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**The Global Crisis in
Mexico: Challenges and
Opportunities**



Instituto Nacional de Administración Pública, A.C.

Presentation

In view of the current scenario, in which economic, political, and social phenomena that arise anywhere on the planet have global consequences from which Mexico cannot stand apart, INAP has deemed it necessary to analyze them in the Public Administration Review (Revista de Administración Pública, RAP) 118, under the title “**The Global Crisis in Mexico: Challenges and Opportunities**”.

The distinguished authors contribute to our understanding of the causes and consequences of the global crisis and offer answers to the specific case of Mexico.

The work submitted by the OECD, entitled ***Strategic Response to the Financial and Economic Crisis: Contributions to the Global Effort***, is useful in providing a context for the subject at hand and a look at possible solutions.

Francisco Suárez Dávila, in his contribution ***Mexican Economic Policy facing the Global Crisis: Deficiencies and Opportunities***, sees in the crisis an opportunity for redesigning our economic and social strategies in the long term.

Dr. Guillermo Ortiz Martínez, Governor of the Bank of Mexico, makes several valuable contributions in his ***The Challenges of the Mexican Economy*** for Achieving High Sustained Growth in the Medium Term, by analyzing the causes of low growth in order to identify lines of action that may be followed to propel potential growth in the medium term.

On the other hand, the article entitled ***Repairing an International Financial System: A Work in the Bud***, by Dr. Jorge A. Chávez Presa, is relevant and motivates thought on the “titanic undertaking” which reforming the international financial system entails, in the voice of the author.

Raúl Martínez Almazán, in his collaboration *The Global Crisis in Mexico: A glance forward* posits “a change in economic policy so the country can grow a minimum 5% of GDP and generate the jobs demanded by the population, while at the same time, the need for a well-structured and well-scheduled national anti-crisis plan allowing coordinated action of the three orders of government and society, is urgent.”

INAP acknowledges that progress in a coherent National Project will not be possible without a modern and efficient fiscal and financial response that corresponds to the new realities of states and municipalities and is squarely built upon regional equilibrium and the division of powers. Therefore, we consider the collaboration *Towards a New Model of Fiscal Federalism in Mexico in the Long Term: Lessons from other Federations within the OECD* by teacher José Antonio Ardavín, Interim Director of OECD’s Centre for Latin America in Mexico, to be very valuable and timely.

The National Institute for the Public Administration wishes to thank the authors for their valuable contributions, as well as everyone who participated in the making of the magazine in one way or another. We especially wish to acknowledge the invaluable collaboration of Lic. Alejandro Camacho Barajas and Lic. Ivonne López, from the OECD’s Centre for Latin America in Mexico; Lic. Federico Rubli Kaiser, Director of Outreach of the Bank of Mexico, and Lic. Mercedes Martínez Cossío.

**José R. Castelazo
President.**

Revista de Administración Pública



Introduction

Dionisio Pérez-Jácome Friscione*

In a moment like the world is going through now, due to the economic and financial crisis, it is very pertinent the decision of the National Institute for Public Administration (INAP for its initials in Spanish), the publication of the current issue of the Mexican Public Administration Review for Mexico *The World Crisis in Mexico: Challenges and Opportunities*, devoted to the effects and opportunities in the current world economic crisis.

Such crisis is, no doubt, the deepest of the last decades, for it affects both industrial as well as developing countries. And yet at the same time, may be a turning point to create a new world economic dynamic, which can combine efforts and agreements to avoid these kind of situations in the future.

Right now the scenario is of global recession in this year (2009) and its due to several causes. It started as a crisis of the international financial system, initially in the United States real state market, when the so called *mortgage market* burst, due to several years of inflation in that market. Additionally there were a growing unfulfillment of credits in that country that provoked a general crisis in the investment banks which had a contagion effect on the main world economies, which in turn provoked a loss of confidence in the financial institutions of the financial markets,

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However the crisis was not limited to the financial system. According to the Economic Development and Cooperation Organization (2009) "there still exists a great degree of uncertainty about the depth and duration of the financial crisis, and that has become the main factor in the slow down of the economies (which) has translated in many countries in unemployment, affecting many families and communities and raising the level of public uncertainty.

Governments and international organizations and societies in general are making important efforts to overcome this situation.

