PART I.

OVERVIEW OF THE MEXICAN ECONOMY

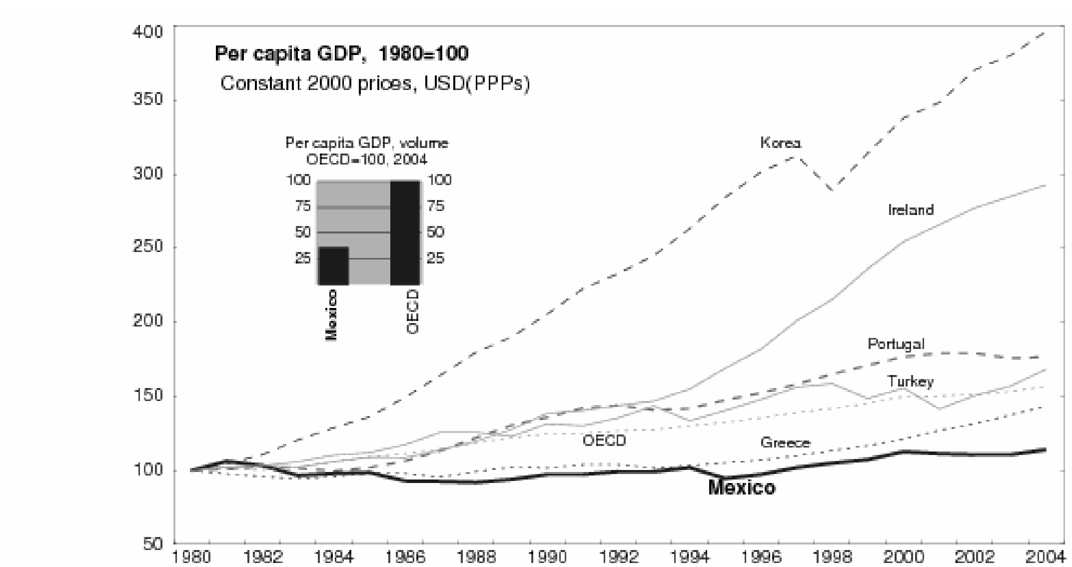
Chapter 1.

An overview of economic performance and the structural environment in Mexico

Introduction

This chapter provides an overview of the performance and the structural characteristics of the Mexican economy. It is divided into two main sections. The first section describes the performance of the Mexican economy over the past two decades and the current situation and prospects. While great progress has been made to achieve macroeconomic stability the rate of growth of gross domestic product (GDP) per capita remains insufficient for a rapid catching-up to the levels of other OECD members (Figure 1.1). The second section therefore discusses some framework conditions that are of key importance to raise growth potential of the Mexican economy and which would at the same time improve productivity in the agricultural and fisheries sectors.

Figure 1.1. Mexico's Growth performance in comparison



1. The average growth rate of GDP per capita is calculated in constant 2000 prices, USD (PPP), over the period 1996-2004. The level of GDP per capita is for 2004.

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

The economy has become more open in the 1980s and 1990s

The process of economic liberalisation commenced in the 1980s. Restrictions on foreign investment were reduced and trade policy was liberalised and in 1986 Mexico became a member of the General Agreement on Trade and Tariffs (GATT). A process of product market liberalisation also began in the 1980s with the lifting of price controls, including in agriculture, and the deregulation efforts in transport and communications. Financial market restrictions were lifted from 1988 with the elimination of credit quotas to high priority sectors, the lifting of interest rate ceilings and a limited reduction in ownership restrictions in the banking sector.

The key step in the liberalisation in the early 1990s period was the North American Free Trade Agreement (NAFTA). Negotiations began in 1990 and concluded in 1992, with the treaty coming into force from the beginning of 1994. This continued the opening process and dramatically increased the size of markets available for free entry of Mexican goods and increased Mexico's exposure to import competition from the United States and Canada, which enhanced efficiency of Mexican firms. With the opening of the economy, exports and imports combined have increased as a share of GDP from 39% in 1990 to 61% in 2005. Mexico's major trading partner is the United States, which accounts for over 70% of Mexico's agricultural exports and over 85% of exports of agricultural and fishery products. The United States also supplies more than two-thirds of Mexico's imports of agricultural and fishery products. The main exports[1] of Mexico to the United States are machinery and transport equipment (56%), other manufactures (22%), mineral fuels (12%), agricultural and fishery exports (including food, live animals, beverages and tobacco) (5%) and chemicals (4%). Following NAFTA, agricultural and fisheries exports have almost doubled and the range of products has diversified. Imports of agricultural and fisheries products are larger than exports and have more then doubled during the period since NAFTA.

Macroeconomic performance

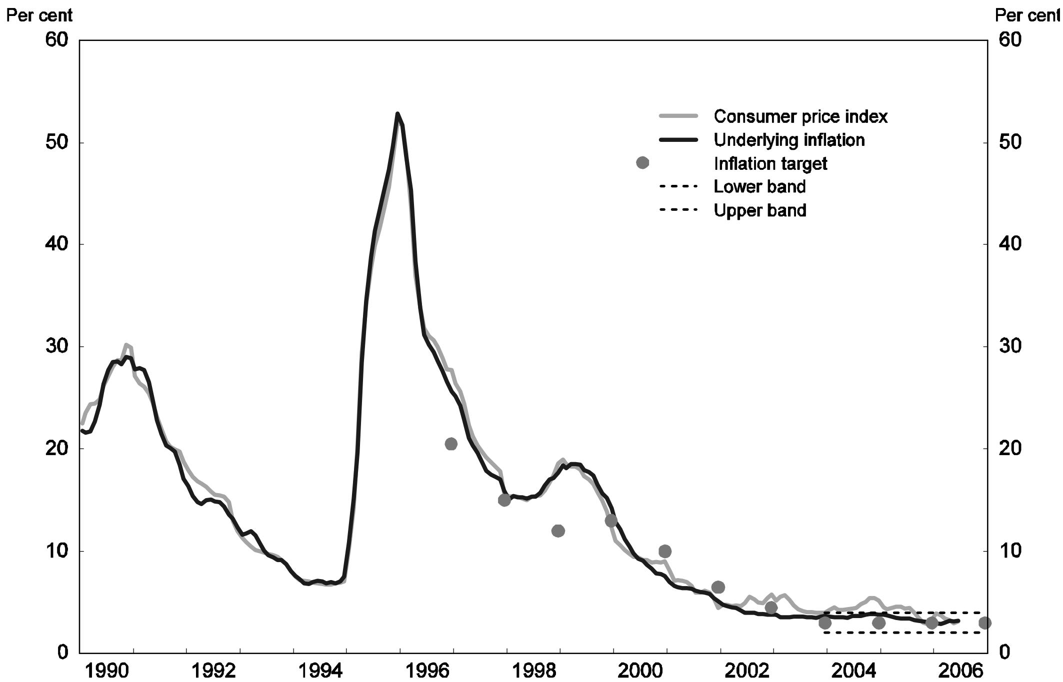
From the debt crisis in 1982 to the currency crisis in 1995

During the past 25 years the Mexican economy has suffered two major crises, the debt crisis in 1982 and the currency crisis in 1995. In 1982 the fiscal deficit had reached 17% of GDP and Mexico was no longer able to service its increasing foreign liabilities. The government defaulted on its sovereign debt obligations, sparking the debt crisis, and necessitating a large consolidation of the fiscal position throughout the 1980s and into the 1990s. This consolidation was interrupted by a terms of trade shock resulting from an oil price collapse and a major earthquake in 1985, but then continued in earnest from the mid 1980s through to 1991. From 1988 to 1994 the central objective of monetary policy was to stabilise the exchange rate, first by fixing the peso rate to the US dollar, then by a crawling peg followed by a system of widening fluctuation bands, where the peso depreciated at a pre-announced daily rate. This implied setting a fixed limit on the appreciation of the peso *vis-à-vis* the dollar, but allowing a gradual depreciation of the peso, and a gradual widening of the fluctuation band.

