

# THE MACROECONOMIC CHALLENGES FOR MEXICO<sup>1</sup>

by Andrew Dean  
Deputy Director, Economics Department, OECD

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It is a great pleasure to be here with such a distinguished audience and set of panellists, including a former Mexican Ambassador to the OECD.

If I had to put in a nutshell what we know about Mexico, based on work done in the OECD's Economics Department over the years, I would say that the economy is doing much better than in the past, but it can do much better still.

Several weaknesses still need to be addressed. These areas of concern have generally been well identified by the authorities, past and present. But the measures that have been taken have fallen short of what is needed.

I would like to identify two main macroeconomic challenges. Only two – but they call for measures taken simultaneously on many fronts:

## ***The first challenge is related to fiscal policy:***

- As most of the people here know – and as was noted by some of the previous speakers – budget targets have been met, the PSBR is down below 2% of GDP and hence fiscal policy has gained credibility. This has been an admirable performance
- But the recent past has been relatively easy, not least because of oil revenues; the underlying fiscal position is not yet comfortable especially in the longer term. There are pressing needs for public expenditure (education, health, infrastructure) and taxes are very low as share of GDP.

## ***The second challenge is to raise potential growth***

- Mexico's growth performance is good, but not very impressive when compared with other catching-up countries.
- With a rate of 4% on average, it is not sufficient to allow convergence of living standards towards those of more advanced OECD countries. If one looks at charts of Mexico compared with the OECD area, one sees no catch up.

I will pick up both of these challenges in turn, starting with fiscal policy which is covered in Chapter 2 of the *Getting it Right* book produced for this forum:

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<sup>1</sup> This paper draws heavily on Chapter 1 (by Bénédicte Larre) and Chapter 2 (by Bénédicte Larre and Chris Heady) in *Getting it Right*, which was distributed to the Mexico Forum participants. I am grateful, in particular, to Bénédicte Larre, Head of the OECD's Mexico desk, for her extensive help in preparing these remarks.

***The key issue is the fragility of public finances which comes from the heavy reliance on oil revenue.***

This has two consequences:

First, it is difficult to use fiscal policy to smooth the cycle, because of the influence of the oil cycle;

Second, development priorities, including poverty relief, human capital and physical infrastructure, do not have the financing that is needed on a predictable basis.

The problem has now become more acute. After two very good years for oil revenue, the future is uncertain:

- As happened in the past, there are uncertainties related to oil prices.
- There are now also uncertainties related to oil production. Extraction from the main field (Cantarell) has started to come down. Starting exploitation in new fields requires more investment, new technology and the use of best practices.

Mexico is entering a new phase: it may no longer be able to count on generous oil revenue.

### ***The policy response***

Immediate action is called for in three areas:

- Tax revenue is very low in international comparison. Everyone is aware of the need to undertake a tax reform that generates more revenue, by widening the tax base. I will not spell out the details now as it will be discussed tomorrow, at another panel, by Chris Heady and others.
- Large-scale investment in oil exploration and production is needed. Changes will have to be made in the way PEMEX is managed. Joint ventures between PEMEX and private companies will have to be encouraged.
- I would also like to stress the need to take action on the spending side. There are spending needs that are important for growth - in education, health, infrastructure, poverty alleviation – so it is important to ensure that all expenditure is carried out efficiently and that room can be made for priority needs.

Let me briefly note some specific expenditure pressures:

- In education more children have to be enrolled, especially in upper secondary levels, and shortages in school facilities need to be addressed.
- In health, implementation of the new "seguro popular" (social insurance in health) has a substantial budget cost.
- There are pressures on pension systems from population ageing, in the government (at both the federal and state levels) and in the private sector.

***Reforms are needed to improve efficiency at all levels of government.***

All OECD countries are interested in "getting more value for money" and we are doing work at the OECD on this issue.

Some areas in particular come to mind, as examples:

- In education, for instance, measures are needed to increase efficiency and improve the quality of teaching.
- There are subsidies in many areas: water, electricity and gasoline (where price at the pump did not rise with crude oil prices). They distort incentives, are regressive and costly for public finances.
- How effective are state and local governments in developing infrastructure with the special funds they have been receiving for that purpose? As more and more resources (from the oil windfall) have been transferred to sub-national governments for investment, the accountability at the sub-national level has become more important.

Even if some efficiency gains can be achieved, they will only go part of the way to meet spending needs.

This therefore comes back to taxes again since an increase in tax revenue is needed to finance these needs with permanent and stable sources of revenue, a *sine qua non* for successful development.

Let me come back to the second challenge (covered in Chapter 1 of *Getting it Right*).

***The most important challenge confronting the Mexican authorities is to close the very large income gap between Mexico and the more advanced OECD countries.***

Figure 1.1 in *Getting it Right* shows the disappointing relative performance of Mexico vis-à-vis the OECD, with no catch-up even to other low income OECD countries such as Greece, Portugal and Turkey who have all done better than Mexico.

Catching up will require policies and reforms that raise output growth in a durable way, especially via higher labour and total factor productivity.

Mexico's gap in standards of living reflects a low productivity level.<sup>2</sup> The growth of GDP per capita in Mexico has to be stronger to close the gap in living standards.

Let me recall the first chart on page 25 of *Getting it Right*. Mexico should be aspire to be a Korea or an Ireland.

To increase productivity on a sustained basis, the reform strategy should involve all areas of public policy:

- Improving infrastructure in transport for instance. This would help maximise the benefits from geographic proximity to the US.

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<sup>2</sup> Employment rates are already relatively high in Mexico, in comparison to many other OECD countries (at least for men and for the older population).

- Strengthening competition – and improving regulations – in communications, transport and energy, would have a direct impact by lowering costs of doing business. It would make the country more attractive for investors (domestic and foreign). It would boost innovation and technological advances.
- Enhancing education and promoting lifelong learning. Even *vis à vis* other Latin American countries, Mexico's performance is weak. It is a key area for reform to enable Mexico to reap all the benefits from its young and growing labour force.
- Improving the functioning of the labour market. Here two issues are particularly relevant: to make it more attractive for employees to work (and for employers to hire) in the formal labour market; and to facilitate the adjustment to the new global environment.

I would also like to stress the importance of providing more effective social protection, and continuing targeted assistance to the poor. Macroeconomic stability and stronger economic growth are necessary conditions for a more rapid reduction of poverty. But it is not sufficient in Mexico where poverty, including acute poverty, is widespread.

Other areas could be listed: innovation, the rule of law, environmental considerations. There are chapters in *Getting it Right* on some of the specific areas just mentioned above, which include policy recommendations, and many of these policy issues are going to be discussed in the panels today and tomorrow.

Let me close by adding a few points on structural reform.

Some people in Mexico think that reforms are not paying off. But experience from other OECD countries shows that structural reforms are the only way forward to raise living standards. Mexico has the advantage of being close to the world's strongest economy so that the benefits from reforms may well be higher than in some other countries. The following three basic ingredients are required:

- First, reforming on a larger front than in the past: a broad set of reforms, including in network industries, education and the labour market, would pay off more than a piecemeal approach.
- Second, improving the implementation of reforms, which also requires a better rule of law and improved governance at all levels of the public administration.
- Thirdly, communicating effectively to promote the needed reforms. It is important that reforms be well-prepared and assessed and judged on their intrinsic merits rather than through the prism of short-term political considerations.

As the OECD's book title says, *Getting it Right* is very important. But with the need for Congress and the country to be on board, *Getting it Together* is also a key requirement.

Reform is seldom easy, but it is what Mexico needs and I wish the reformers well.