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OECD Economic Surveys: Mexico

Assessment and recommendations

Despite improved macroeconomic fundamentals, Mexico is being hit hard by the financial crisis and world economic downturn

Mexico is affected severely by the global recession, like many other OECD countries, with negative economic, budgetary and social consequences. Although the banking sector has so far weathered the financial crisis rather well, manufacturing industries are being severely affected by the downturn of global demand, particularly in high-value added industries. Shipments of goods to US markets have plummeted at a fast pace, following a global readjustment of industrial inventories and leading to a sharp contraction of industrial production. Like other emerging markets, Mexico has suffered from reduced net capital inflows, as investments returned to safer havens, contributing to a decline in equity prices, rising interest rate spreads and a large depreciation of the peso. In addition, several country-specific shocks have had adverse consequences, such as the outbreak of influenza A H1N1. Also, the budget has been put under pressure by the sharp decline in energy prices, as oil exports provide a large share of tax revenues, although temporary relief comes from a price hedge and weaker peso. The rise in uncertainty has depressed business and consumer confidence to record lows, which, coupled with tightening credit conditions at home and abroad, is bearing on consumption and investment. Despite the slowdown in activity and declining commodity prices, inflation has remained persistently high as prices of tradables and food are adjusting with a lag.

In this environment, it is likely that growth will be sharply negative in 2009 with only a moderate recovery in 2010. The sharp and broad-based drop in activity is set to increase unemployment, which is projected to reach levels last seen during the financial crisis of 1994-1995. As pressures from high commodity prices wear off and the output gap widens, inflation is likely to recede and reach its target by the end of 2010. With monetary and fiscal stimulus taking hold and world activity picking up, demand should stabilize with quarterly growth rates becoming positive towards end 2009 and reaching about 4% in annualised terms by end 2010. Risks to the outlook remain on the downside, driven by continued uncertainties with world financial markets and growth. Risks can also arise from foreign financing needs, if conditions for emerging markets worsen further.

Macroeconomic stability and increased policy credibility has helped to deflect severe financial stress

Since the Tequila crisis in 1994-95, which caused a dramatic output contraction, much progress has been made in improving macroeconomic policies, reducing economic imbalances and restoring policy credibility. The inflation-targeting framework has been successful in better anchoring price expectations. The fiscal rule has been instrumental in achieving balanced federal budgets and reducing public indebtedness. The development of domestic bond markets and a pro-active debt management strategy have increased maturities and substituted foreign for domestic debt, thereby reducing exposure to currency and rollover risks. The low current account deficits, in turn, have lowered foreign financing needs. The build-up of foreign reserves, facilitated by the rise in oil prices, the swap with the US Federal Reserve and the IMF's Flexible Credit Line, provided another cushion to face economic shocks. Reflecting this better policy environment, Mexico has avoided the type of full-blown financial stress currently experienced by some other emerging markets, although it could not totally protect the real sector from the global downturn.

Monetary policy has become more supportive, but interest rates might be lowered further

Although there was a cycle of global monetary easing that, in general, started in the third quarter for industrialized economies and in the fourth quarter for some emerging markets, Mexico's central bank kept its policy rates unchanged so as to contain inflation expectations at a time when inflation was increasing. Monetary policy loosening took place later than in other OECD countries, reflecting risks of additional capital outflows and further exchange rate pressure. With price pressures showing signs of levelling off in early 2009 and activity on a clear downward trend, policy rates were lowered in several rapid steps. *The deterioration of economic activity in Mexico might provide room for a further lowering of policy rates, so as to sustain demand and improve financial conditions, while keeping an eye on the evolution of actual and expected inflation*. Quantitative estimates suggest that exchange-rate pass through has become more limited, reflecting strengthened policy credibility and better anchored inflation expectations, so it will be important to preserve this hard-won credibility. In an environment of tight credit supply and weak market prospects, lower interest rates may not have a large direct effect on consumption and investment, but it could have some beneficial effects on confidence.