In the early 1990s Mexico was benefiting from earlier reforms in the 1980s with GDP growth of around 4% per annum that had begun in earnest in 1989 after seven years of stagnation. However, high population growth meant that per capita GDP growth remained below 2%.

The fiscal consolidation improved the fiscal position from a deficit of around 15% of GDP in 1986 to a surplus by 1991, mainly through a cut in the expenditure to GDP ratio. However, from 1992 onwards there was a return to a loosening stance with the fiscal balance returning to a small deficit. The effective loosening was greater as the government permitted rapid net lending growth by publicly owned banks, which generated a significant indirect fiscal stimulus to the economy. Nonetheless, the process of disinflation continued thanks to the exchange rate commitment which was successful in reducing Mexican inflation from over 100% in 1988 to 20% in 1989 and 7% by 1994 (Figure 1.2).

Figure 1.2. Inflation performance



Source: Bank of Mexico.

The return to solid growth and falling inflation was accompanied by an ongoing widening of the current account deficit reflecting a rising saving-investment gap. There was a sharp decline in private saving associated with financial market deregulation, increased confidence following fiscal consolidation and higher asset values, while public saving increased. Investment increased driven by the liberalisation of the economy, increasing competition and the prospects of NAFTA. The ongoing fall in private sector savings combined with a decline in public savings from 1992 onwards and the continued increase in investment led to a current account deficit of around 8% by 1994.

The widening of the current account deficit meant that Mexico became increasingly dependent on capital inflows from abroad. With foreign direct investment (FDI) remaining broadly stable, a growing proportion of the current account deficit was financed by increases in short-term portfolio investment. The increasing size of the current account deficit and the reliance on short-term funding increased Mexico's vulnerability to a sudden change in investor sentiment. This vulnerability was further compounded by a large change in the composition of Mexico's public debt. Interest rates

on government debt started to rise at the end of 1993 and it became difficult for the government to place short-term peso debt in the market. From 1993 to 1994 the proportion of US dollar indexed bonds (*tesobonos*) issued by the Mexican government rose from 4% to 74% of total government bonds as the government sought to take advantage of lower interest rates on these securities, but this made the government budget vulnerable to exchange rate changes.

Triggered by political events investor sentiment deteriorated during the course of 1994, leading to large outflows of portfolio capital and a rapid run down in foreign exchange reserves. As reserve levels declined the central bank's exchange rate commitment was no longer sustainable and the government was forced to devalue and then float the peso in December 1994. Confidence continued to deteriorate into 1995 with concerns about the health of the banking sector and the Mexican government's ability to repay *tesobonos*. By the first months of 1995 the peso had fallen to around 50% of its pre-crisis level and with the withdrawal of foreign capital, interest rates had increased to over 80%. At the same time, the international community came to the rescue with USD 40 billion in financial support made available by the US Treasury, US Federal Reserve, the Bank of Canada, the BIS and the IMF, some of which was used to replace *tesobono* borrowings.

The currency crisis was accompanied by a banking crisis. Following deregulation of the financial sector in the 1980s, an increasing number of commercial banks competed for market share without adequate procedures for credit control and banking supervision. This led to an explosion of credit to the private sector, which was followed by a large rise in non-performing loans from 2% of total loans in 1990 to around 10% in 1994.

The effect of the currency crisis on the banking sector was mainly via a decreased capacity of borrowers to repay loans. The large rise in interest rates, the depreciation of the exchange rate (30% of commercial bank lending to the private sector was foreign-currency denominated) and the collapse in activity in 1995 severely constrained borrower's ability to repay debt and the proportion of non-performing loans continued to increase. The rise in non-performing loans and inadequate bankruptcy laws put severe pressure on banks' profitability and the banking system came under extreme pressure.

The problems in the private sector were further compounded by large non-performing loans of state-owned development banks, including those of Banrural in the agricultural sector. To prevent a systemic collapse and ease the stress on the financial system, a range of bank assistance measures was taken, including temporary capital injections and a US dollar lending mechanism provided to banks through the Bank of Mexico using international support resources. Rescue measures continued over several years generating concerns about the emergence of moral hazard problems in the banking sector.

The crisis forced a sudden readjustment of the economy, which had to fund investment almost entirely from domestic savings. As a result the current account deficit shrunk from -7% in 1994 to -0.6% in 1995 and GDP fell by 6% as investment and private consumption contracted sharply after the withdrawal of foreign capital and the sharp rise in interest rates. At the same time, the large fall in the exchange rate combined with previous policy reforms to open the economy, including NAFTA, allowed Mexico's producers to switch their sales from domestic markets to abroad resulting in large increases in exports. Inflation jumped to over 50% following the depreciation of the peso. There was also a worsening of labour market conditions, with a significant decline in private sector insured employment[2] and a rise in the open unemployment rate from 3.6% to 6.3%. In addition the scale of both informal labour and poverty increased.

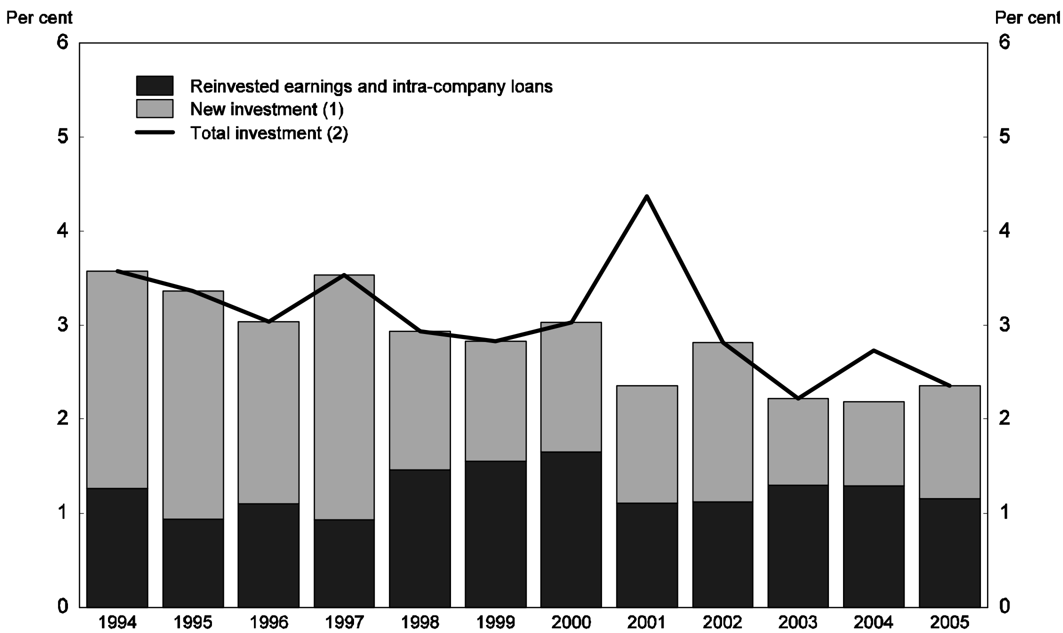
Regaining stability and sustained growth

