would be only partly compensated by the lower interest payments on the external debt, because of the relatively small scale of this cost.
33. Part of the fiscal cost was covered over the years. In particular, in 2000, revenue windfall was used to redeem part of the liabilities. These liabilities are discussed in more details in Chapter IV.
34. The Budget Revenue Laws for 2000 and 2001 set a limit on public external and domestic borrowing for the year ahead. Domestic borrowing can go over the limit when external borrowing is below, or if additional borrowed resources are to be entirely used to replace external debt.
35. The cost of the pension reform for the private sector (the IMSS reform dates from 1997) has been quantified and it is recorded in the budget (as well as in the

PSBR), but the implications that a reform for the government employees pension regime would have on the budget are not taken into account.

36. The so-called "direct" PIDIREGAS are reflected in public debt, while "conditioned" PIDIREGAS used mostly in the electricity sector create contingent liabilities. In the electricity sector, in particular, subsidies in electricity pricing may jeopardise the future profitability of current PIDIREGAS projects. (See 2001 *Economic Survey* for details on the Mexican experiences in "contracting out" and their budget implications.)
37. There is a clear pattern across OECD countries whereby higher income inequality (measured by the Gini coefficient) is associated with lower tax revenue, as a percentage of GDP. With a Gini coefficient of 0.481 in 2000, Mexico has, with Turkey, one of the widest income distributions among OECD countries.
38. Transfers for low income categories could include the use of individual AFOREs accounts (privately managed pension accounts for the formal labour), money transfers through PROGRESA (existing poverty programme for families in acute poverty). The targeting of the compensation package and its effectiveness would have to be carefully evaluated.
39. Among the least advanced OECD countries, Korea, Spain, Portugal and Ireland recorded much more rapid growth rates than Mexico during their take-off phase and increase in their per capita GDP. Growth rates are calculated from GDP at constant prices and 1995 PPPs for all the OECD countries.
40. Per capita GDP in 2000 was 10 per cent higher than that in 1994 but barely above the 1981 level, the previous recovery (1983-1993) not having made it possible to make up the decline that followed the debt crisis.
41. The estimates are based on 1999 GDP (PPP) data. Employment data for Mexico are based on the national employment survey.
42. In the absence of unemployment insurance, most of the people who do not find their first job, or who lose their job, in the formal sector do not remain "unemployed", but engage in an activity in the informal sector that allows them to survive, or else they emigrate. In urban areas, retail trade and construction are typical informal activities. See OECD, *Mexico Economic Survey*, 1997.
43. The expansion of foreign direct investment (FDI) began in the early 1990s. The proximity of the United States, relatively low wage levels and the availability of a supply of sufficiently skilled labour were determining factors in the decision of several US firms to move production to Mexico. Most inward investment was in the auto industry but also in electronics, computers and clothing, most often in in-bond enterprises (*maquiladoras*) though not always. For example, in 1999, nearly half of FDI was in the automobile sector, 12 per cent in the energy sector, 8 per cent in the agro-food sector, and 5 per cent in the textile industry.
44. The northern States considered here are Nuevo Leon, Sonora, Coahuila and Chihuahua; the growth rate is calculated over the period 1993-99. This region saw its population rise by around 3 per cent a year as a result of large internal migration from States in the south and centre, while total GDP grew by close to 4.5 per cent a year.
45. The States of Oaxaca, Guerrero and Chiapas are considered here. Total GDP growth was less than the national average (1.8 per cent per year compared with 3 per cent). Despite large-scale emigration from these States, their population rose due to relatively high birth rates. Regional disparities can also be gauged from indicators of marginalisation at municipal level, which reveal the existence of areas of extreme poverty even in some relatively rich States. But the statistical data are very inadequate at this level. In contrast, national accounts and public finance data are available by State.

46. Up until the beginning of the 1980s, public investment was channelled primarily to States accounting for the bulk of GDP. This pattern changed significantly only from the mid-1990s (Source: Ministry of Finance, budget data). Like the rail network previously, the road network was first developed in the North and Centre. It is only in the past few years that a sizeable effort has also been made to develop road infrastructure in the South.
47. Three quarters of Oaxaca's exports consisted of agricultural commodities at the start of the 1990s (corresponding data for the States of Chiapas and Guerrero are not available). Between 1994 and 1999, exports of these commodities grew by only 4 per cent, compared with 85 per cent for manufactures. For a detailed analysis of the impact of Mexico's trade integration on regional disparities, see R. Tamayo Flores (2001).
48. The estimates of poverty (moderate and extreme) in Mexico come from the World Bank. Attanasio and Székely (1999) arrive at similar orders of magnitude. Also, according to estimates by the CEPAL and the INEGI, nearly 30 per cent of the population was in extreme poverty in the second half of the 1990s, the poverty line being defined as the cost of a basket of basic foodstuffs.
49. Data for a single person before tax and excluding transfers. The poverty line varies according to the size of the family. See "Poverty in the United States", 2000, US Census Bureau.
50. The Gini coefficient calculated by the OECD on the basis of per capita income in 2000 was 0.481 for Mexico (based on total income according to the Survey of Household Income and Expenditure, INEGI). It was slightly lower in 1992 and 1994 (0.475 and 0.477), showing that income distribution has not become more equitable in the past ten years. By way of comparison among OECD countries, the Gini coefficient for Turkey is close to that of Mexico. It is around 0.4 per cent for the United States and New Zealand and between 0.25 and 0.35 for most other OECD countries (IMF, 1995 and 1996).
51. One of the main instruments for alleviating poverty is the Education, Health and Nutrition Programme (PROGESA) introduced in 1997. This programme, the scope of which has been widened over the years, has features that help to make it effective: it is integrated so as to generate synergies between basic education and health care (monetary payments are made to families provided they attend medical examinations regularly and the children go to school); it is targeted through a transparent process (Larre and Bonturi, 2000, Annex I). In 2001, PROGRESA covered 3.2 million families, *i.e.* virtually the totality of families in extreme poverty in rural and semi-urban areas; it had been extended to small towns (after adjustments).
52. Bassanini A. and S. Scarpetta (2001).
53. Junior secondary schooling ends at 15, the age which marks the end of compulsory schooling in most OECD countries. See OECD (2001), E*ducation at a glance*.
54. The retraining programme for workers (PROBECAT) awarded about 550 000 grants in 2000, while some 400 000 small firms received CIMO support.
55. The tax wedge includes social security contributions (employer's and employee's) and personal income tax. It does not include consumption taxes. Taking account of these taxes would widen disparities among OECD countries with the European Union countries on the one hand, where taxes are the highest both on labour income and on consumption, and on the other hand, Mexico which has the lowest taxes.
56. The informal sector in Mexico covers a diverse and heterogeneous set of individuals and firms and is a wider concept than the "grey sector" in more advanced OECD econ-

omies. Informal units typically have no accounts or premises, and rarely comply with registration obligations or labour regulations. They operate on a very small scale, often on subsistence activities and most often their income is so low that they would constitute a limited taxation base. See T. Dalsgaard (2000).

57. In several OECD countries, SMEs have simplified tax regimes and often fewer regulations to comply with. Recent reforms in Mexico go in this direction; due to the extreme heterogeneity of the informal sector – which includes individual subsistence workers as well as micro enterprises and SMEs – there are no simple solutions; rather, a range of actions is required to help widen the scope of "formality".

58. Incentives also need to be put in place to enable the most profitable projects to be selected, and accountability for expenditure to be identified. For a review of experiences in selected OECD countries and recommendations regarding measures to foster entrepreneurship, see *Implementing The OECD Jobs Strategy* (1999). More recently, for SME's in particular, see OECD (2000) *The Bologna Charter* and *The OECD Small and Medium Enterprise Outlook*.

59. The electronic government procurement system (CompraNet) reduces firms' operating costs, Furthermore, by reducing interaction with government departments and deadlines, it reduces the scope for "unethical" practices. Lastly, by making the procurement process more transparent, CompraNet allows SMEs to compete for government contracts by giving them the same information as the biggest firms. In the United States, the Small Business Administration performs a similar role by ensuring that SMEs can tender for public contracts.

60. Progress made is reported in OECD, *Regulatory Reform in Mexico*, 1999. Business surveys refer to those of exporters conducted by the Bank of Mexico and the Ministry for Trade and Industry (1999), quoted in "Mexico: export dynamics and productivity", Document of the World Bank, No. 19864-ME, 2000.

61. See Annex III for some detail on measures in support of SMEs in Mexico and selected other OECD countries.

62. Poverty in Mexico mainly concerns families in rural areas. Yet approximately half of their income is of non-agricultural origin, including dependent employment and the retail trade. Such "supplementary" incomes are higher wherever the regional economy is expanding. The development of small towns, in particular, constitutes a source of increased income when the roads and means of transport allow the rural population to grasp job opportunities there. See F. Rello (2001).