In the case of Mexico, since the year 2007, in relation to the possible effects of the growing crisis, there were politics designed to prevent its effects, in particular in the Federal Budget for the year 2008, with the goal to maintain the level of economic activity and to lower the impact of the economic crisis.

These actions of the Federal Government were structured around three axes: (1) The increase of public expenditure as a main factor against the crisis; (2) The application of public budget to meet the established goals, and (3) Efficiency and quality the application of public budget.

As a result of the first axis, the public budget for the year 2008 was increased 309 thousand million pesos; for the next year this tendency continued with a growth of 13%. This effort was not only quantitative for it aimed to support investment in basic structure in order to generate a strong stimulus for employment.

The second axis is equally important because is not enough to increase the budget in investment and social programs, unless it is applied with opportunity to meet its goals.

In 2007 and 2008, taking into account this consideration, the exercised budget was higher than originally approved, 12.3% in the first case and 5.3% in the second. For the year 2009 this tendency continues, as shows the paid budget for the first three months (104% higher than the programmed).

The third axis, aimed to improve the efficiency and quality of the public budget, has been focused on four actions. First, the establishment

of a *Budget Based on Results* and of a *System of Performance Evaluation*, that seek to ensure that taxpayers resources are assigned according to national priorities and based on the programs performance. Second, the coordination of public accounting of the three levels of government, which allows the generation of quality information for decision making. Third, granting more faculties to the Auditoría Superior de la Federación (Budget Fiscal), to ensure the correct exercise of the public budget. And finally, measures of rationality and austerity for its exercise, different from those aimed at social programs and investment projects.

This internal work of the government is complementary to the efforts that are carried out on a world level. In an unprecedented international cooperation task, national governments and international organizations are applying measures to overcome this crisis.

In this way, what national governments *do* is a critical element for the reactivation of the world economy. This *doing of the governments*, due to the characteristics of the crisis, supranational, international and subnational dimensions. The first one includes the case of countries that form economic and commercial blocs (European Union, North America, etc.) that have authorities in common. The second includes a wide variety of international cooperation with other governments, international organizations or financial institutions, which is required to overcome the present situation. Finally, there are the internal changes that each government has to do in order to resume its economic growth.

The *doing of government* must therefore be oriented to three clear concepts: trust, growth and opportunity. So the doing of government should be used to reestablish the confidence lost in the international financial system; to impulse, sustain and share economic growth among all regions; and to take advantage of the opportunity to correct the flaws of the present economic model to avoid situations like the present one.

In this way, the reflections, criticism and proposals that may be put forward to meet these goals are of much value. Each effort in that sense is important, as is precisely this issue of the Public Administration Review. In it, several authors put forward their

view of the present scenario, their diagnosis of the elements that came together to generate it, their proposals to overcome it and their opinions about the world economic crisis and its effects in our country. And yet, all of them coincide with some of the point before mentioned: the necessary participation of governments, the need to recover the trust in the financial system and its authorities and institutions, the duty to ensure a sustained and shares growth and the opportunity to take advantage of this crisis to build a better model.

So does Jorge Chávez Presa in *The repair of the international financial system: a work in progress*; it gives the clues to understand the factors which generated the present economic world crisis. The OCDE, in its turn, in *Strategic answer to the economic and financial crisis: contributions to a global effort* points out that it requires an *integral strategy to mitigate the impact of the present recession and turn the global economy back to the path of sustained growth* which requires that national governments do what is necessary to increase their economic productivity and to support the development beyond the short term.

Francisco Suárez Dávila in *The Mexican political economy before the world crisis: deficiencies and opportunities*, Analyses the world crisis impact in Mexico and the instruments the government is using to overcome it. Centering also in the case of Mexico, Guillermo Ortiz Martínez in *The challenges of the Mexican economy to achieve a high sustained growth in the midterm*, points out the factors that have been involved in an economic growth lower than expected and desired. In his turn, José Antonio Ardavín in *Towards a new model of fiscal federalism for Mexico in the long term: lessons from other federations in the OCDE*, considers the use of a better and more efficient fiscal federalism as an instrument to build a better and more solid economy.

Finally, Raúl Martínez Almazán in *The world crisis in Mexico: looking forward*, considers that we are before *the historic opportunity to face the great national issues with structural reforms built upon agreements and consensus among the different actors of the society*.