In contrast to the long period of stagnation that followed the 1982 debt crisis, the economy quickly returned to growth following the currency crisis and recession in 1995, with GDP expanding 5% in 1996. A rebound in investment by export-oriented firms as well as public sector projects helped to drive this turnaround. The fundamental policy reforms taken after the 1982 crisis that had opened and liberalised the economy allowed it to adjust much faster than previously.

The economy continued to grow vigorously for five years from 1996 to 2000, averaging growth of over 5% per annum. The increased openness of the economy led to an increase in the share of exports in GDP from 17% in 1994 to 32% in 2000. Openness also manifested itself in significant inflows of FDI, which continued even during the 1995 currency crisis, with the gross inflow of FDI around 3% of GDP per annum from 1996-2000, representing a significant source of investment capital (Figure 1.3).

Figure 1.3. Gross foreign direct investment in Mexico

Per cent of GDP



1. Excludes the sales of Banamex in 2001 and of BBVA-Bancomer in 2004.
2. Includes the sales of Banamex in 2001 and of BBVA-Bancomer in 2004.

Source: Secretaria de Economia, Dirreción General de Inversión Extranjera.

In the labour market approximately three million new jobs were created in the formal sector from 1996 to 2000 and the official unemployment rate fell back to 2.1%. However, rapid working-age population growth meant that informal employment also continued to absorb new entrants to the labour market, with its share remaining broadly constant at around 25% of total employment.

Nevertheless, despite the quick recovery in GDP, the currency and banking crises still caused a significant set back to Mexican living standards. The level of GDP per capita did not return to its 1994 level until 1998 and private consumption per capita did not surpass its 1994 level until 2000. The loss in living standards was also evidenced by the significant fall in real wages that followed the crisis. While the post crisis fall in wages helped to improve competitiveness, exports, the recovery of the economy and a reduction in inflation, it also represented a large fall in the purchasing power of Mexicans.

Fiscal and monetary policy

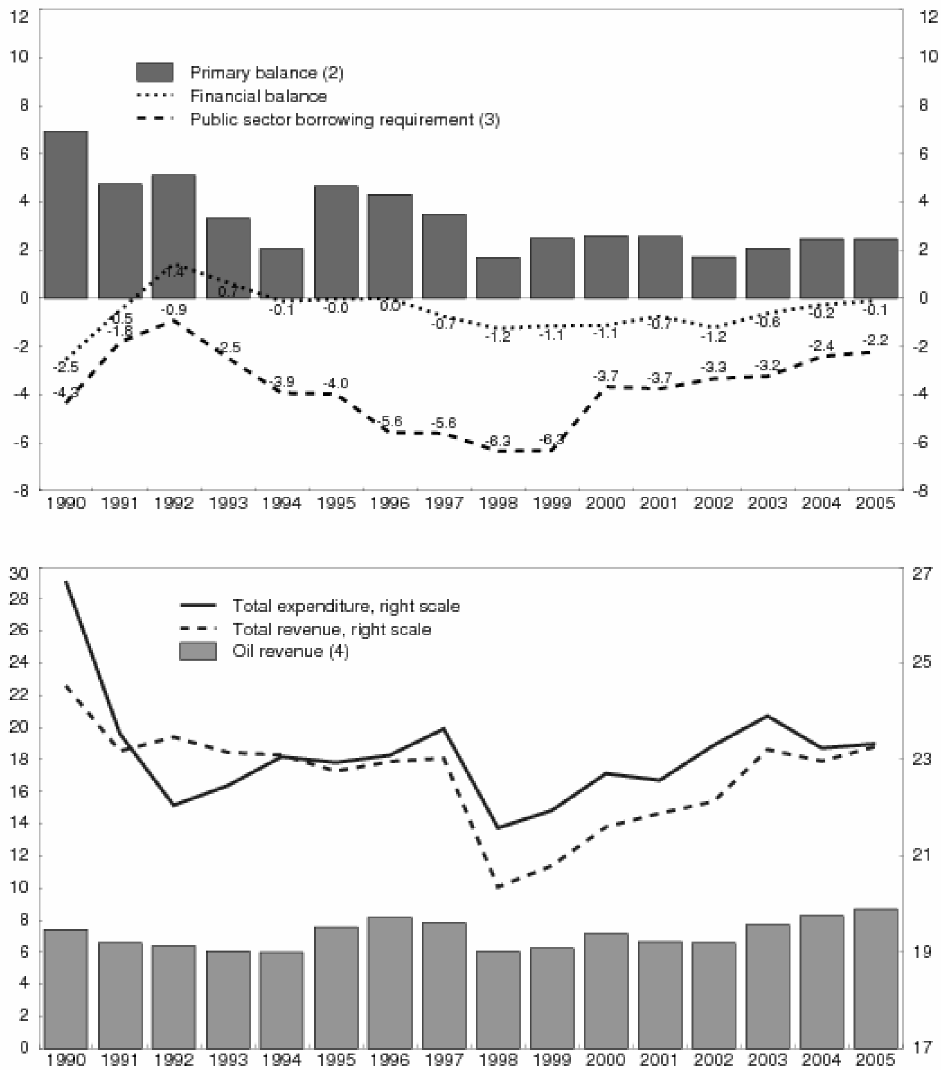
During the currency crisis in 1995 the government tightened fiscal policy via expenditure cuts and achieved a nearly balanced budget despite large increases in interest payments (Figure 1.4). From 1996 to 1997 the financial balance was maintained close to zero. Oil accounts for about one third of total government revenues and in 1998, government revenue came under pressure when the oil price fell below original budget assumptions. The government responded swiftly, cutting expenditure, particularly investment, to keep the budget on target. In 1999 and 2000, when the oil price rose again significantly, the windfalls were used to lower public sector debt and contribute to a newly created oil stabilisation fund.

Despite the budget discipline, the crisis did affect the broader public finance position. The government's commitments to support the financial sector came at a high fiscal cost, around 20% of GDP. These programmes contributed, along with public-private partnership commitments in the electricity and the oil sector (PIDIREGAS), to a public sector borrowing requirement (PBSR) that was around 6% of GDP from 1996 to 1999. While narrow public debt decreased as a percentage of GDP over this period, public debt including these wider obligations increased by around 5 percentage points to over 40% of GDP.