63. Loans granted by commercial banks were very short term and interest rates high, causing serious problems for both banks and debtors after 1994.

64. The development of "clusters" of industries has been the subject of several OECD studies, notably because of their potential contribution to regional development (for more details on the conditions conducive to the formation of "clusters", see OECD Bologna Conference 2001). The measures taken in certain countries to set up groups of high-tech enterprises have had mixed results. Annex III presents a few examples of the approaches adopted in some OECD countries and summarises the principles that can serve to guide government action in this area.

65. Comparative analysis of the sources of productivity growth in the OECD countries suggests that use of information and communications technologies (ICT) can have an impact on output growth and productivity, especially in countries where income levels are low and the ICT sector is relatively small. See OECD *Economic Outlook*,

No. 67 June 2000, Chapter V, "Recent growth trends in OECD countries" and Bassanini, Scarpetta, Visco (2000).

66. A number of concrete examples are given in Larre and Bonturi (2000).
67. The aim will be to set up industrial links between PEMEX's petrochemical plants and private sector companies in order to achieve process integration and cost reductions for participants in these alliances (information provided by the Energy Ministry authorities).
68. The OECD has carried out detailed studies of the electricity sector, in particular as part of the regulatory reform project for a certain number of countries, see F. Steiner (2000). A summary of regulatory reform appears in Gonenc, Maher and Nicoletti (2001). For details on the United States experience, see Joskow (2000) (which dates from before the crisis in California); and OECD *Economic Survey of the United States* (2001).
69. Once a distinction has been established between electricity as a public utility for residential use and its use as an industrial and commercial input, big industrial consumers (60 per cent of total demand) would be allowed to participate in a market and choose their supplier. Measures would be taken to ensure that private generators enjoyed the same conditions as the big public monopolies.
70. See Annex IV.1. and previous *Economic Surveys* for a description of the Mexican financial system before the 1994-95 peso crisis, as well as the main liberalisation measures taken in the late 1980s and early 1990s.
71. By 1995, the three largest banks held between 15 and 20 per cent of total assets in the banking system.
72. Mexico is not alone in the OECD in having experienced a banking crisis in recent years. The transition from a heavily regulated to a liberalised banking regime was followed by substantial institutional failures in the financial sector; with significant costs to the economy as a whole and to the public treasury in particular. Notably, these have included the savings and loan crisis in the United States and banking failures in the Nordic countries, as well as some serious banking difficulties in Japan, Korea, France, and Spain, as well as Mexico.
73. For more details of the financial rescue package, see Annex IV.2.
74. This cost estimate includes the expected recovery value of taken-over assets.
75. According to original NAFTA rules, no foreign bank could have more than 1.5 per cent market share, while in aggregate, foreign investors could not own more than 8 per cent of total assets in the banking system (rising gradually to 15 per cent by 2000). These rules were replaced in February 1995 by the restriction of foreign controlling stakes in banks whose capital exceeded 6 per cent of the total net capital of the banking system. Another significant restriction in the original NAFTA rules was the requirement that a foreign financial institution hold at least 99 per cent of the common share of the affiliate, severely limiting the scope for partnerships. In February 1995, the minimum stake requirement fell to 51 per cent and it disappeared altogether in January 1999.
76. See Crystel *et al.* "Does foreign ownership contribute to sounder banks in Emerging Markets? The Latin American Experience". The Federal Reserve Bank of New York, May 2001.
77. See Annex IV.3. for more details of the 1998-99 financial sector reforms.
78. The programme, implemented from January 1999 to March 2000, provided discounts ranging from 45 to 60 per cent of outstanding principal, with special incentives for the

pre-payment of outstanding debt. Of the 1.3 million eligible debtors, about 85 per cent participated in the programme, representing more than 70 per cent of loans outstanding. The Ministry of Finance estimated the cost of the programme at about 3.3 per cent of GDP.

79. See Annex IV.6. for details of recent financial sector reforms.

80. With the approval of a new package of financial sector reforms in mid-2001, important advances have been made in the updating of the corporate governance regime and in the revision of capital market regulations, which could be determinant in increasing capital deepening and financial intermediation. See Martínez, L. "La Importancia de la Protección de los Derechos de Propriedad en el Sistema Financiero y en el Crecimiento Económico ". Bank of Mexico Working Paper No. 2000-07, December 2000.

81. These banks were classified according to their geographical coverage: there were 6 nation-wide banks, 7 multi-regional banks and 5 regional banks.

82. By mid-2001, the number of banks operating in Mexico had fallen to 35, six of which under IPAB administration (*i.e.* awaiting sale or liquidation). The number of branches also jumped sharply in the few years following liberalisation, as competition in the retail end of the market increased. After the peso crisis however, the bank branch density stagnated at levels considerably lower than the OECD average.

83. The share of foreign-controlled banks in total assets in the banking system is among the highest in the OECD. The three largest banks operating in Mexico in mid-2001 were BBVA-BANCOMER, CITIBANK-BANAMEX and SANTANDER-SERFIN.

84. *Fideicomiso Liquidador de Instituciones y Organizaciones Auxiliares de Crédito*.

85. See Annex IV.4. for more details of the recent performance of state-owned financial intermediaries.

86. Solvency ratio is defined as the ratio of past-due loans minus loan loss provisions to stockholders' equity.

87. Data on non-performing loans refer to the first quarter of 1997, when new accounting rules took effect. Data for the last quarter of 1996 are not comparable with data for the following period.

88. Operating expenses continued to move up, in spite of the drop in the number of employees. In fact, although some individual banks have obtained significant savings in operating expenses from recent mergers, the banking system as a whole has experienced an increase in staff costs since 1996. These figures are misleading, however, since this has been mostly as a result of the one-off cost of redundancy packages.

89. Financial sector reforms have also tended to introduce incentives for financial innovation, customer differentiation and the diversification in the supply of financial services. The modernisation of the financial system in OECD countries is evidenced by the large increase in the availability of automatic teller machines (ATMs) and other means of electronic payments, such as credit and debit card transactions. In the case of ATMs, the number of terminals in Mexico has increased rapidly, from less than 5 000 in 1994 to almost 18 000 in 2000. But at 18 terminals per million inhabitants, this considerably lags the OECD average of over 500. The number of credit cards dropped by half after the peso crisis, from 14 million in 1994 to 7 million in 1997, and has since stagnated. Debit cards, on the other hand, have more than doubled, jumping from 14 million in January 1997 to 33 million in December 2000. The value of transactions with credit and debit cards taken together has reached 9 per cent of GDP in 1999,

lower than in Canada or the US (19 and 17 per cent respectively), but close to the average level in OECD Europe.

90. This includes funds in the new system, as well as accumulated balances in an old voluntary scheme, known as SAR92. More details on other institutional investors, like mutual funds and insurance sector, are included in Annex IV.5.
91. The Mexican Pension System Law forbids that a single Afores hold more than 20 per cent of the market.
92. The regulatory regime is under revision by Congress. The administration has proposed reforms in order to allow pension funds to invest in a broader class of private bonds.
93. These infrastructures have included the development of rating agencies for local markets, electronic trading systems, delivery vs. payment security settlement mechanisms and the creation of a derivatives exchange.
94. Market structure has been monitored by means of the review of mergers, a large proportion of which have an international dimension. In the last two years, the FCC has reviewed 70 operations affecting several financial markets, including Afores, insurance and leasing. Business conduct has also been monitored through complaints and ex-officio procedures. In the past two years, no anti-competitive conduct has been verified.
95. See DAFFE/CLP/WP2/WD(98)17 for details of the Federal Competition Commission's role in enhancing competition in the regulation of banks.
96. Part of these high costs are related to one-off expenditures related to mergers and acquisitions.
97. There is strong evidence that information sharing between lenders attenuates adverse selection and moral hazard. See Jappelli, M. and Pagano, M. (1999); and Negrin, J (2000).
98. Significant legal changes took place in December 2001, with the approval of a new law that improved the access of individuals to their credit history and provided for the expeditious correction of mistakes. The new law also established regulations that promote competition in credit information through mandatory sharing of certain types of information between credit bureaus.
99. In the past few years, development banks have increasingly relied on second-tier lending. The budgets for 2001 and for 2002 included provisions that cap first-tier lending by development banks.
100. The current insurance quota regime charges a flat fee of 0.4 per cent of banking institutions' liabilities. Under extraordinary circumstances, or through risk differentiation, this fee can be increased up to a maximum of 0.8 per cent. In any case, the base for charging this fee is total bank liability. IPAB has reserved the right to differentiate quotas by risk in the future, but this is not expected until the system reaches greater maturity
101. In mid-2001, CNBV acquired additional powers to introduce prompt corrective actions in case of a threat of bank failure. Although this measure was appropriate, recent interventions in problem banks (including Quadrum Bank for instance) point to the need of redesigning the bank failure resolution system, giving authorities the opportunity to act more expeditiously.
102. A closer observation of banks' loan portfolio indicates that performing loans have started to increase slightly in real terms in the last quarter of 2000 and the first quar-

ter of 2001, although at rates lower than output growth (implying that they are still falling as a percentage of GDP). Indeed, non-performing loans have declined sharply, explaining in large part the contraction in the loan portfolio overall. The growth of consumer credit, starting from a very low basis, has been particularly buoyant. Commercial credit, which still represents the bulk of bank lending, has started to fall less rapidly. By contrast, housing loans continued to contract sharply.