This crisis has turned out deeper and more complex than it was expected. However, its own severity gives another dimension to the

great opportunity it offers. Its dimension requires of coordination efforts among governments, organizations and societies with no precedent, which will allow at the same time to support those positive actions that have been carried out and to consolidate towards the future a global economic model more trustful, stable and safe.

As is well expressed in this issue of the Public Administration Review, we are facing a complex scenario. It is true, however that it represents also an opportunity for the betterment of our systems, our institutions and participation. To achieve that, we all will have to cooperate and do our respective homework. By doing so, we may be able to take those measures and reforms that are needed to increase in important ways our economy's competency.

**OECD Strategic Response to the Financial and Economic
Crisis****Contributions to the global effort****Foreword****Ángel Gurría**

OECD Secretary-General

The world is facing the severest economic crisis in decades, affecting families and communities across the planet. The financial system is paralysed, and restoring stability, confidence and growth is the priority.

The OECD is working with the world's governments and other organisations to overcome the crisis and get our economies moving again. We must also begin shaping the world economy of tomorrow – to make it stronger, cleaner and fairer.

We need healthy financial markets for our prosperity and development, but we also know that business-as-usual is not an option. Any effective strategy requires major new thinking about regulation and markets, about accountability and ethics. We need rules of the game based on a better balance between markets and governments. It is about greater co-ordination and building global institutions for our time.

The OECD's "Strategic Response" reflects this pragmatism by tackling regulatory and policy failures comprehensively. The focus is on the interactions between finance, competition and governance, and, ultimately, on achieving sustainable growth.

We have to restore the conditions for growth driven by innovation, trade and investment. We must do Doha. Notwithstanding the

immediate crisis, we must also apply new thinking to tackling climate change and poverty, as these remain systemic threats to our common future. Sharing the benefits of prosperity and opportunity and ensuring fair social protection are also key to restoring trust in the system.

The OECD Strategic Response points the way forward through action and co-operation. Our thinking is always evolving, but our commitment to building a stronger, cleaner and fairer global economy is unchanged.

Ángel Gurría
OECD Secretary-General

Overview

The world is currently facing the most severe financial and economic crisis in decades. The OECD's latest Economic Outlook shows that the world economy is now in recession. Projections point to a protracted downturn in the OECD, with GDP likely to decline by at least 1/3 of a percent in 2009. In other parts of the world, similar slowdowns are taking place. There remains a large degree of uncertainty about the depth and duration of the financial crisis, which has been the prime driver of the downturn. The spillover to the real economy has already translated into rising unemployment in many countries, hurting families and communities and leading to public uncertainty and anxiety. Reversing this trend has to be a central priority, along with restoring confidence and stability in the financial system.

This crisis has struck at a time of great global interdependence. The response to these unprecedented events cannot be "business as usual". New institutional mechanisms are needed to generate truly global, integrated and multidimensional responses, a point underlined by the G20 leaders at their meeting in November when they called on international organisations to support their work.

The OECD, working hand in hand with emerging economies and other organisations, has a critical role to play in strengthening the global economy. This document presents the OECD's proposed contributions to address the financial and economic crisis. It builds on existing work in areas directly relevant to the current context, as well

as reoriented or new work which has been mandated by committees in response to the crisis. We believe that many elements can feed usefully into the G20's Action Plan, and reinforce other multilateral and national efforts to restore growth and stability.

Countries in the OECD's accession (Chile, Estonia, Israel, Russia and Slovenia) and enhanced engagement (Brazil, China, India, Indonesia and South Africa) initiatives will be integral players in the implementation of the response and should consider themselves standing partners. We will strengthen our dialogue and co-operation on these issues, to ensure the relevance and quality of the work and to promote the necessary convergence of policies and actions amongst developed as well as major emerging economies.

Key considerations

While policy action has rightly concentrated on dealing with immediate stability concerns, a comprehensive strategy is also needed to attenuate the impact of the current recession and put the global economy back on a sustained growth trajectory. This must include productivity enhancing reforms to support growth beyond the short term. So far, the fiscal stimulus measures all include investments in infrastructure, offering an exceptional opportunity to deal with other pressing challenges. For example, packages should include incentives for environment-friendly investments, to maximise growth while addressing climate change. Measures to sustain innovation should contribute to a "green" long-term growth, while social and regional policies should also be oriented towards low-carbon recovery. Given the size and importance of these packages, it will be critical for governments to ensure that they are carefully designed and well implemented.