Consumer Price Index (CPI) inflation was gradually reduced over this period to 9.5% in 2000. Following the 1995 crisis, the central bank switched from its previous focus on the exchange rate towards an inflation targeting regime. Nominal exchange rate stability from the beginning of 1996 and moderate wage developments helped to reduce inflation initially and steadily reduced inflation expectations. As it continued to achieve its objective of reducing inflation, the Bank of Mexico also increased its credibility.

Figure 1.4. Public sector budget aggregates

Per cent of GDP[1]



1. The public sector comprises federal government and public enterprises under budgetary control.
2. The primary balance is the financial balance less net interest payments (such as PEMEX). Financial intermediation by development banks is not included.
3. 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.
4. Includes oil extraction royalties, VAT and excise taxes on oil products.

Source: Ministry of Finance; Bank of Mexico; OECD Economic Outlook database 79.

Increased linkages between Mexico and the United States

In 2001 the economy began to slow significantly in response to a sharp slowdown in the United States, resulting from a decline in investment as profit expectations deteriorated and the stock market bubble burst. In contrast to the sharp decline in GDP in the 1995 crisis, this recession remained mild with GDP falling by only 0.2% in 2001. While the previous two crises in 1982 and 1995 were “home-made” the 2001 recession was caused by a negative shock originating abroad and reflecting closer integration of the Mexican economy with the US economy after the beginning of NAFTA. Exports slowed sharply from 16% growth in 2000 to -3% growth in 2001 (Figure 1.5). Since 1994, when NAFTA took effect, the correlation between US and Mexican annual growth rates (based on a sample of the previous five years) increased from -0.46 in 1994 to 0.42 in 2000 to 0.82 in 2005. Given the long-term strength and stability of the US economy, as evidenced by its long and stable expansions and relatively few and short recessions, this increasing synchronisation with the US economy is a positive influence on Mexico.

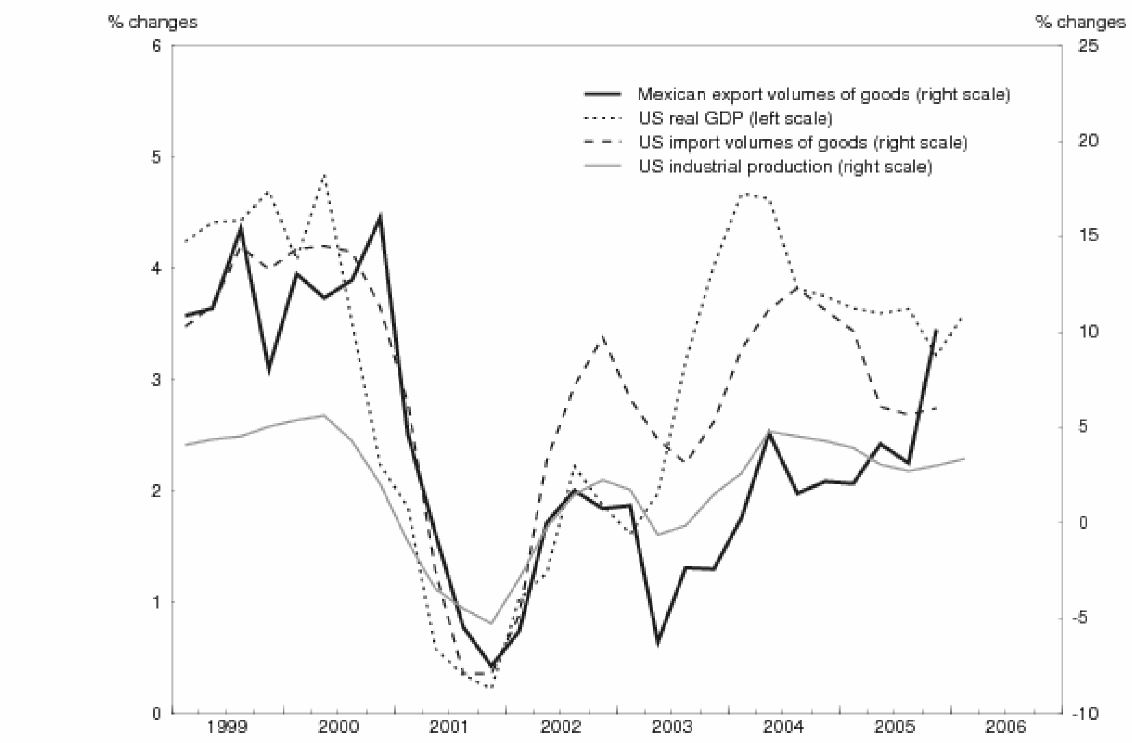
Following the mild 2001 recession, the Mexican economy exhibited sluggish growth in 2002 and 2003 with growth below 1.5% in both years. This reflected very slow export growth and investment growth rates relative to the 1996-2000 period. In 2004 and 2005 the economy returned to stronger export and investment growth and consumption also picked up, with GDP growth of 4% in 2004 and 3% in 2005. Regulatory reform in the banking sector and the increase in foreign ownership have resulted in an increasingly solid banking system. With the stronger economy, bank lending also picked up to around 20-30% real annual growth in 2004 and 2005. The 2001 recession helped to reduce CPI inflation to 5% in 2002 and inflation continued to decline to 4% by 2005. Despite weak economic growth in 2002 and 2003, the government maintained the financial balance at around -1% of GDP. Continued increases in oil prices post 2003 have contributed to increasing revenue and a narrowing of the public sector financial balance to -0.3% of GDP. There has also been consolidation in the public sector borrowing requirement, which includes support programmes for the financial sector and PIDIREGAS, with a fall in the PBSR from 6% of GDP in 1999 to 2.4% in 2004.

The broad-based expansion is expected to continue, with GDP growth around 4% in both 2006 and 2007 and employment in the formal sector expanding. Inflation is set to be on target and the current account deficit should remain close to 1% of GDP. Nevertheless, over the medium-term assuming unchanged policies, the Mexican economy is expected to grow at around 3½ to 4 %, but with ongoing population growth, rapid convergence to average living standards in the OECD would require faster GDP growth.

From 1995-2004 Mexican GDP per capita grew at an average of 2.1%. This was a large improvement from the 1980s (-1%) and better than the early 1990s (1.6%). However, it was still lower than average GDP per capita growth in the OECD from 1995 to 2004 of 2.6%. Given the low level of average income of the Mexican population — about 1/3 of the US income level (in purchasing parity) in 2004 — it would be desirable to achieve a faster catching up.