103. These purchases are generally intermediated by commercial banks through repurchase operations.

104. As seen above, the creation of pension funds is affecting the distribution of savings among financial intermediaries. As the government incurs the cost of the transition from the PAYG system to the capitalisation system, reforms are in practice inducing a shift from public to private saving. Beyond that, and because of the voluntary scheme, it can also have an effect on the pool of savings in aggregate.

105. Social banking, with 2.3 million account holders, has an undeniable role in a country where two-thirds of the workforce are not covered by commercial banking services. The main challenge related to non-bank intermediaries in the relatively small social banking sector – which includes savings and loans associations, credit unions, co-operatives, solidarity and popular savings banks – is of a prudential nature.

106. The large share of public sector debt reflects in part the exchange of private paper for public securities in banks' portfolio as a result of the bank rescue operation.

107. Non-earning assets, including past-due loans, accounted for 15 per cent of commercial banks' portfolio in late 2000, high by international standards. Cash and other liquid assets accounted for another 13 per cent, mostly as a result of prudential requirements.

108. These recommendations are broadly in line with these made by the IMF, in the context of the Financial Sector Assessment Programme (FSAP) released in October 2001. The FSAP concluded that "the banking system does not pose a risk to the financial stability of the Mexican economy, but still has to resume broad-based and sound lending to the private sector. Other financial sectors are not expected to be a source of systemic risk in the near future".

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Annex I

List of selected Internet resources on Mexico

Government institutions	
Ministry of Control and Administration Development (SECODAM)	*http://www.secodam.gob.mx/*
Ministry of Economy	*http://www.se.gob.mx/*
Ministry of Energy	*http://www.energia.gob.mx/*
Ministry of Finance and Public Credit	*http://www.shcp.gob.mx/*
Ministry of Foreign Affairs	*http://www.sre.gob.mx/*
Ministry of Labour and Social Welfare	*http://www.stps.gob.mx/*
Ministry of Social Development	*http://www.sedesol.gob.mx/*
Other public institutions	
National Statistical Office	*http://www.inegi.gob.mx/*
Mexican Institute for Social Security	*http://www.imss.gob.mx/*
Federal Competition Commission	*http://www.cfc.gob.mx/*
Federal Commission for Telecommunication	*http://www.cft.gob.mx/*
Federal Commission of Electricity	*http://www.cfe.gob.mx/*
Energy Regulatory Commission	*http://www.cre.gob.mx/*
Mexican Petroleum	*http://www.pemex.mx/*
Financial markets	
Bank of Mexico (Central bank)	*http://www.banxico.org.mx/*
Institute for the Protection of Bank Saving (IPAB)	*http://www.ipab.org.mx/*
Banking and Securities Commission (CNBV)	*http://www.cnbv.org.mx/*
Insurance Commission (CNSF)	*http://www.cnsf.org.mx*
Retirement Fund Commission (CONSAR)	*http://www.consar.org.mx/*
National Protection Agency for Users of Financial Services	*http://www.condusef.org.mx/*
Mexican Stock Exchange	*http://www.bmv.com.mx/*
International organisations	
OECD	*http://www.oecd.org/*
OECD country page for Mexico	*http://www.oecd.org/htm/*M00008000/M00008476*.htm*
IMF	*http://www.imf.org/*
WTO	*http://www.wto.org/*
The World Bank Group	*http://www.worldbank.org/*
CEPAL	*http://www.cepal.org/*

Annex II

Chronology of main economic events

2000

June

The Bank of Mexico increases the *corto* from 200 to 230 million pesos.

July

Vicente Fox, candidate of the PAN party, is elected president.

The Bank of Mexico increases the *corto* from 230 to 280 million pesos.

August

Grupo Financiero Bancomer takes full control of Banca Promex (sold by IPAB).

October

The Bank of Mexico increases the *corto* from 280 to 310 million pesos.

November

Free Trade Agreement between the United Mexican States and the States of the European Free Trade Association signed.

ScotiaBank takes majority stake in Inverlat Financial Group (GFI). IPAB keeps a share in the capital of GFI.

The Bank of Mexico increases the *corto* from 310 to 350 million pesos.

December

The new administration takes office on 1st December.

Congress approves the budget and the Federal Revenues Law for 2001, setting the target for the public sector deficit at 0.65 per cent of GDP.

National Commission of Minimum Wages approves a general minimum wage increment of 7 per cent for 2001.

2001

January

The Bank of Mexico publishes the Monetary Policy Program for 2001. It specifies a medium-term target for CPI inflation of 3 per cent by December 2003. Annual inflation for 2001 shall not exceed 6.5 per cent.

The Bank of Mexico increases the *corto* from 350 to 400 million pesos.

April

The government presents to Congress a proposal for a comprehensive tax reform.

May

Acquisition of Banamex by Citigroup, implying a substantial increase of the inflow of foreign direct investment.

President Fox releases the new administration's National Development Plan for 2001-2006.

The Bank of Mexico reduces the *corto* from 400 to 350 million pesos.

June

Decree approving the Free Trade Agreement between the United Mexican States and the States of the European Free Trade Association, signed in November 2000.

Financial Reform Law approved. It includes modifications to the Credit Institutions Law, the Financial Groups Law, the Securities Market Law and the Mutual Fund Law.

Law on popular saving and credit approved, as well as Law creating the National Savings and Financial Services Bank, Bansefi, a development bank that replaces the former government institution for social savings, PAHNAL.

July

The Bank of Mexico reduces the *corto* from 350 to 300 million pesos.

A 10-year fixed rate peso denominated bond is auctioned for the first time. The Ministry of Finance explains its intention to establish a long-term benchmark yield curve as a prerequisite for the development of a long-term private debt market.

August

Agreement establishing the Mexican Council for Rural Development.

September

Announcement of the expropriation of 27 sugar refineries, taken over by the government to avoid their bankruptcy.

Grupo Financiero Banorte takes full control on Bancrecer, sold by IPAB.

November

The government presents the budget proposal for 2002.

December

Argentina's president announced that the country will suspend its foreign debt payments. Discounts on sovereign bonds from Argentina continue to deepen, while prices of similar Mexican bonds are not affected substantially.

National Commission of Mininum Wages approves a general minimum wage increment of 5.8 per cent for 2002 (the inflation objective for the year is 4.5 per cent).

The Budget for 2002 is approved by Congress. The tax measures include modifications to the income tax regime, the introduction of a tax on telecommunications and the creation of a sales tax on luxury goods and services.

2002

January

The Bank of Mexico publishes the Monetary Policy Program for 2002. Annual inflation to December 2002 shall not exceed 4.5 per cent.

February

The Bank of Mexico increases the *corto* from 300 to 360 million pesos.

Subsidies to electricity tariffs are partly eliminated.

Annex III

Background information to Chapter III

A. Measures in favour of SMEs and the development of enterprise clusters

1. Measures in favour of SMEs

General principles

OECD countries recognize that SMEs can make an important contribution to employment creation, innovation and local development. The majority of countries have, over the years, set up specific aid programmes for SMEs. The work done by the OECD on these policies shows that the different layers of government mechanisms are in some cases costly and that their existence is not always justified or their efficiency clearly demonstrated. The proliferation of specific aid programmes for SMEs may have created distortions in the functioning of the market by protecting some firms from the normal constraints of business life, slowing the elimination of non-viable firms, discouraging requests for alternative financing and, even, dissuading some of them from expanding for fear of losing the aid they receive on account of their size.[1] In the precise case of SME loan guarantee programmes, the results have to be evaluated not only from the point of view of the recipient company, but also in relation to overall entrepreneurial activity, the evaluations carried out having shown that, in some cases, the firms receiving aid would have prospered even without credit guarantees and that in some cases even, the said firms' expansion was to the detriment of others.[2]

The implementation of specific measures for SMEs is only justified in the event of the market weakening or because of administrative or other malfunctions. For example, the fact that unincorporated entrepreneurs and small firms lack information lessens their capacity to grasp opportunities such as accessing distant markets or securing finance when the traditional circuits are lacking. Then again, the sometimes excessive complexity of administrative procedures is liable to prevent new firms coming into being or developing, and the proliferation of firms in the "grey" sector is to some extent symptomatic of this type of problem. Sometimes, too, there are breakdowns in relations between the institutions responsible for aid to SMEs and the ministries or government agencies whose actions affect the economy as a whole, but also impact on the performance of SMEs.