The authorities should remain vigilant in monitoring overall financial stability, including corporate balance sheets

The financial sector looked relatively sound at the onset of the crisis and its limited exposure to foreign assets and liabilities reduced vulnerability to shocks. Conservative lending policies helped contain credit demand and avoided housing bubbles. The sector remains well capitalised and profitable, which partly reflects strict prudential regulations that limited banks' asset exposure to currency risk and risky products. High net interest margins and operating costs also provide some cushion for absorbing losses. However, the financial indicators tend to be backward looking and can change rapidly as the economy worsens. The weakening economy and declining asset prices may lead to second-round effects on Mexican banks with a feedback to the real economy. Both consumers and enterprises may find it difficult to service their debts, thus affecting the quality of bank portfolios. Vulnerabilities might also arise from the enterprise sector, which relies on foreign sources for close to half of its credit needs, if maturing foreign debt cannot be rolled over. *These risks should be monitored closely by the authorities.*

A welcome fiscal stimulus package in 2009

Fiscal policy has been prudently guided by a framework aiming at balanced budgets and saving part of oil revenues in a stabilization fund. The framework has contributed to securing long-term sustainability and improved policy credibility. The fiscal stimulus measures in the 2009 budget and the January 2009 package to stimulate demand, which account for 1.6% of GDP, are broadly welcome. In particular, the increase in infrastructure spending, subsidies to employment and increased social transfers with sunset clauses should smooth the downturn. However, the fiscal package contained provision to freeze nominal energy prices, which is a socially-regressive form of support and an inefficient type of economic stimulus. *Shifting more of the stimulus to support employment and incomes would enhance its impact on demand and protect workers from falling into poverty.*

Fiscal policy should remain supportive in 2010

Budget revenues are projected to fall in 2010, reflecting the depressing effect of low world energy prices on oil revenue and the negative influence of the downswing on non-oil tax revenue. While oil revenue has been protected in 2009 by a hedge on oil export prices, this advantage will disappear in 2010. Thus, the OECD's *Economic Outlook* projects that the government deficit (in terms of net lending or public sector net borrowing requirement) will increase from some 3-4% of GDP in 2009 to about 5% of GDP in 2010, assuming no corrective measures to cut expenditure or raise taxes. Mexico would be able to cover this level of borrowing, including by drawing down oil stabilization funds that were accumulated during the past period of high energy prices. To help meet external financing requirements, the government has secured large sources of foreign lending from the capital market, multilateral agencies and the US Federal Reserve. *The stance of fiscal policy should not turn restrictive in 2010, as ongoing support to domestic demand will remain necessary to combat the economic downturn; thus the deficit should be allowed to increase by the amount of automatic stabilizers, considering the use of the stabilization funds for the financing of this deficit while at the same time not imperilling long-term fiscal sustainability.* The preliminary budgetary projections for 2010 submitted by the government go in this direction: the expected fall in oil-related revenues is financed by drawing down oil stabilization funds.

Mexico faces the challenge of managing oil revenue

Like other large oil-exporting countries, Mexico faces the challenge of managing the macroeconomic impact of oil revenue. While such revenue provides useful resources to the economy, its management raises a number of difficult issues. Oil revenue tends to be highly volatile and the budget risks channelling this volatility to the non-oil parts of the economy; indeed, in Mexico, public consumption and GDP are highly volatile by OECD standards. In addition, because oil price fluctuations tend to be synchronized with the world economic cycle, the budget has a tendency for pro-cyclicality, with more spending in good times and spending cuts during downturns. This is reinforced in Mexico by the balanced-budget rule, which requires matching the swings in revenues by parallel swings in spending.

Thus, the fiscal framework should be adjusted to better shield public expenditure from the high volatility of oil revenue. In some countries, this is achieved by transferring the bulk of oil wealth to future generations, thus minimizing the injection of oil revenue into domestic demand. In Mexico, however, it seems both efficient and fair that the current generation uses oil revenue to finance economic development, so as to raise present as well as future living standards. Hence, fiscal policy should seek to smooth the injection of oil revenue into the economy over the cycle and avoid abrupt changes in public spending. Mexico established several oil-stabilization funds for this purpose but accumulated savings were capped at relatively low levels, which made the funds less useful for the purpose of macroeconomic stabilization. The recent decision to raise the maximum size of the oil stabilization funds goes in the right direction, but *Mexico should consider eliminating this limit altogether*. Also, *like other oil-exporting countries, Mexico should seek to strengthen the counter cyclical framework of the budget, by adopting a new fiscal rule adjusted for the cycle*. This would lead to prudent fiscal management practices including *a)* smooth growth of public spending in line with economic growth, *b)* automatic savings of oil revenue above what is implied by the rule when the oil price is high and *c)* automatic spending of accumulated savings when oil revenue is low. This would improve the role played by fiscal policy in macroeconomic management, would phase in gradually the injection of oil wealth into the economy and would contribute to long-term sustainability. The appropriate level of the limit on the structural non-oil deficit would depend on various factors, many of which come with large uncertainties, such as level of oil extraction. *Given these uncertainties, the limit for the non-oil structural deficit should be reviewed regularly, so as to stabilize the net financial position of the public sector*: increases in net financial assets would suggest that there is space for running a higher non-oil structural deficit, while increases in net financial liabilities would call for tightening the non-oil structural deficit target.