Figure 1.5. Activity in the United States and Mexican exports

Year-on-year change



How to achieve a faster rise in living standards? [3]

The structure of the Mexican economy has changed significantly over the last 15 years. On the production side of GDP, services have continued to grow while manufacturing and agriculture continue to decrease in relative importance. In 2004 agriculture accounted for less than 6% of GDP, and fisheries accounted for about 0.1%. Despite their declining share of GDP, improving performance of the agricultural and fishery sectors has greater significance for the overall economy than this proportion would suggest. Labour productivity is low: agriculture accounted for a much higher proportion of employment, around 15%, than its share of GDP in 2004, and fisheries accounted for 0.3% of employment. Furthermore, income distribution remains very skewed in Mexico and a large share of the poorest deciles are employed in these sectors. This suggests that there is large scope for productivity improvements in this sector that have the potential to improve the incomes of the poorest members of Mexican society.

Strengths

In the aftermath of the 1995 crisis, the introduction of inflation targeting monetary policy and fiscal discipline have created a stable macroeconomic environment in Mexico with falling inflation and solid growth. This provides a stable platform on which to introduce further growth-enhancing structural policy reforms. Mexico also has the advantage of being in close geographical proximity to the United States, one of the best performing economies in the world. This geographical proximity combined with Mexico's high level of openness is a very important engine of growth for the Mexican

economy, as demonstrated by the strong export performance of the Mexican economy over the last ten years. The United States is also a major source of FDI capital for the Mexican economy. In addition, Mexico's banking system has become increasingly sound.

Weaknesses

The main challenge is to raise growth potential and initiate a catching-up of GDP per capita towards countries with higher living standards. Raising potential growth will require improvements in the quality of labour, a higher and more efficient physical capital stock, and more innovation.

The low level of labour productivity per hour worked is the main explanation for the income gap *vis-à-vis* higher income OECD countries. Productivity growth, except in the manufacturing sector, has been mediocre, despite the reform programmes of the past two decades. The evidence suggests that productivity growth is depressed in particular by:

- low levels of human capital, with low educational attainment even for younger workers and scarce adult training, and
- the slow pace of structural reforms in a number of areas including in some key network industries, such as telecommunications and transportation.

Further reform to fiscal policy

To improve the country's potential growth rate the government needs to increase its investment in human capital and this requires a stable revenue source. Fiscal revenue is currently very dependent on receipts from oil. Part of this oil revenue is subject to oil price volatility, which is influenced by a variety of very unpredictable forces including political uncertainty, the weather and high levels of speculation. A tax reform remains a priority. It should raise tax revenue, by enlarging the tax base. Non-oil related revenue is low relative to GDP and even with oil-related revenue the tax/GDP ratio is one of the lowest in the OECD.

The following sections discuss various areas that influence growth potential and also the overall economic context in which the agriculture and fishery sectors operate. It provides a summary of the current situation and important policy reforms that are required in sectors that are highly relevant for agricultural and fishery production, including banking, infrastructure and education.

Structural environment

Banking[4]

A well-developed financial system, which efficiently channels resources towards the most rewarding activities and stimulates investment, is important to support stronger growth. After coming close to collapse in the 1995 banking and currency crisis, the banking sector required massive government support including bank recapitalisations, take-over of some banks and debtor support programmes. In 1998 restrictions on FDI in Mexico's largest banks were lifted and in 2001 a raft of reforms including the banking, securities market and savings and loans laws were enacted to improve supervision, corporate governance, accountability and transparency. In 2003 the bank guarantee law was reformed to improve the enforceability of contracts. Following these wide ranging reforms and the lifting of restrictions on FDI and increased foreign ownership, Mexico's

banking sector is increasingly sound. Profitability is now comparable to other OECD countries and bank supervision and regulatory frameworks are much closer to best practice.

Foreign investment improved efficiency

The banking sector remained hampered by significant restrictions on foreign ownership until 1998. The removal of restrictions led to a rapid increase in foreign ownership of Mexican banks, with the percentage of total commercial banking assets owned by foreign firms rising from 7% in 1995 to 25% in 1998. Within three years, the three largest commercial banks, representing about half of total bank assets, were foreign owned with investments by the United States' Citibank and Spain's BBVA and Santander. In total, foreign ownership accounted for 85% of commercial bank assets. With this high level of foreign ownership, Mexico's banking sector has excellent access to human capital, including foreign management expertise, and leading international technology and practices. This should ensure continued improvements in productivity and ongoing soundness of key parts of the overall system.

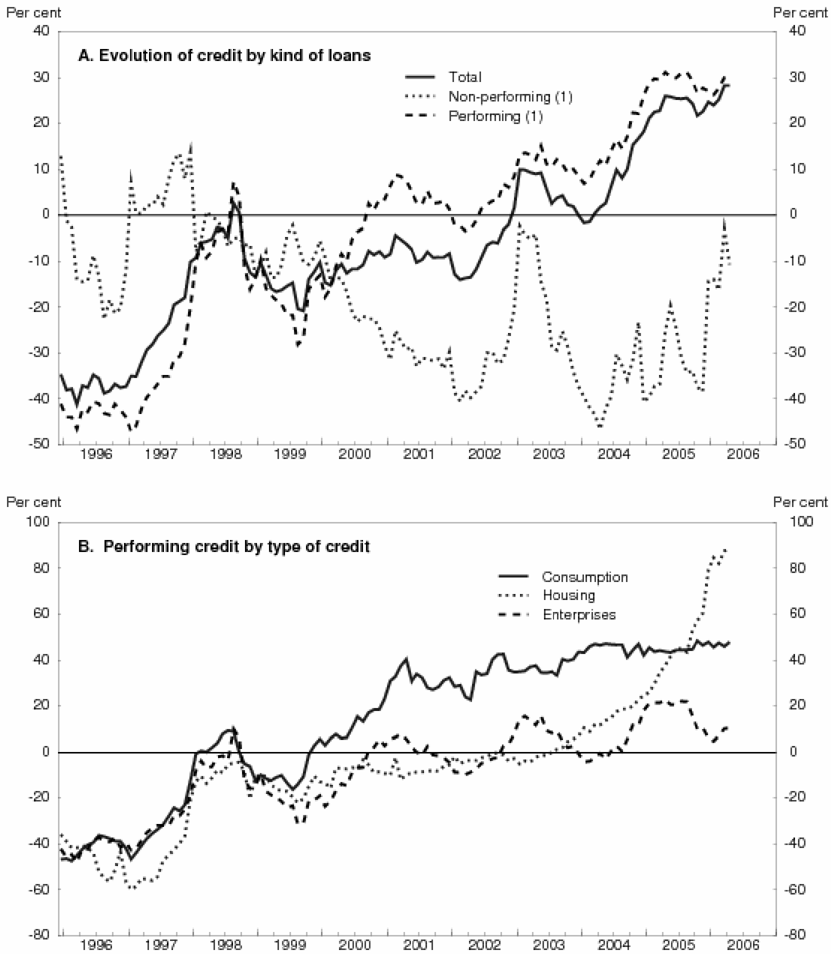
After the 1995 crisis bank profitability recovered and non-performing loans declined. However, growth in domestic credit to the private sector was slow to recover with small and medium enterprises facing the greatest difficulties in accessing bank finance given their higher risk and lack of access to foreign borrowing that large firms have at their disposal. Bank credit to the private sector exhibited negative real annual growth, except for a brief period in 1998, throughout the late 1990s and into the early 2000s. With the return to stronger growth in 2004 and 2005 real credit growth turned positive again (Figure 1.6).