The experience gained by the OECD countries shows that there are a number of guidelines as to how to improve the effectiveness of government action: *i*) the overall consistency of measures in favour of SMEs is vital and necessarily means identifying a medium-term strategy and co-ordinating the schemes pursued by the public authorities in their various areas of competence; *ii*) precise evaluation systems have to be established and information circulated on the results of the measures taken;[3] *iii*) when programmes appear to be ineffective or counterproductive, it has to be possible to terminate or alter them (the introduction of pilot projects is useful in this respect). In order better to co -ordinate government action, some countries have set up specialised agencies, examples being:

- In the United States, the Small Business Administration (SBA) was set up to help and advise SMEs and do as much as possible to protect their interests. It has to ensure that a fair proportion of government expenditure and contracts goes to small firms. Its task is to help small businesses with questions relating to finance, calls for tender and management. The SBA has regional, district and branch offices, in addition to which there are offices dealing with claims arising from natural disasters. Like other federal agencies, it is obliged to report to Congress on its objectives and results.
- France has announced the establishment of an *Agence pour les* PME which would merge the many schemes aimed at facilitating the creation, financing and development of SMEs. Its role will be to keep a permanent watch on over-complicated regulations and take steps to simplify them. A study is also being conducted with the object of rationalising government aid to enterprise creation, which is often ineffective because it is poorly co-ordinated.

In Mexico

Over the years, various measures have been taken to help SMEs,[4] and in particular to facilitate their financing by assuming part of the risk (via loan guarantees, indirect credit operations and tax incentives). Another part of government action is designed to boost R&D activities and technology diffusion by facilitating SME access to new technologies. Lastly, where occupational training is concerned, there is a special programme targeted to SME employees. The box below contains a few examples of programmes in favour of SMEs.

Apparently, there have been cases where the firms that have benefited from programmes and on-line counselling for SMEs were not those targeted at the start of the programmes in question, with very small SMEs (microenterprises) having very limited access to aid. While there have been some instances of services being duplicated, the main problem in Mexico is rather one of inadequate coverage. Above all, though, evaluation processes are altogether insufficient. When they do exist, evaluation results are in terms of output (number of participating firms) rather than impact, because on the whole no methodology has been put together on how to measure the expected results. The 2001-2006 National Development Plan stresses the need to do more to co-ordinate government measures to help business, and provides for the introduction of a formal framework for programme monitoring and evaluation.[5] Moreover, the 2001-2006 Entrepreneurial Development Programme (EDP) of the Ministry of Economy aims at strengthening federalism, support programmes and financing. The programme sets six main objectives: to provide for an economic, legal and regulatory environment which facilitates enterprise development; to facilitate access to financing; to promote entrepreneurial training, management, labour and production skills in order to improve competitiveness; to promote innovation and technological development; to develop production regions and sectors across the country; to rebuild and develop production chains with a view to strengthen the domestic market. To improve co-ordination, the Ministry of Economy announced in June 2001 the creation of an Advisory Council for SMEs. One of its responsibilities will be to co-ordinate its activities with the Ministry for Social Development (SEDESOL) in particular, and also with other agencies.[6]

2. *Types of measure used to encourage industrial cluster formation*

Industrial clusters are production networks composed of interdependent firms, including specialised suppliers, which are grouped together geographically. Sometimes they also

Programmes in favour of SMEs

Existing measures for SMEs, aimed at increasing the productivity and competitiveness of the productive system, include:

– Where occupational training is concerned, the quality and modernisation programme for SMEs (CIMO), set up in collaboration with the Ministry of Education and the Ministry of Labour and Social Welfare, provides technical support and financial assistance.

– A specific programme for technological development in SMEs, drawn up jointly by the Education Ministry and the National Council for Science and Technology (CONACyT), the purpose of which is to help SMEs to access new technologies; the private sector is extensively involved in the provision of training services.

– A broad-ranging programme for industrial policy and foreign trade (PROPICE, 1996-2000), under the responsibility of the Ministry for Economic Affairs, especially targeting measures to improve the quality of Mexican production and encourage the development of enterprise clusters with greater microenterprise and SME participation. The object is to promote the competitiveness of Mexican industry on international markets by diversifying into products with a greater technology content.

– The Regional Centre for Entrepreneurial Competitiveness (CETRO-CRECE), aimed at improving firms' profitability through counselling on administrative, technical and accounting questions. The private sector is in principle involved in the diffusion and implementation of the programme, but its participation in fact remains fairly limited.

– The National Committee for Productivity and Technological Innovation (COMPITE) started up in 1997. It provides specifically targeted counselling for micro-firms and SMEs, aimed at helping them to apply more efficient manufacturing methods and so improve their productivity.

– The Mexican Entrepreneurial Information System (SIEM) is a web site providing information and online advice for SMEs, similar to those that exist in most OECD countries. Its role is to circulate information on the formalities involved in setting up a company and on government aid schemes, and to provide companies with self-diagnostics tools.

involve alliances with universities and research institutes, consultants and special clients. The quality of the locality where the cluster is set up is crucial to the success and expansion of the activities pursued, which is why the authorities, and particularly local government and government agencies, are endeavouring to establish sound foundations by improving infrastructure and the development of competencies and by making the public services already available still more effective. In some cases, the government has conducted information campaigns to promote existing enterprise networks, the effect of which has been to attract additional capital.

Experiences in selected OECD countries

The different OECD countries have taken very contrasting approaches:

– In the United States, local government played a predominant role to begin with by encouraging partnerships between industrial companies.

– In Italy, local government or the regions, in association with certain players established in the region (universities, research centres, regional banks), typically developed organisations given the task of identifying and overcoming the obstacles confronting industrial clusters.

– In Spain, too, it was regional government that took the initiative in developing industrial clusters, with universities and regional financial entities also being involved.

– In Scotland and Wales, Regional Development Agencies sought to attract investment in this type of organisation, including from abroad. In both cases, the Agency also set up programmes to promote training and research.

– In Mexico, the Programme for Promotion of Entrepreneurial Groupings (Clusters), launched in 1997, has been designed and is implemented in a coordinated manner with the participation of entrepreneurs, support institutions, the Federal Government and local governments. The programme covers a wide range of sectors.[7] The productive projects have been designed and launched according to the productive vocation of the regions where they operate. Regarding clusters located in the northern and central regions of Mexico, their geographical position, close to the United States, has had the following positive effects: increasing industrial development of those regions (and sectors); giving access to state-of-the-art technology for SME's; enhancing competitiveness and entrepreneurial innovation.

Best practices

Experiences of various OECD countries show that authorities generally seek to strengthen the capacity of local economies rather than select a few winners. The following best practices have been identified:

Government efforts have to be conducted in partnership with private players:

– Government initiatives have to be aimed mainly at correcting market inadequacies and providing the necessary public goods and services. Measures can be taken to help set up groups of suppliers, facilitate contacts between the different participants in an industrial cluster and ensure related services, since this can improve the results of the firms concerned.

– The aims of government intervention and the intended location have to be precisely identified.

– For the authorities, the emphasis has to be on consolidating existing or nascent enterprise networks, without seeking to build specific firms or entirely new sectors. It is up to the private sector to provide the impetus behind schemes to create industrial clusters.

– Governments have initially to favour low-cost, early profitability projects.

– The level of government that is to be involved varies: a fairly decentralised level makes for a better understanding of the terrain and hence of the precise needs of local industrial clusters, but an overall vision is also necessary, as is the capacity to influence programmes and expenditure, notably when it comes to developing infrastructure.

B. Microfinance[8]

Introduction

Microenterprises are small entities with minimal equipment and little capital, operating in a range of sectors of activity.[9] Like any other entrepreneurs, microentrepreneurs often need to have access to credit to start up or develop their activities, but in most cases cannot offer the traditional financial or productive guarantees required by commercial banks. The difficulty of securing finance is greater in countries like Mexico, where most microenterprises operate in the informal sector. Microcredit differs from traditional credit (consumer, trade or housing credit) in terms of the status of the institution, the amount, the clients and the procedure involved between the client and the institution. Table A1 sums up the main differences.

Because of the social importance of microenterprises in certain countries, and their capacity to reduce poverty and exclusion, a number of savings and loan schemes for the poorer members of the population were set up with public sector backing. Traditionally, they operated within the framework of credit unions and development finance institutions with access to government finance. Over the last twenty years, new strategies have come into being because of the ineffectiveness of traditional practices.[10] As a result, a number of new financial tools have been created, based on a "microfinance" concept. The latter is defined in principle as the "granting of loans in support of an independent activity and the provision of other financial and commercial services (including saving and technical assistance) for people living in conditions of extreme poverty".[11] In practice, the term is used more broadly, not just in cases of extreme poverty. Fieldwork has revealed a number of points in common and recommendations for the different providers of microfinance.