The crisis demands tough decisions now, but it must not turn our attention away from other serious structural challenges. Efforts to address poverty and inequality must be maintained, along with commitments to scale up development aid, keep global flows of trade and investment open, and develop cleaner energy and production processes. Such global challenges provide opportunities for a sustainable and strong growth environment. Thus, the OECD will accelerate its work programme in these areas.

An effective and sustainable global response will require the involvement of all major players, as well as better co-ordination and

greater coherence among the major international organisations, as already mandated in the 2008 Hokkaido G8 communiqué.

The OECD Strategic Response

The OECD Strategic Response, which was developed with the collective inputs of the OECD Council, the Committees and the Secretariat, aims both to address the crisis and to seize the opportunity to build a stronger world economy. For decades, the OECD has advised Member countries and helped coordinate their policies. The Organisation's coverage of a wide range of policy issues directly relevant to the current crisis and its focus on medium-term responses and long-term solutions to policy challenges are unique strengths. Our analysis suggests a focus on two priority areas:

Finance, competition and governance. In the context of regulatory reform in financial markets, the OECD provides an institutional framework for an ongoing dialogue between different policy communities, focusing on areas where it has leadership, such as transparency, corporate governance, competition, tax, pensions, and financial education, as well as the interaction of policy with institutional and market structures and the overall consistency and efficiency of reforms. The OECD will continue to work on strengthening and implementing principles and guidelines in these areas. Deliverables will also include inputs for the review and improvement of national policies as well as better policy coordination at the international level. The focus will be on fostering the conditions for effective and appropriate regulations and identifying areas where there may be regulatory gaps.

Restoring sustainable long-term growth. Building on the OECD's expertise on structural issues and whole-of-government approaches to policy making, and on the OECD's longstanding work on open markets, employment, the environment and innovation, the OECD will monitor developments and identify policy options and recommendations for putting countries back on a path of sustainable growth. Such strategies should ensure that recovery is based on low-carbon paths to growth, on eco-innovation, and on knowledge creation, all within a more equitable society that spreads opportunity and extends protection to the most vulnerable. A key contribution will be forward-looking analysis and guidance to ensure a healthy balance between governments and markets, and to define

exit strategies for governments to withdraw their intervention in the private sector, once we reach the post-crisis phase.

Delivering on the Strategic Response

The OECD's Strategic Response is based on a cross-cutting and holistic view of the different policy areas and government actions involved in making markets work effectively. It will mobilise the OECD's vast global network of experts and national policy makers to generate relevant analyses and recommendations. Implementation and monitoring of the Strategic Response will lie with the respective committees, who will approve and provide guidance in the regular committee process. Work will be carried out with close cooperation – and under joint projects – between committees and directorates. Emerging and developing economies will be welcome as standing partners in the efforts to define collective solutions.

Deliverables will be of three types - actions by Members and non-members (such as pledges or instruments), policy recommendations, and surveillance. Many will be rolled out in the coming weeks and months, so that they can feed into the process launched by the G20. Work will proceed in collaboration with other organisations involved in the process. An overview is provided in Table 1 and a list of deliverables in an Annex.

Table 1

Overview of OECD Strategic Response Deliverables

	Actions (pledges, instruments, etc.)	Policy recommendations	Monitoring/surveillance
Finance, competition and governance			
Incentives	X	X	X
Corporate governance		X	X
Taxation	X	X	
Business environment & competition policy		X	X
Consumer protection and education		X	
Regulatory management quality	X	X	
Sustainable long-term growth			
Keeping markets open	X	X	X
Macro, fiscal & labour market policies for stability & resilience		X	X
"Green" and innovation-led recovery		X	X
Development	X	X	X
Balancing markets and policies and fostering exit from public ownership		X	X

A communications and dissemination strategy will be put in place for the OECD's Response, to increase its effectiveness and usefulness for member countries, partners and stakeholders throughout the world. Substantive deliverables will be connected to key events, publications and other world-wide initiatives to maximise timing and impact. This could include contacts with major actors dealing with the crisis in member and non-member countries (especially major emerging markets); participation in public events; and tailor-made presentations to relevant groups. Initiatives with civil society, including universities, labour and the private sector, could be organised to discuss results.