Credit growth remains partly constrained by problems lending institutions face in enforcing contracts involving collateral. There have been improvements but more will need to be accomplished. In 2003 legislation relating to bank guarantees (collateral) was amended to improve the mechanisms for recovery of collateral by lending institutions in the case of debt repayment default. It is designed to prevent debtors from engaging in practices that delay or obstruct the creditor's repossession, for example by selling the collateral. The new framework is better, but in practice it still has not led to full enforceability of contracts as debtors often make abusive use of *amparo* proceedings to block enforcement. These proceedings delay decisions and even if the creditor is successful the collateral may have depreciated significantly in the mean time.

To increase lending to the private sector further measures need to be taken to increase the enforceability of credit contracts. Initiatives to improve small saver access to secure savings instruments and liberalise investment rules for government pension funds would also help to improve credit growth by increasing the supply of funds available for lending to the private sector.

Figure 1.6. Recent trends in domestic credit to the private sector

Year-on-year percentage change in real terms[1]



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

Public development bank lending to the agricultural sector

Development banks have traditionally had an important role in financial intermediation including in agriculture. After being badly affected by the 1995 crisis, they curtailed lending even more sharply than commercial banks. By early 2001 their share of total bank assets had fallen to only a third of total banking system assets and the share continued to fall. They have become more concentrated in providing funds to commercial banks (second–tier) lending, which limits capital market distortions. Their share of direct non-bank private lending fell to less than 10% of lending by 2001.

Nevertheless, despite repeated capital injections by the government, the development banks continued post 1995 to make losses over the business cycle indicating distortion inducing subsidisation, which has continued to constrain the development of private banking. Lending efficiency was further hampered by overlaps between various state-owned financial intermediaries, including in agriculture where the trust fund FIRA and

Banrural (the agriculture sector development bank) were both targeting the agricultural sector.

The presence of development banks prevented the development of a well functioning rural financial market and credit programmes undermined repayment discipline due to poor debt recovery and large scale debt forgiveness. In the early 1990s credit to the agricultural sector was growing but it fell sharply following the 1995 crisis and the reduction in development bank operations. Commercial banks did not fill the gap because of the high default rate of farmers, and the limited supply of credit in the second half of the 1990s was directed towards large farmers. In 2002 a new institution, *Financiera Rural*, was opened to replace the insolvent Banrural. Its purpose is to provide access to credit to acquire machinery, equipment and technology to increase productivity in the agricultural sector. It aims to fill gaps not covered by the private sector.

Infrastructure needs to be improved

Regulatory obstacles to private investment and FDI

Although demand for electricity has been met and the frequency of power cuts has declined, prices for industry users were relatively high *vis-à-vis* other OECD countries in 2003 and continue to be so (Figure 1.7).

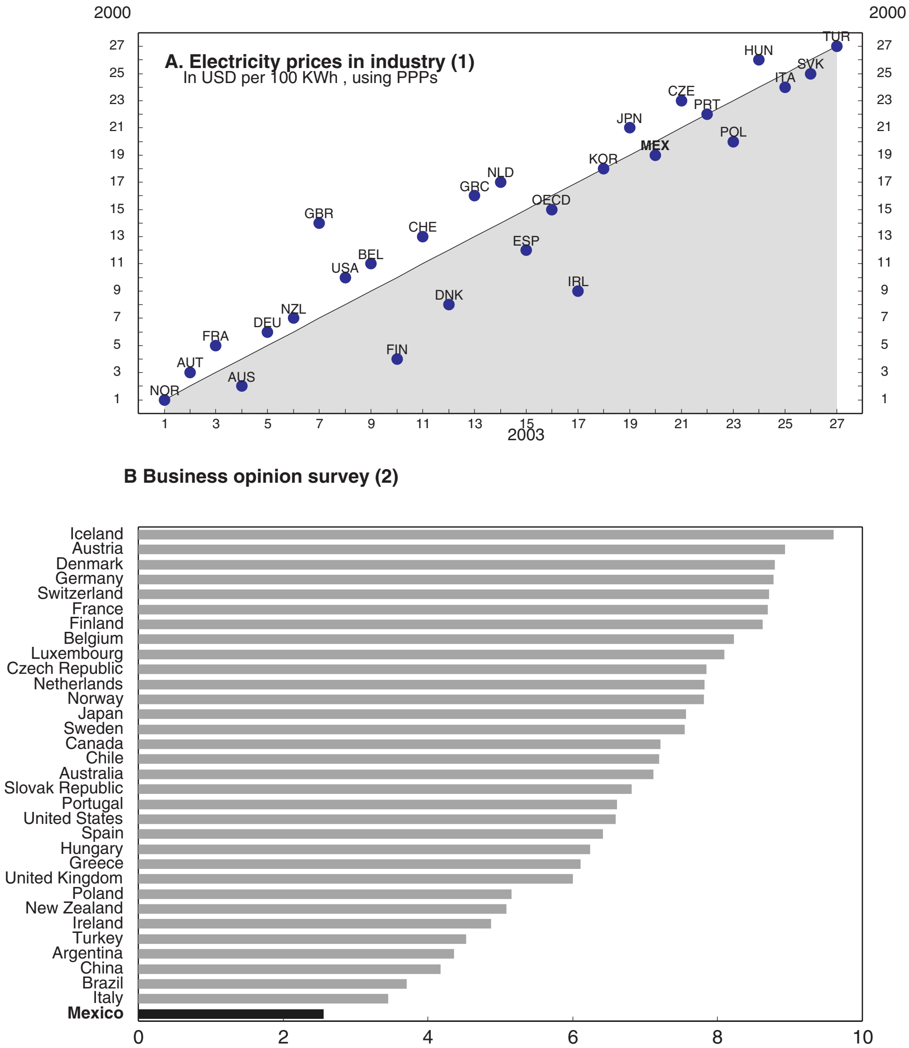
To meet expected demand, the *electricity sector* requires large scale investment for expanding and modernizing the transmission and distribution network. Removing legal obstacles to private investment in the electricity sector would help to ensure that business and households have access to a low-cost and reliable energy source.

Lack of effective competition

There are also areas which are in principle opened to competition, but where application of the law is impaired so that there is no effective competition. Improving transport and communications infrastructure is crucial for maximising the gains that Mexico can obtain from having an open economy, including within NAFTA.

In *rail freight transportation,* the restructuring and privatisation process in the late 1990s has made the sector more productive, but inefficiencies are still constraining the use of rail. Because of large cost structure discrepancies initially and the lack of clear and objective regulations, the private concession holders have been involved in serious disputes. Some have undertaken anti-competitive practices, setting excessive and discriminatory rates, limiting access conditions and refusing to provide interconnection and right of way. The Ministry of Communication and Transport has been unable to resolve the disputes between private railroad companies and to stop anticompetitive practices. The companies under investigation by the Federal Competition Commission CFC are using judicial procedures (*amparos)* to avoid resolution. Enforcement of the competition law will not suffice to solve the problem. Because of the weaknesses in the regulations initially established, the entire regulatory framework should be reviewed.