Table A1. **Distinctive features of microcredit**

Category	Conventional credit	Microcredit
Characteristics of the institution	Individual or institutional shareholders Profit-making entity (such as commercial banks Centralised organisation, with branches in the town	Mainly non-profit institutions NGOs converted into financial institutions Offices near to clients: rural and urban areas
Client characteristics	Formal sector firms and individuals giving guarantees	Rudimentary enterprises Low-income entrepreneurs Limited formal supporting documents
Loan characteristics	1) larger amounts 2) longer-term 3) lower interest rates	1) smaller amounts 2) shorter-term 3) higher interest rates
Lending method	1) based on real guarantees and clearly-defined formalities 2) agents' work methods more regular and standardised 3) monthly repayment	1) depends on personality of the customer, requires a cash flow analysis 2) work method requiring more time 3) weekly or twice-weekly repayment

Source: Based on Jansson (2001).

Sources of finance and operational framework

The main challenge facing microfinance institutions (MIs), most of which were initially non-governmental organisations (NGOs), is to play a social role while remaining financially viable. A stable source of financing is therefore vital. Such sources can be divided into four types:

– Grants stemming from multinational aid programmes, national authorities, private lenders (philanthropic and religious organisations, companies).

– Loans from financial institutions at subsidised rates.

– Loans guaranteed by institutions or organisations.

– Loans with commercial banks: this possibility is available above all to programmes that have gained sufficient stature to be economically viable.

If it is not to be counterproductive, however, such financing has to abide by the rules. On the lenders' side, in particular, it is important: not to take the place of local raising of finance; not to cover operating losses; to grant loans on the basis of strict rules, laying down quantifiable realisation indicators; to ensure that programmes are effective within a reasonable period of time; to avoid foreign currency loans; and, lastly, not to unsettle local financial markets by, for example, injecting excessive resources or undermining institutions' efforts to attract saving by making loans available at rates lower than the cost of so doing.

For their part, MIs have to be able to provide guarantees by: using effective and low-cost credit methods (being close to their clients, collecting repayments on a regular basis); checking default rates by means of incentives to encourage repayment; rationalising the cost structure (wage costs, for example). They have to apply an interest rate policy that reflects the real cost of loans, use transparent accounting standards like those applying in the commercial sector, be competent in the use of financial data and employ effective technologies (computing, etc.). Special attention must also be given to the training of staff, who are the driving force in this sector. Lastly, the development of the microfinance sector has to be envisaged within the context of the national economy, and in this respect the authorities have a role to play in providing an adequate regulatory and prudential framework.

The case of Mexico

Recent trends

The microfinance sector in Mexico goes by the name "social banking".[12] The market in question having been deserted by the commercial banks, savings and loan facilities for people excluded from the traditional financial system are provided by a large number of entities,[13] of differing legal form. Social banking institutions may be split into two major groups: popular banking institutions, encompassing financial entities (co-operative or non-co-operative) and microfinance institutions (microfinanciers) which target the marginalised population more especially and mainly do not take deposits. Most co-operative institutions (co-operatives, mutual savings institutions, NGOs) developed without any regulatory framework and without supervision[14] (Table A2). The fact that most of them were not regulated and were in some cases poorly managed has been a source of insecurity (fraud, bankruptcy) both for customers and, more generally, for the population and the financial system as a whole (loss of confidence). Which is why the authorities decided that legislation was needed to ensure that the sector could develop on a sound footing. This is all the more important in that access to the financial market is very variable in Mexico, it being estimated that only 37 per cent of Mexican workers have access to financial services provided by commercial

Table A2. **Microfinance in Mexico**

Institutions	Number	Number of customers	Total assets US$ million	Credit portfolio US$ million	Autorisation to take savings	Regulation and supervision
Savings and loan companies (SAPs)	11	675	647.7	362.7	Yes	Yes
Credit unions	32	19	148.0	94.6	Yes	Yes
Savings and loan co-operatives	157	1 081	692.8	457.5	Yes	No
Joint savings banks	210	190	69.9	n.d.	..	..
Mutual savings banks (estimates)[1]	220	344	n.d.	n.d.	..	..
Total	630	2 309[2]	n.d.	n.d.	..	..

1. Non-affiliated co-operatives and civil associations, for which information is available.
2. Which makes 6 per cent of the labour force.
Source: BANSEFI and CNBV, November 2001.

banks. Microcredit demand is therefore potentially very considerable and the present government, aware of the sector's potential role, has taken a number of measures in this area.

A *new institutional framework*

To strengthen the popular banking sector and enable it to play its role, Congress approved legislation on popular savings and loans in June 2001 (*Ley de Ahorro y Crédito Popular*), the new law being set to be implemented gradually over a two year period.

The aims of the law are:

- To regulate, promote and facilitate the collection of funds and granting of loans by the entities authorized to operate according to the law, and also the organisation and functioning of the federations and confederations in which the said entities come together on a voluntary basis.
- To protect the interests of the people carrying out transactions with the entities in question.
- To establish the conditions under which the popular savings and loan system is supervised by the financial authorities.

Under the new law, viable popular banking institutions are to be organised in network form[15] and will be encouraged to form federations or confederations. Grouping microfinancial institutions together in networks has a series of advantages, including economies of scale and scope.[16] At confederation level, a technical committee will be responsible for managing a protection fund, the latter being a protection system to which each entity will have to contribute a given fee every month (depending on the type of operation and the amount of the deposits to be protected). At federation level, a supervisory committee will be in charge of auxiliary supervision of the entities. Lastly, supervision and the application of the overall prudential rules will be the responsibility of the National Banking and Securities Commission *Comisión Nacional Bancaria y de Valores*, CNBV).

At the same time, the organic law of the National Savings and Financial Services Bank (*Ley Orgánica del Banco del Ahorro Nacional y Servicios Financieros*, BANSEFI) turned the National Savings Trust (a decentralised body of the federal government, *Patronato del Ahorro Nacional*, or PAHNAL) into a development bank institution (BANSEFI), the transformation set to be effective in January 1[17], 2002. The aim of the PAHNAL, set up in 1949, was to stimulate national saving for the benefit of economic development, and to that end it provided attractive financial services to the segment of the population which is excluded from the traditional system. As a result of its transformation into the BANSEFI, it has also the task of promoting saving, financing and investing in the "popular banking" sector. It will act as a second tier bank for participants in the sector, and will operate as the sector's "central bank"; BANSEFI will not extend any direct loans to the sector. It will be in a position to provide services to the participants in the popular banking sector, including financial services (risk management, accounts, etc.) and training staff, while also generating the appropriate technical conditions and starting up telecommunications and computer networks. These operations will contribute to the transition process required by the law on popular savings and loans.

The institutional and organisational framework of the popular banking sector has thus been set up. To help and guide the said institutions so that they are able to meet the regulatory conditions, a number of financial, technical and training support programmes have been introduced, in particular by BANSEFI. Also, in June 2001, the national programme for microfinancier financing (Finafim) was introduced with the participation of the Ministry of Economy and the Development Bank (NAFIN). The aim is to finance a number of selected MIs according to pre-established criteria[18] so as to grant small loans to 40 000 clients (self employed, shopkeepers… going by the name *microchangarros*). The size of the loans (from Pesos 500 to 30 000) and the interest rates (from 1.5 to 7 per cent per month) are set by the programme.

Notes

1. A recent study shows that, in Japan, subsidised loans to small retailers have slowed the elimination of underperforming stores (McKinsey Global Institute, 2000). In the United Kingdom, survey data show that 21% of manufacturing SMEs have received subsidies for innovative activities, and that these have made them less inclined to seek other sources of finance (Freel, 1999); and OECD *Small and Medium Enterprise Outlook*, 2000).
2. The United States and Canada are examples of what constitutes best practice with regard to loan guarantee programmes made available by commercial banks which grant loans directly to SMEs, on the basis of standard trade credit criteria (see OECD, *Enhancing* SME *Competitiveness*, 2000).
3. As soon as a programme is set up, it has to be established how it will be monitored and how its impact will be measured.
4. According to a recent inventory, there are some 200 programmes in favour of SMEs (including micro-enterprises), which are financed from federal funds and distributed between the different ministries. Several of these were put in place over the period 1994-2000 (see World Bank, A *Comprehensive Development Agenda for the New Era*, 2001).
5. As early as 1996, an Intersectoral Commission for Industrial Policy (CIPI) was set up under the aegis of the Ministry for Industry and Trade Development (SECOFI) – now called the Ministry of Economy – to co-ordinate a number of measures impacting on business activity.
6. Co-ordination with SEDESOL will be via the Ministry's Citizen's Advisory Council on Social Development. The Council, which brings together people from both the public and the private sector, was set up in December 1998 to monitor and evaluate social development programmes. Its role is to make proposals on long-term strategy and to improve transparency and the taking of responsibility.
7. *The Bologna Charter* (2000) on SME policies recognizes the important role that clusters can play in stimulating the innovative capacity and competitiveness of SMEs. The following section is based on the specific studies published by the OECD, in particular *Boosting Innovation: The Cluster Approach* (1999) and *Innovative Clusters: Drivers of National Innovation Systems*.
8. The following sectors are covered by the Clusters programme: automotive and auto-parts; electronics; fibers-textiles-clothing; fruits and vegetables, silver jewelry; construction materials; metal-mechanic; furniture; fishing and aquaculture; petrochemical; meat products and tourism.