I. Finance, competition and governance

While thriving markets are critical for growth and prosperity, recent events demonstrate the importance of a strong and effective regulatory framework and proper supervision. Indeed, the crisis is the result of both market failures and policy failures. The task ahead is to build a sound governance and regulatory framework that will align incentives, while maintaining a healthy balance between markets on the one hand, and policy interventions on the other. To do so, governments may need to strengthen their relevant institutions. As the financial crisis demonstrated, there are strong interrelationships between regulations on capital, deposit insurance, tax provisions, corporate governance, competition policy, accounting rules and executive compensation, which produce the overall environment in which risk-taking occurs. The OECD will consider these issues in a holistic manner in order to be effective.

a) Incentives

Present capital rules have left banks with too little capital, and with procyclical capital variation over the cycle. Interacting with tax and governance factors, the features that contributed most to excessive risk taking are: a) coverage (e.g. on and off-balance sheet operations); b) incentives that encourage excessive risk taking in certain products and off-shore locations; and c) uneven treatment of financial institutions, depending on their degree of sophistication, the sector in which they operate, or the jurisdiction in which they reside. These features interacted with corporate objectives for business strategy and earnings growth, including location, business structure, choice of products and tax minimisation.

Mergers and acquisitions have been a part of crisis management, with stronger firms taking over weaker or failed high-risk and previously under regulated investment banks. The effect of capital regulations on intra-firm capital allocation processes remains to be seen. After de-leveraging, consideration should be given to the desirable size of the volatile investment bank segment, and to updating and strengthening the governance and regulation of these institutions, including possible stronger capital requirements.

In the area of pension funds, recent losses have created much disquiet and given rise to calls for a major rethink of pension provisions which would rely less on volatile financial markets. Regulation of pension funds and the appropriate diversification strategy between public and private provision of retirement income must also be considered. Public pension schemes, too, must cope with reduced employment which will lower contributions to PAYG schemes and eventual pension entitlements. Pressures to suspend automatic sustainability adjustments will be high in those countries which have such systems.

More generally, regulatory management principles have not been extended to cover some financial services. In a number of OECD countries, authorities in charge of the financial sector, including central banks, some independent regulatory authorities or ministries of finance, have been exempted from regulatory quality policies. Use of the 2005 OECD Guiding Principles for Regulatory Quality and Performance could help control the risk of over-reaction through ill-conceived and overly costly regulation.

b) Corporate governance

International co-operation, including among private sector bodies, should be improved to ensure better co-ordination and implementation of agreed international corporate governance standards, especially the OECD *Principles of Corporate Governance*. Remuneration and incentive systems are supposed to align the interests of corporate officials with the long-term interest of the company and the shareholders. Distortions in these structures may lead to a short-term bias towards additional risk-taking, a tendency reinforced by tax provisions in many countries. Improvements and analysis are needed in the following areas: board oversight of risk management;

board practices; governance of the remuneration process; and the exercise of shareholder rights.

c) Taxation

Taxation impacts on and is influenced by developments in financial markets. A number of governments and private sector participants are already examining how tax may have influenced the current financial crisis and what changes in the rules are required to avoid a re-occurrence of recent events. Tax provisions may have encouraged excessive risk taking and reliance on debt by market players; a tendency for top management of financial institutions to focus on the short rather than the medium to long term; and to move to less transparent jurisdictions offshore to evade tax and regulatory provisions. Governments could benefit from examining whether tax systems are providing the right signals and incentives to market operators, and whether these incentives are consistent with the rest of the regulatory framework.

The removal of tax barriers which hamper the effective functioning of financial markets, particularly at the international level, can help countries exit from the crisis. This would include tax provisions which distort investor choices as to whether to invest directly or by means of collective investment vehicles, and tax provisions which act as a barrier to the use of different financial products which reduce the cost of capital. Governments should also consider the broader tax implications of the government bailout packages for financial institutions and how they may influence the future attitudes of these institutions to risk taking.

d) Business environment and competition policy

In a more consolidated financial system, competition may be weaker, leading to higher costs of credit and other financial services to consumers and businesses. If this is the case, countervailing policies will be needed to restore or improve competitive conditions. Restructuring may integrate within a single institution potentially independent operations, such as consumer banking, SME lending and investment banking, leading to questions about the resulting efficiencies and competition risks. Another question to be addressed is whether deposit insurance increases the risk of moral hazard in portfolio decisions and reduces competition between banks.