Figure 1.7. Energy indicators



1. Ranking for 27 OECD countries excluding Canada, Iceland, Luxembourg and Sweden. Countries in the shaded area have below average progress. Although comparable data are not yet available, several OECD countries have recorded substantial declines in electricity prices since 2003.
2. “Is the energy infrastructure adequate and efficient?” Value 10 indicates the most positive perception.

Source: IEA database; IMD World competitiveness Yearbook 2004.

In *road infrastructure*, an important problem is the lack of co-ordination between the states and with the Ministry of Communication and Transport. Inadequate co-ordination between levels of government creates problems in the planning of the network; and the fact that responsibilities are not clearly defined contributes to poor maintenance of existing roads. Mexican *ports,* which were privatised in the late 1990s, suffer from efficiency problems and are relatively expensive by international comparison. Poor co-ordination in customs, sanitary controls and other formalities are important factors in the high costs of handling and storage.

Despite large declines in *telephone charges* over past years, Mexico remains one of the OECD countries with the highest charges, and although the number of users has been

increasing rapidly, the density of services (for the combined fixed and mobile telephony) is one of the lowest in the OECD. In common with other infrastructure sectors, in the telecommunications sector, many of the difficulties slowing the development of effective competition stem from the abusive use of *amparo*s, to block the implementation of decisions by regulators and the Federal Competition Commission.

Low cost recovery and investment in water infrastructure[5]

Mexico's water infrastructure is inadequate, both in quantity and quality. Over 11 million inhabitants lack access to piped water and over 21 million to sanitary drainage. Furthermore, much of the existing infrastructure is in poor condition, with around 40% of water supplied being lost through leakage. Current policy under the 2001-2006 National Water Programme is to increase water supply coverage to 89% nationally and 71% in rural areas. This implies connecting an additional 1.5 million people a year to the water supply and has been estimated to cost USD 1.6 billion.

Spending on water infrastructure, both private and public, amounted to 0.2% of GDP in 2001, well below that in most OECD countries. Public funding should be supplemented by increased user charges. At present user charges only cover around 30% of the capital and operational costs. Concern is often expressed that poorer households cannot afford higher water charges. However, in Mexico's case the poorest households are not connected to the water supply and purchase it from individual vendors. They are paying much higher proportions of their income for water than connected households (15-30% of income compared to 1-4% for connected households). As well as being used to upgrade the quality of water systems, higher user charges could be used to fund increased infrastructure to the poorer households. Even when connected, poorer households would pay only a fraction for water compared to the cost from purchasing water from individual vendors. Water usage could also be progressively priced with a basic water block being charged at lower rates and extra blocks being charged at higher rates.

The implementation of higher water charges must be carefully timed. OECD work suggests that the public are often only willing to accept higher water charges if there is a significant improvement in service. Careful consideration needs to be given to timing increased water charges so that Mexico can break out of its current vicious circle where households are unwilling to pay much for water because the service is of low quality and utilities do not have the funds to improve service efficiency. Charge increases need to be accompanied by significant quality improvements.

Water in the agricultural sector

The agricultural sector currently accounts for 76% of Mexico's water usage. There has been a zero fee (currently under review) on water use in the sector and there are even subsidies for electricity used to pump ground water. The efficiency of agricultural irrigation needs to be improved and measures taken to halt over-exploitation of groundwater aquifers.

Water management and water services provision are too fragmented and in some cases poorly co-ordinated. There needs to be a clearer distinction of functions with municipalities setting policies and utilities concentrating on water service delivery. Contracts should be used to define clearly the responsibilities of each party and regular public performance reports issued to increase accountability.

Education[6]

Very rapid population growth means that a high proportion of the Mexican population is currently of school age, with close to 30 million students or nearly 1/3 of the population enrolled from preschool to upper secondary education in 2001. This means Mexico faces both a greater challenge in meeting the education needs of its population than other OECD countries, but can also potentially reap greater rewards from improving its education system.

Human capital is the lowest in the OECD and the education system does not perform well enough to reduce the lag at an acceptable pace. Over the past decades Mexico has made great progress in increasing school enrolment and there has been a deliberate increase in public spending on education. However, while the volume of educational services has increased, there are doubts about whether the additional funding is actually delivering the expected improvements. Both the coverage and quality of education services remain far behind OECD best practices even though, on paper, average teacher-pupil ratios are not out of line. Mexican children still spend comparatively few years in formal education, and do not profit from it as much as they should, so that poor educational attainment is reproduced from one generation to the next, and with it poverty (Figure 1.8). Many children, especially the poor ones, still drop out before completing compulsory education and school-leavers have poor literacy and numerical skills.

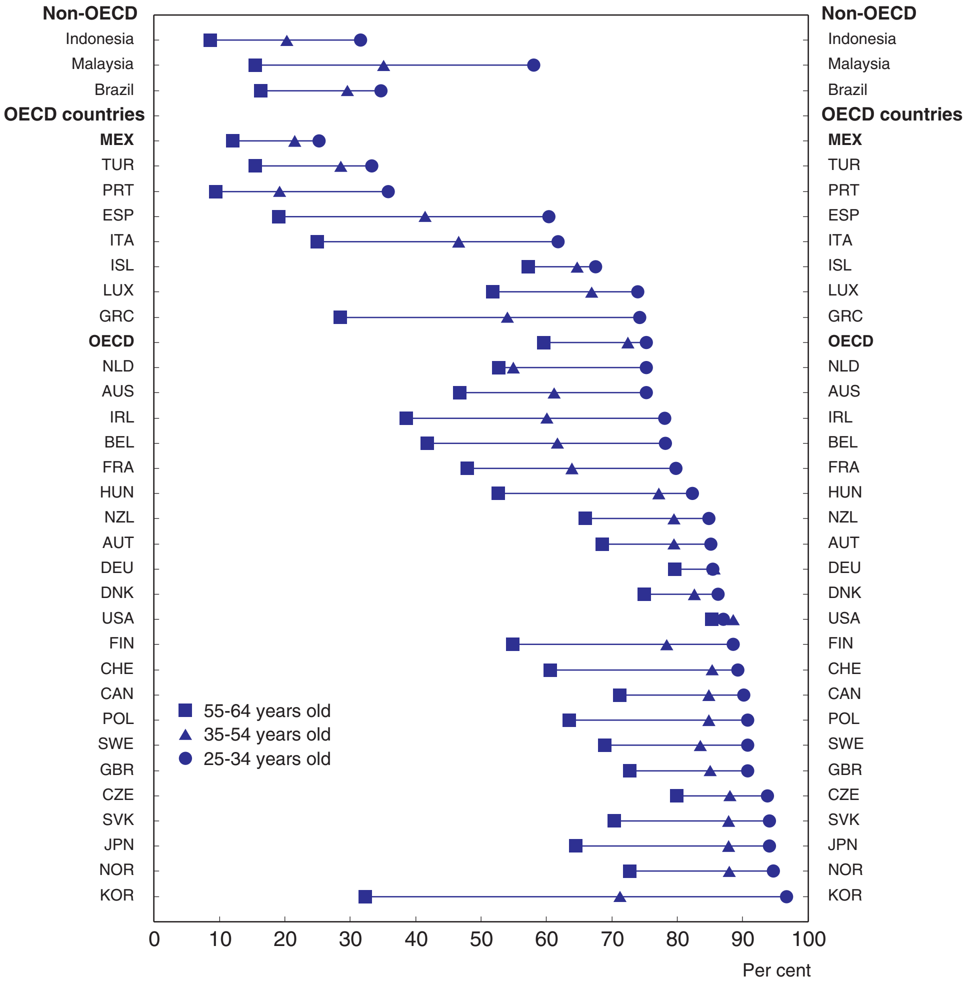
Educational resources need to be better allocated. Teachers' pay absorbs a high proportion of total education spending by international comparison, while spending on infrastructure and teaching aids is low (Figure 1.9). Although low in absolute terms, teachers' wages relative to GDP per capita are already among the highest in the OECD, as is usual in a lower-income country, but also among the highest in Latin America. A greater proportion of future spending needs to be directed towards non-wage items.