9. This annex is based on a number of publications dealing with microcredit that are available on the Internet. The sites consulted are given in the bibliography at the end of the annex.
10. These activities can be in very contrasting sectors, ranging from vegetable retailing, hairdressing and small catering outfits to small production and distribution units and more formal services (repairing of household appliances, car body shops, launderettes). These activities are often, but not always, family-based. The number of employees usually ranges from 0 to 5, and can go to as much as 10. In some countries, between 40 and 60 per cent of the labour force are employed in this sector, with the figure for Mexico being put at 40 per cent (National Employment Survey, 2000).
11. Loans were granted at reduced rates and collection rates were low. These practices proved ineffective because lending institutions were often not financially self-sufficient and could cause distortions in the formal financial market. Then again, the funds did not always reach the intended populations because operating costs were high and the opportunities for corruption considerable.
12. This definition was adopted at the 1997 Microcredit Summit. Microcredit providers pointed out at the time that, to be effective, operations aimed at the most disadvantaged would need substantial back-up work.
13. The Social Banking institutions' assets at present amount to a little under 1 per cent of those of the commercial banks. The "social bank" lends to some 2.3 million Mexicans, whereas potential demand is estimated in 20 million.
14. There is not at present any official listing of these institutions. According to CNBV data, it is estimated that there are 630 institutions that take deposits, but some specialists put the figure at between 650 and 700. See *El Mercado De Valores* (NAFIN), June 2001: "*La transformación de las Cajas de Ahorro y Crédito. Un programa para la Expansión de las Microfinanzas en México*".
15. It is estimated that only 8 per cent of them are regulated and supervised by the financial authorities. Also, the majority of them are not authorised to take savings.
16. Popular banking entities will be classified, or reclassified in two groups: either as non-profit co-operatives (with a minimum of 100 to 200 members, depending on the type of operation) allowed to do business only with their members, or as profit-making limited liability companies of unlimited duration, authorised to obtain loans either for their members or for external customers. The said entities will be able to group together in federations (of at least 10 entities) which will combine to form confederations made up of at least 5 federations.
17. Being organised in networks facilitates interdependent relations which, for participants, can result in economies of scale, scope and time, various facilities (access to expert services, new technologies, new markets, etc.) and more flexible transactions with more elastic operating structures.
18. The selection criteria are as follows: at least 3 years' experience in microcredit and a collection rate of over 93 per cent. Currently, 25 MIs have been selected (credit unions, civil associations, NGOs and government aid institutions).

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International organisation websites:

- Inter-American Development Bank *www.iadb.org*
- Consultative Group to Assist the Poorest *www.cgap.org*
- The Microcredit Summit *www.microcreditsummit.org*

Microcredit and popular banking websites:

- Banco del Ahorro Nacional y Servicios Financieros (Bansefi) *www.bonosdelahorronacional.gob.mx*
- Développement international Desjardins *www.desjardins.com*
- GlobeNet, l'Internet associatif et solidaire *www.globenet.org*
- The Micro Enterprise Innovation Project *www.mip.org*
- Microfinance network *www.bellanet.org*
- Nacional Financiera (Nafin) *www.nafin.mx*
- Pôle Microfinancement *www.microfinancement.cirad.fr*
- The virtual library on microfinance *www.gdrc.org*

Annex IV

Background information to Chapter IV

IV.1. The financial system before the 1994-95 crisis: inadequate supervision leading to weaknesses

The Mexican financial system during the 1980s was largely shaped by the emergency measures introduced in the wake of the 1982 balance of payments crisis. The financial sector had been nationalised, so that financial intermediation was almost exclusively in public hands. The operation of the financial system was severely limited by high reserve requirements, capital controls and direct controls (including credit rationing and interest rate ceilings). Part of the rationale for these restrictions included the need to finance a large budget deficit, which peaked at 13 per cent of GDP in 1988. Affected by heavy regulation, high inflation (which reached close to 100 per cent in 1988) and little exposure to innovative foreign influence, the financial system remained undeveloped and characterised by thin secondary markets and a limited choice of financial instruments.

The reform process started in the mid-1980s with the reduction in reserve requirements. This was followed by the phasing out of mandatory investment on government securities in 1988 and the elimination of credit rationing and interest rate ceilings in 1989. Meanwhile, a state-led consolidation process brought the number of banks down from 58 to 18 in the six years following nationalisation. By then, private ownership was already widespread in the non-bank financial sector, which had started to be liberalised a few years earlier.* Some steps were also taken to open the capital account, modernise the regulatory framework and tighten supervision, although these were either timid or ineffective. Finally, in 1991-92 most banks were privatised and entry barriers for domestic investors were eliminated (those for foreign investors remained, however).

The lifting of the restrictions on the operation of financial markets helped correct the misallocation of credit, which had put a heavy burden on the economy. Also, as specialisation and segmentation rules were abrogated, the various activities associated with financial intermediation could be integrated, creating positive synergies and economies of scope, and thus enhancing the internal efficiency of the financial system. Also helping the reform process in its first stages was a benign macroeconomic scenario, not least because initial liberalisation steps were taken in the context of a fiscal adjustment programme that had significantly reduced public sector borrowing requirements. The process was also supported

* Private ownership of non-bank intermediaries was allowed as of 1985. This together with the approval of new stock market regulations led to a rapid development of capital markets and increased lending to the private sector.

by an ambitious privatisation programme, receipts from which had led to a sharp drop in public debt. Given that the nationalised banking system was geared towards financing the public sector, fiscal consolidation was a *sine qua non* pre-condition for financial sector liberalisation. Authorities were also careful to consolidate the banking system before privatisation, with the effect that the system was composed of medium-sized banks, several of them with nation-wide operations, but with no institution holding a dominant position in the market. As a result, liberalisation initially had the desired effect of increasing competition in the banking sector and boosting financial depth indicators, including through a sharp increase in bank lending.

The success was short-lived, however. As in many other OECD countries, financial sector liberalisation was followed by a boom-bust cycle characterised by a deterioration of credit quality and bank failures. In Mexico, as elsewhere, this was caused by two main factors. First, the explosive expansion of credit, which was associated with a sharp drop in saving ratios, was not counteracted by the authorities. Second, supervision authorities were unable to prevent excessive risk-taking by banks. This second factor was of particular importance in Mexico, because ineffective prudential oversight and the poor regulatory/supervision framework was compounded by inadequate accounting standards and the lack of required transparency, hiding the true financial situation of banks. Problems also existed at the level of bank management. The sharp expansion of lending was undertaken with inappropriate levels of human expertise to evaluate risk and allocate credit, while problems also existed in managing credit collection and raising guarantees. The exclusion of foreign participants in the privatisation process, by preventing the transfer of management expertise, was unfortunate in this regard.

IV.2. The financial rescue package

To shore up the financial system in the aftermath of the 1994 peso crisis, the administration acted on three main fronts: *a*) debtor support programmes; *b*) take-over of some banks, by putting them under direct supervision; and *c*) the introduction of measures to strengthen remaining banks, including both a temporary capitalisation programme and a loan purchase mechanism to promote permanent capitalisation.

a) Debtor support programmes

Debtor support programmes mainly involved incentives for debt restructuring. Loan maturities were lengthened and the real interest rate was fixed through an indexation mechanism based on UDIs (a unit of account indexed to inflation). The government is bearing the risk of mismatch in interest rates, but the banks continue to carry the credit and funding risks. The UDI programme originally applied to mortgages, loans to state and local governments and commercial loans, but was later extended to foreign currency commercial loans. Another programme (ADE) was designed for small debtors to provide them with an incentive to continue to service their debt. It involved an immediate interest rate reduction and the possibility of restructuring in UDIs. The banks and the government are sharing the interest rate subsidy. More recent programmes targeted the agriculture and fishing industries (FINAPE), state and local governments, small and medium enterprises (FOPYME) and mortgage debtors. They also provided discounts on debt payments and in some cases, incentives for the granting of new loans, with the cost being shared between the government and banks.

b) Take-over of some banks

Since 1995, 13 banks (some of which were capital deficient, some management deficient) were taken over by the government, the last one in mid-1977. By late 1998, many of them had already been closed or re-sold after being re-capitalised and "cleaned-up" of their bad loan portfolio. These loans were purchased by the government agency responsible for dealing with bank insolvencies, FOBAPROA.

c) Strengthening remaining banks

One of the first measures implemented to cope with the emergency in 1995 was the temporary capitalisation programme (PROCAPTE), which injected capital into the banking system in the form of mandatory convertible subordinated debentures. These were temporary loans (5-year maximum term) convertible into equity (if not repaid). By June 1997, the five banks which had received support under PROCAPTE had settled their debts and the programme was discontinued. Another programme involved "permanent capitalisation" for viable banks and consisted mainly of net loan purchases by FOBAPROA. In effect, the loan purchase by FOBAPROA is a swap in which the flows on a 10-year government bond are exchanged for the flows on part of the banks' loan portfolio. Portfolios were evaluated to be worth between 70 and 99 per cent of book value, depending on the bank. Several incentives were created for banks to adequately recover and collect interest on these loans, including the possibility of "repurchasing" them and provisions for loss-sharing in case there would be a shortfall between loan recovery and the bonds' value.