Public finances should be prepared for the long term decline of oil

Declining oil production will squeeze the contributions made by PEMEX to the budget over the next two decades, putting pressure on social spending and infrastructure development. It is therefore essential to prepare the public finances for this decline. The recent reforms to improve governance of Pemex are welcome, but more needs to be done. The policy of keeping gasoline prices constant in real terms – which at times implies lower prices than in the United States –, and subsidies on LP gas and electricity for household use, are inefficient and unfair. *Instead, gasoline prices should move in line with international reference prices, an energy excise tax should be introduced, and subsidies on other energy products should be removed*. Keeping gasoline and energy prices at present low levels comes with few benefits: empirical research shows that the subsidy is mainly captured by well-off social groups and tends therefore to be regressive; it also leads to a distortion in the allocation of resources, reducing interest for alternative and sustainable sources of energy; finally it encourages the burning of hydrocarbons, with detrimental effects on greenhouse gas emissions and global climate change. While helping low-income groups with the price of energy might be a legitimate social goal, this can be achieved in better ways, for instance with means-tested income support schemes or subsidies to cooking gas in poor areas. It is also essential to boost the non-oil tax base. About 30-40% of budget revenues depend on oil, while non-oil taxes are only about 10% of GDP, which is low compared to peers or the social needs of Mexico. While recent tax reforms are welcome, *more needs to be done to broaden the tax base*. Further reform that tackles in particular exemptions in both direct and indirect taxes is needed in line with recommendations in the 2007 *Survey*. Finally, more needs to be done to raise the efficiency of public spending in education and health, as discussed below.

Spending efficiency in health can be improved

Although public spending per capita on health has more than doubled in real terms since the 1995 financial crisis, it remains low by international standards. At the same time, Mexico's health indicators lag behind those of most OECD countries. Although population health indicators have improved over the past two decades, life expectancy at birth remains lower, child mortality higher and outcomes highly uneven across socioeconomic groups. While this partly reflects Mexico's lower per capita income, incomplete coverage and fragmentation in services provision contribute to poor outcomes. Further spending pressures will arise from the plan to achieve universal health insurance by 2011. While additional spending may help, improving health outcomes will result primarily from increasing the efficiency of spending. Although current reforms go into the right direction, better outcomes in some Latin American countries with similar per capita income and spending suggest that there is further scope for improving the efficiency of the health sector in Mexico.

The fragmentation of the health system should be reduced

The fragmentation of the health care system into several separate units that vertically integrate financing, insurance and provision functions contributes to inefficiencies, including by duplicating facilities and by increasing costs. The social security institutes cover salaried workers in the formal sector, while the "popular health insurance" scheme (*Seguro Popular*) covers part of the population working in the informal sector and non-salaried formal workers. There is no split between insurer and provider functions, which has reduced quality of services and led to cost inefficiencies because money does not flow to the highest-quality and most efficient providers. To reduce administrative costs in health systems with multiple insurers, other OECD countries have introduced centralized claims management systems. While the health reform of 2004 and current policies, including the sharing of new facilities between insurers, address some of these issues, there is further scope for improving the efficiency of spending. *A clear split between the functions of insurer and provider of care should be introduced throughout the system and any insurer should be allowed to contract with any provider. Administrative costs could be reduced by introducing a unified claims management system.*

Universal health coverage may require making insurance mandatory

One third of the population, mostly in low-income groups, has no health insurance, which has contributed to poor health outcomes. The uninsured are less likely to receive appropriate preventive care and timely treatment when sick, which results in higher spending, often out-of-pocket, and worse outcomes. The government is aiming for universal coverage by 2011 by further expanding *Seguro Popular*, which has been successful in increasing coverage by about 25% of the population since 2004. However, coverage should be made mandatory to ensure nobody is inadvertently left uncovered and to contain adverse selection (the healthy may avoid paying premiums) that could undermine the finances of the programme. This is a key lesson from the experience of other OECD countries that have recently adopted universal health insurance. To achieve this, *the authorities should enter discussions about making health insurance mandatory and identifying resources to finance the likely increase in public spending in a sustainable way.*

Enrolment into secondary education should be enhanced through an expansion of conditional cash transfers to poor students