Value for money could be improved**.** Actions are needed to: (1) improve further the selection and training of teachers; (2) include teaching standards that foster comprehension skills and communication; (3) match better curricula with student and labour market needs; and (4) find alternatives to the systematic use of class repetition which is an inefficient way to correct lags in learning. Mexico has yet to introduce efficiency enhancing policies*,* introducing credible mechanisms for sanctions and rewards for teachers and principals and giving more responsibilities to schools so that they better adapt to local conditions and needs.

The authorities at the federal government and state level are aware of the weaknesses of the educational system, and some reforms have been launched to improve its performance and accountability. However, these efforts are spread among many programmes with sometimes conflicting priorities. In some states, interesting experiments are taking place to improve quality and efficiency, reflecting successful negotiations with the local sections of the teachers' union. The next step should be to evaluate these experiences and find ways to generalise the most successful ones to other states. To facilitate implementation, the required reform should be launched as a package, mixing measures with an immediate and visible impact with deeper efficiency and quality, enhancing reforms that have more diffuse benefits and are likely to raise opposition. Once they are well informed, parents could also contribute by putting pressure on the authorities and teachers for a higher quality education for their children.

Figure 1.8. Educational attainment of the working-age population

Population with at least an upper-secondary qualification, 2003[1]

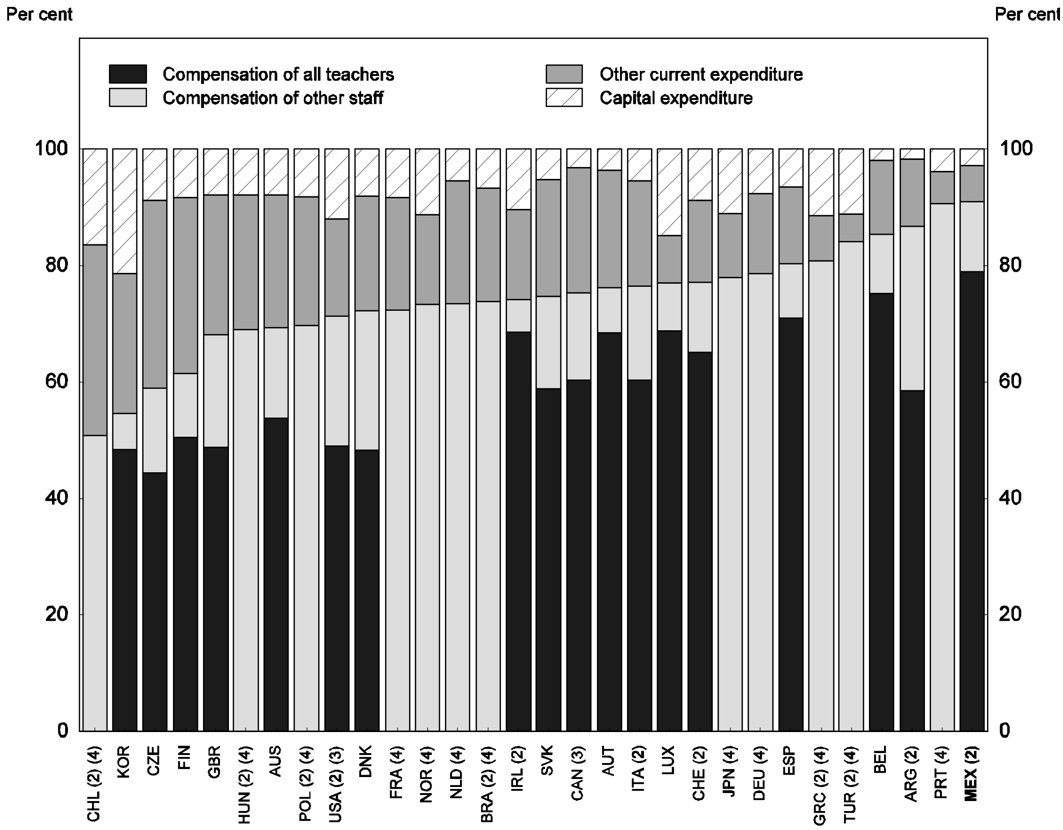


1. Per cent of each age group. Year 2002 for Czech Republic, Iceland, Italy and Netherlands.

Source: OECD, *Labour Market Statistics* database.

Figure 1.9. Distribution of total and current expenditure on educational institutions

By resource category in primary, secondary and post secondary non-tertiary education[1]



1. In 2001. Brazil: 2000; Argentina: 2002.
2. Public institutions only.
3. Excludes post-secondary non-tertiary.
4. The breakdown of compensation of teachers and compensation of other staff is not available.

Source: OECD, *Education at a Glance* (2004), Table B6.3.

Conclusion

The Mexican economy has transformed significantly over the last 15 years, becoming increasingly open and outward orientated. At the same time macroeconomic stability has improved markedly with relatively low levels of inflation, small current account and fiscal deficits and solid and reasonably steady rates of GDP growth. However, GDP growth remains inadequate to rapidly close the gap with other OECD countries. The current favourable global outlook, combined with a stable macroeconomic environment, provides a solid platform for Mexico to introduce a wide range of urgently needed structural reforms. These reforms are required to prepare Mexico for increases in global competition and raise overall GDP growth rates and living standards, as well as improve performance in the agricultural and fisheries sectors.

NOTES

1. SITC rev3 2004.
2. Insured employees are registered with the social security institutes and are the best available indicator of formal employment.
3. This section is based on *OECD Economic Surveys: Mexico*, 2005 and previous issues.
4. This section is based on *OECD Economic Surveys: Mexico*, 2002 and previous issues. For further details, see Bonturi (2002).
5. This section is based on information and analysis provided by the OECD Environment Directorate.
6. This section is based on *OECD Economic Surveys: Mexico*, 2005. For further details, see Guichard (2005).

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Table of contents

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