IV.3. 1998-99 financial reforms

The package of reforms concerning the financial sector, approved in December 1998, included the creation of the Institute for Bank Deposit Insurance (*Instituto para la Protección del Ahorro Bancario*, IPAB), the easing of foreign ownership restrictions, the gradual reduction in the coverage of the deposit guarantee scheme, and the clarification of the legal status of the liabilities arising from the financial rescue package:[1]

– The new Institute for Bank Deposit Insurance became operational in June 1999. Its main roles are to administer the various financial support programmes and manage the deposit guarantee scheme, while implementing a programme to maximise the recovery value of assets, by disposing of these and collecting overdue loans Until the creation of IPAB, asset sales had been slow -since transactions focused on selling banks as a whole. On the other hand, in 1997 and 1998, the authorities had worked to remove the legal and practical obstacles for the direct sale of assets, including tax impediments. IPAB has succeeded in selling the collection rights to several loan packages through public bidding processes and reprivatising several banks that had been under intervention. It has also started to refinance rescue-related liabilities with the aim of improving their maturity profile and lowering debt servicing costs.

– Restrictions which barred majority foreign stakes on large financial institutions – defined as those with more than 6 per cent of total capital in the banking system[2] were lifted and replaced by non-discriminatory restrictions on individual holdings. This measure has opened the way for further consolidation of the banking sector. This is expected to reduce the overall fragility of the system and lower the risk of a systemic crisis. Foreign-controlled (majority-owned) banks accounted for 22.1 per cent of assets in the Mexican banking in December 1999, up from 4 per cent in 1994. With the easing of restrictions, this share is expected to increase further in the next few years.

– The elimination of blanket coverage on bank deposits and the capping of guarantees at about US$100 000 are meant to reduce risks of moral hazard.[3] The deposit insurance fund is to be financed by insurance quotas paid by commercial banks and is expected to induce more prudent behaviour by depositors and lead to better financial management practices by banks – since quotas will vary according to the level of individual bank consolidation. Three-quarters of funds collected from these levies, which are relatively high by international standards, will be used to pay the current fiscal cost of the post-1995 rescue package. The remaining quarter will be accumulated on a contingency fund for future rescue operations.[4]

– In July 1999, IPAB securities with a sovereign guarantee started to be issued in replacement of old liabilities. As of 2000, the government is legally committed to complement IPAB's own resources through budgetary transfers so that the real component of its debt is fully serviced. Until then, liabilities associated with the rescue programmes did not have a regular service schedule and interest payments were recapitalised. As a result, these liabilities continued to grow, reaching 27 per cent of commercial banks' total assets in November 1999, inhibiting fresh lending to the private sector. The issuance and regular service of new guaranteed securities is expected to lead to a pick up in lending to the private sector and lower IPAB's debt servicing costs (as yields are reduced and changes are made to the term structure of the debt). It should also allow for more efficient liquidity management by commercial banks (as securities are traded in the secondary market), helping to strengthen their balance sheets by enhancing profitability.

Notes

1. Other parts of the package, sent to Congress in March 1998, have not been approved by the legislature, namely, the proposals for: *i*) changing the Bank of Mexico Basic law to give it full autonomy for exchange-rate policy; and *ii*) transferring most functions pertaining to regulation, supervision and control of the financial system to the supervisory agency for banks and securities (*Comisión Nacional Bancaria y de Valores*, CNBV), while giving it operational independence from the Finance Ministry.
2. In practice, these restrictions applied to the three largest banks in terms of capital: Banamex, Bancomer and Serfin. Serfin was taken-over by IPAB in July 1999 and sold in May 2000.
3. This measure will be implemented gradually. Until January 2002, several instruments, including liabilities arising from derivative operations, will no longer be guaranteed. From 2003 to 2005, the coverage on remaining operations, mostly savings, checking, time deposits and loans, will be gradually reduced until it is capped at 400 000 UDIs (an inflation-indexed instrument), equivalent to US$100 000.
4. Insurance quotas may vary between 0.4 and 0.8 per cent of banking institutions' liabilities. They have been initially set at 0.4 per cent, independently of the characteristics of the liability. IPAB has reserved the right to differentiate quotas by risk in the future, but this is not expected to occur until the system reaches greater stability.

IV.4. The recent performance of state-owned institutions

After the bailout in 1996/97, the activities of development banks have been sharply curtailed. Efforts have also been made to capitalise institutions and make them more efficient and transparent, including through the stricter application of prudential rules and the tightening of accounting practices. Development banks have also increasingly concentrated on second-tier banking – *i.e.* the provision of funds to commercial banks, which then engage in direct lending to targeted sectors. This has the potential to minimise distortions created by these state-owned financial intermediaries. However, care should be exercised in drawing contracts between government and private institutions, to ensure transparency and a clear assignment of risk in case of non-payment.

The reform strategy has been met with good results: by mid-2001, most development banks' performance indicators had improved significantly, and solvency and capitalisation ratios were adequate and comparable with those of commercial banks (Table A3). Development bank profitability still lagged that of private sector counterparts however, mostly as a result of the importance of the former's non-profit activities. FIDEICOMISOS, non-bank financial intermediaries organised as government trust funds, experienced similar phenomena of dis-intermediation, re-capitalisation and increased efficiency since the mid-1990s. By early 2001, their profitability and productivity had improved and were somewhere in-between those of development and commercial banks.*

Table A3. **State-owned financial intermediaries: performance indicators in comparison**

	Development banks[1]	Government trust funds	Commercial banks[2]
Profitability, productivity			
Net profit/total assets	0.1	0.8	0.8
Net profit/equity	1.0	2.8	8.8
Net profit/employee	0.02	0.8	0.1
Operational costs/balance sheet total	0.2	0.6	5.7
Solvency, capitalisation			
Capitalisation ratios	19.6	–	14.3
Non-performing loans/total loans	6.5	–	5.7
Provisions/non-performing loans	84.4	–	117.2
Equity/liabilities	5.5	–	11.0

– Not applicable.
1. February 2001.
2. September 2000.
Source: CNBV and Ministry of Finance.

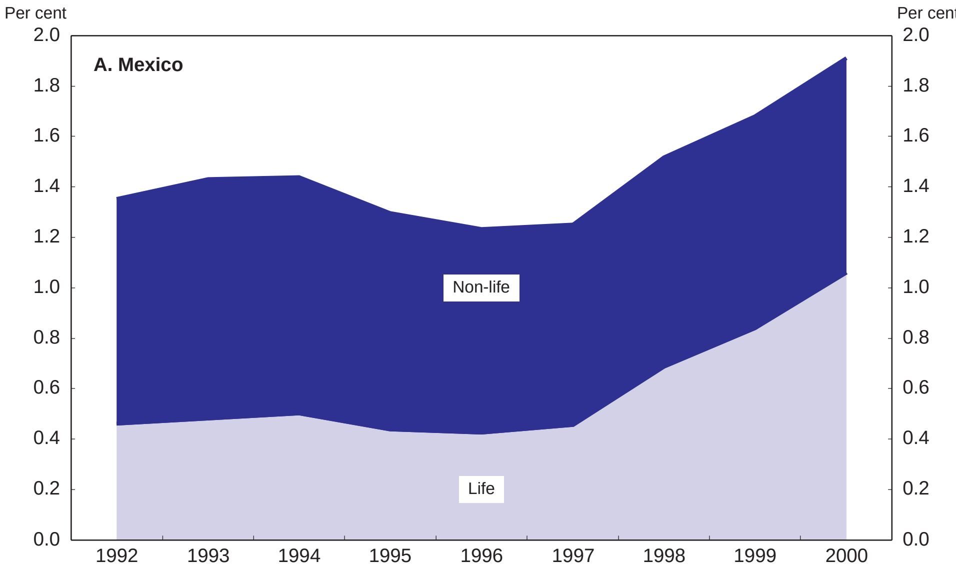
* Capitalisation and solvency ratios are not comparable with those of banks, as Fideicomisos are not subject to the same prudential rules and are directly financed from the budget.