Mexico's relatively poor PISA scores and low secondary school enrolment are strongly related to socio-economic backgrounds. Less than 50% of children from households in the bottom decile of the income distribution attend secondary school, in contrast to more than 80% in the top decile. To improve coverage in secondary education, the government has recently introduced the *Jóvenes con Oportunidades* programme that gives cash grants conditional upon secondary school completion. *Expanding the scope of this programme can be a good way of increasing coverage and spending efficiency in education.*

Education outcomes would benefit from implementing the Alianza quality-enhancing programme and improving incentives in schools

Education outcomes in Mexico are also influenced by poor school and teaching quality. Until recently, the teacher selection process was not transparent, and the main teacher incentive scheme continues to put excessive weight on seniority, which lowers teaching quality. Schools have limited autonomy in budgeting, instruction and personnel and there is no national exit exam after secondary education that would make schools accountable to the government and parents. In other OECD countries greater autonomy and exit exams have been major factors in improving teaching quality. Existing evaluation programmes that focus on rote knowledge instead of analytical capabilities, and the undercapitalisation of the school system, are also likely to have contributed to poor PISA scores. Some of these issues are being addressed by recent reforms such as the quality school programme and the (voluntary) Alliance for quality education. This agreement between the government and the main teachers' union should be implemented country-wide. *In particular, the teacher selection process should be based on a nation-wide entry exam, as planned by the Alliance and implemented for the first time in 2008. Incentives for teachers should be more closely linked to*

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teaching performance and existing evaluation schemes should be consolidated and focused on analytical capabilities instead of knowledge.

Mexico's living standards are catching up only slowly

Though improving, the growth performance in Mexico over the past 20 years has been disappointing when compared to other emerging markets, reflecting mainly weak labour productivity growth, which was slightly negative over the period. A breakdown by industry shows that the poor performance was broad based – the weak relative performance of productivity applies to about 80% of total employment. Growth in Mexico has relied more on the accumulation of production factors, notably the utilisation of labour resources, than on rising productivity. By contrast, the better performing countries, such as Chile and Turkey exhibit an "intensive" growth path, with a greater reliance on high labour productivity growth rates. However, breaking down Mexico's performance into 5-year periods reveals a more encouraging story, as productivity growth has increased continuously from each 5-year period to the next. Although productivity and per capita GDP growth rates have increased, they remain too low to allow rapid convergence with the high-income OECD countries.

Mexico's slow catch up towards higher levels of incomes is mainly due to the lack of progress with some growth-friendly structural reforms. OECD regulatory impact indicators show that Mexico is in many key sectors close to, or equal to, the maximum (negative) regulatory impact, and that Mexican productivity would be higher with less strict product-market regulation. The largest negative impact is in the network industries (electricity, gas and water) where Mexico's product-market regulation is much stricter than in most other OECD countries.

Structural reforms should continue to boost productivity growth

The recent significant reductions in import tariffs should help the economy take fuller advantage of trade and investment integration, which could be a relative strength for Mexico given its geographic location. Reforms introduced in the past two years, including those to promote competition and transparency in the financial sector and, to a lesser extent in telecommunications, will also stimulate the dynamism of the economy. Despite this progress, further reforms are needed to boost overall and within-sector productivity. Relative weaknesses in education, infrastructure, financial development, the rule of law, trade integration and investment levels, especially in machinery and equipment, as well as a lack of competition arising from overly restrictive product market regulation and excessive state control come out in various studies as explaining why Mexico has not grown as fast as other countries. Science, technology and innovation policies can also be important over time as noted in the OECD *Review of Innovation Policy* in Mexico.

High priority should be given to structural reforms with rapid payoffs

There are certain structural reforms that can both help countries exit from the financial crisis and provide longer-term growth benefits. Potentially rapid pay-offs can be obtained from *reforms in education and training, and from reducing entry barriers to business*. These can boost demand by improving employment prospects and growth by enhancing future productivity. *Increasing competition can bring gains to productivity over time, and recent efforts in this area should be continued without delay.* The road, rail, port and telecommunication networks remain weak compared to those in its emerging market peers. In this context, the rise in infrastructure spending in the 2009 budget is welcome. The decision to conduct a broad review of existing regulatory policies is an important step towards reducing a key structural barrier to faster growth. *There is scope for regulatory action to increase competition in the main network industries, electricity, gas, water, telecommunications and transport*. Greater competition would also help safeguard gains of competitiveness from the lower exchange rate by containing price pressures.

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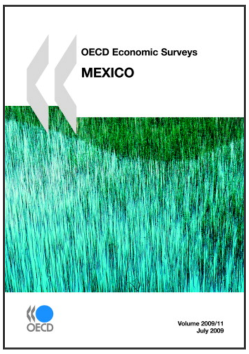

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