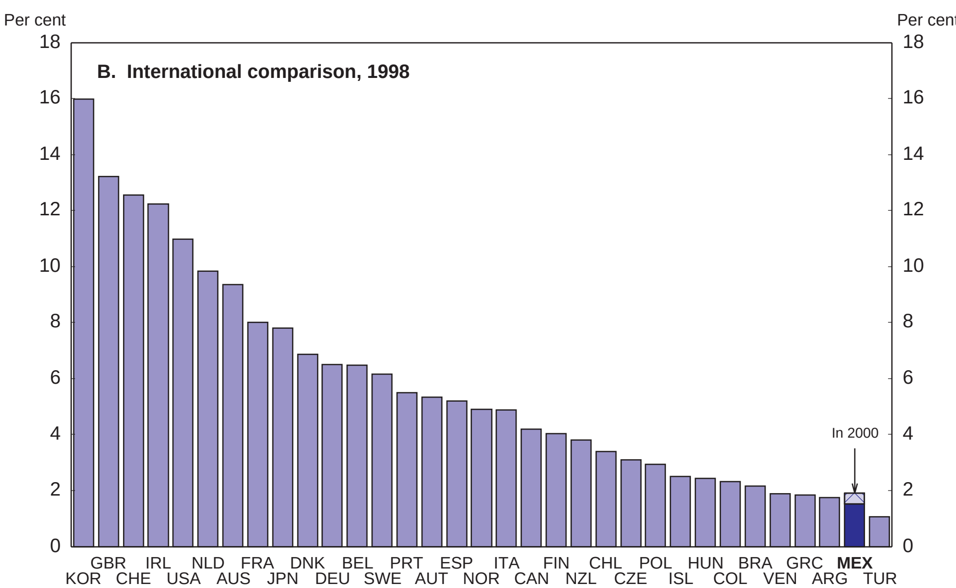
IV.5. Mutual funds and insurance companies

Mutual funds, with almost 9 per cent of total assets in the financial system, are the largest among institutional investors. The mutual fund industry in Mexico dates back to the 1950s, but grew rapidly only after financial sector liberalisation in the 1980s and early 1990s. Since then, its role has been declining steadily as a result of the economy-wide financial dis-intermediation following the peso crisis and more recently, the creation of SIEFORES. Compared with pension funds, mutual funds are more liquid and tend to attract shorter-term investment, acting in many ways as money market funds in the United States.[1] Mutual funds are distributed either by banks or by brokerage houses, although the latter are generally part of bank-led financial conglomerates. The main supervisory and regulatory role falls under the CNBV, although the Bank of Mexico retains a role in supervising repurchase operations and the stock exchange (*Bolsa Mexicana de Valores*, BMV) provides an advisory function. As pension funds, and for similar reasons, mutual funds also invest the bulk of their resources on government securities.

Another important institutional investor in Mexico is the insurance sector, which held assets equivalent to about 2.6 per cent of GDP in December 2000. As with banking, the insurance sector was hard-hit by the peso crisis, but has since experienced a strong recovery (Figure A1). Since 1998, direct gross premia have been growing at an annual average real rate of about 8 per cent (excluding pension funds). The sector has also benefited from the social security reform of mid-1997, to the extent that part of the mandatory contributions (equivalent to 2.5 per cent of wages) are earmarked to disability and life insurance and managed by insurance firms. By late 2000, about 30.8 per cent of reserves in the sector had originated from social security contributions. More recent reforms, including the 1999 creation of specialised health insurance operators (*Instituciones de Seguros Especializadas en Salud*, ISES), are also expected to have a significant impact on the sector. There are 70 firms operating in the insurance sector, 29 of which are subsidiaries of foreign financial groups. Concentration ratios remain relatively high however, with the four largest insurance companies holding 58 per cent of the market in December 2000 (down from 70 per cent in 1994).[2] In spite of the strong recent performance of the sector, insurance penetration rates, both in the life and non-life segments, remain low relative to per capita income, even compared with countries at a similar level of development. This is explained by the low levels (or lack of enforcement) of compulsory insurance, such as automobile and home-owner insurance, and by the relatively unfavourable tax treatment of insurance products compared with the situation in other countries.

Figure A1. **Insurance penetration indicators**[1]
Per cent of GDP





1. Direct gross premium as a percentage of GDP.
Source: Comisión Nacional de Seguros y Fianzas (CNSF); OECD, *Insurance Statistics* 1991-1998.

Notes

1. There are other important differences between mutual funds and voluntary contributions to SIEFORES. First, the tax treatment of savings is slightly more favourable for the latter, especially in the case of longer-term investment. Second, regulations concerning asset allocation by mutual funds are rather restrictive, but less so than for SIEFORES, with the effect that the former can maintain a larger share of portfolio in equity or short-term instruments. Finally, mutual funds had traditionally required higher minimum account balances, making them inaccessible to small investors. More recently however, independent fund managers entered the mutual fund market by offering lower required minimum balances to target those smaller investors.
2. These were Com-Ame, GNP, A. Hidalgo and Seguros Inbursa.

IV.6. Recent financial sector reforms

A series of laws related to the financial sector were amended during 2001. These include the Banking Law (*Ley de Instituciones de Crédito*), the Securities Market Law (*Ley de Mercado de Valores*), the Mutual Fund Act (*Ley de Sociedades de Inversión*), and the Insurance Company Law (*Ley General de Instituciones y Sociedades Mutualistas de Seguros*). Savings and loan institutions are now regulated through the new Popular Savings and Loan Law (*Ley de Ahorro y Crédito Popular*), while a new Law for Credit Information (*Ley de Sociedades de Información Crediticia*) was also enacted. A common theme throughout these reforms is the strengthening of corporate governance practices of the different financial intermediaries. These include limiting the size of boards and creating audit committees to prevent conflict of interest and review all related party transactions. Reforms also include measures aimed at deterring misconduct of intermediaries and promoting investor confidence.

- *Banking Law*: The CNBV was granted powers to determine early corrective measures (*e.g.* limiting dividend payout) for banks with a deteriorating capital base, as well as to disclose all relevant bank information so depositors are able to ascertain the financial strength of each intermediary. Also, tighter rules regarding related lending were introduced which both limit their amount and make a more precise and wide definition of related parties. Finally, factoring and "back to back" operations are introduced as part of banks' menu of activities.
- *Securities Market Law*: The reform aims to promote greater transparency in the capital markets in order to generate confidence and trust among investors about its attractiveness. On the side of publicly quoted companies, corporate governance practices similar to those described above for financial intermediaries were established, while specific minority shareholder's rights were also implemented. Regarding market transactions, a new framework to regulate and sanction incorrect market behaviour was implemented, making it easier for the CNBV to persecute insider trading, front running, market manipulation, etc. The CNBV is for the first time allowed to share information with foreign financial authorities, facilitating the build up of cases of market abuse, while it may now subpoena persons outside the securities industry and obtain key information such as telephone records during investigations.
- *Mutual Fund Act*: This new law aims to completely overhaul the structure and regulation of the mutual fund industry. First, it prohibits banks and brokerage houses to directly act as mutual fund managers, thus effectively strengthening the Chinese walls between asset management and other financial intermediaries' activities such as investment banking and the management of proprietary portfolios. As a result, the new law clearly distinguishes for the first time the role of mutual funds from that of mutual fund managers. The law allows greater flexibility of the products offered by mutual funds, permitting the creation of funds of funds, umbrella funds, hedge funds and funds that invest in foreign assets, derivatives, real estate and in general any kind

of assets, as long as disclosure is accurate and complete. Single mutual funds may now offer different fee and commission structures to different classes of investors. The new regulatory framework also creates the means to wider distribution channels by permitting third parties, including financial intermediaries and specialised companies, to distribute mutual funds.

- *Insurance Law*: To foster the growth of the insurance sector, insurance companies are now allowed to issue medium and long term debt as well as to purchase financial reinsurance, both within clear prudential limits. To protect consumers interests, and in compliance with OECD standards, the law now mandates the specialisation of insurance companies in either life or non-life lines of business. It also establishes a speedier process for revoking the authorisation and liquidating undercapitalised companies and grants executive power to the CNSF to suspend, partially or totally, business operations.
- *Popular Savings and Loan Law*: Provides a regulatory framework for savings and loan kind of intermediaries that did not exist before, thus preventing the scope for abuse within deposit taking institutions. These intermediaries will be subject to prudential regulation that place limits on leverage, concentration of credit, related party transactions etc. A private insurance deposit scheme is allowed for this type of intermediaries.
- *Law for Credit Information Institutions*: This law aims at upgrading the Mexican credit information system to international standards. Among other factors, it establishes for the first time consumers rights to access its report directly from a credit bureau, and creates an expedite process for correction of errors and dispute resolution in credit bureau' data bases. It also establishes mandatory sharing of information between credit bureaus.

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