Competition policy considerations should play an important role not only in financial sector bailouts and restructuring but also in the subsequent recovery. In the wake of the financial crisis, governments have been under pressure to support national industries and “champions” through subsidies and protection. Furthermore, in co-ordination with financial regulators, they have taken emergency and ad hoc measures to shore up financial institutions, in response to severe liquidity shortages and breakdown in lending markets and trust. These measures have included investments and guarantees, asset purchases and time sensitive mergers.

Competition watchdogs may in turn be under pressure to loosen enforcement standards in order to favour economic recovery. In responding to these pressures, competition policy makers must show that competition is part of the solution for benefiting consumers and fostering innovation, competitiveness and productivity. The usual tools of competition analysis and enforcement assume stable market conditions. In a context of crisis, authorities must consider how to safeguard competition principles without hampering policy measures to avoid a slump or the erosion of trust in the financial sector.

In the crisis, businesses, and SMEs in particular, are vulnerable due to their heavy dependence on bank credit and limited recourse to financial markets. It is thus necessary to assess the differentiated impact on sectors and firms and improve the effectiveness of new, innovative and alternative mechanisms to finance local development. Questions to be addressed include: will the economic crisis undermine innovative behaviour, and how can governments sustain or rebuild confidence while encouraging such innovative behaviour?

e) Consumer protection and education

There is a need for better regulatory standards and international codes of conduct on marketing financial services. Information disclosure on basic issues, such as the true cost of credit, is essential. Current mortgages failed to convey key costs and terms to many consumers. Effective financial education and awareness campaigns will help individuals understand financial risks and products and thus take decisions better adapted to their personal circumstances. This also helps prudential supervision, as it is more

difficult to mislead well educated citizens. The OECD will build on its work on financial education and consumer protection to address new issues which have emerged during the crisis.

Sustainable long-term growth

In the current context, an optimal policy strategy to restore sustainable long term growth should include the following key components:

- Keeping markets open;
- Sound macroeconomic, fiscal and labour market policies for stability and resilience;
- Fostering a “green” and innovation-led recovery;
- Advancing development; and
- Balancing markets and policies and fostering exit from public ownership.

The OECD’s work will provide guidance on the policy responses to the crisis, seeking to find the right balance between short-term measures and long-term sustainability. It will strengthen OECD surveillance on macroeconomic and structural performance and further develop horizontal work linking structural and macroeconomic issues.

a) Keeping markets open for trade and investment

Open markets for trade and investment are a key driver of economic growth and development. Keeping markets open will therefore be an essential condition for recovery and long-term growth. Yet, just as the need to maintain open markets is greatest, concerns about the consequences of liberalisation and the perception that liberalisation may have even contributed to the current crisis have been growing. If these concerns result in a wavering commitment to multilateralism and in rising protectionism, the crisis will become even worse and recovery will be delayed.

These threats are real and the system is showing signs of strain. With respect to trade, the Doha Round of WTO trade negotiations, a priority for OECD and G20 Members, has yet to reach a successful

conclusion. Furthermore, the essential financing required for the smooth functioning of the global trading system has all but dried up, highlighting the need for increased official export financing. Investment protectionism is also on the rise in both OECD and non-OECD countries. Such protectionist pressures could increase as companies restructure in response to the crisis and as new categories of investors, including state-owned enterprises and SWFs from non-OECD emerging economies, become more active.

Against this background, and following the G20 communiqué, the OECD is ideally placed to communicate effectively the benefits of open markets for trade and investment, as well as the costs of protectionism. In addition, with its investment instruments, the OECD provides the only multilateral forum for countering investment protectionism. Strong peer monitoring under the OECD’s “Freedom of Investment” project and the commitments under the OECD investment instruments will be vital to combating protectionism.

b) Sound macroeconomic, fiscal and labour market policies for growth and resilience

The recession will narrow the space for fiscal policy and will put government budgets under pressure, due to the simultaneous fall in revenue and rising expenditure demands, not least for social protection, as employment prospects deteriorate further in most OECD countries over the coming months.

In such an environment, structural policies, including those highlighted in the *Reassessed Jobs Strategy and Going for Growth*, will continue to play a key role in strengthening the resilience to economic shocks. Resilience is particularly important in the current situation, because it influences how broad-based and deep the economic downturn will turn out to be. The OECD’s work will incorporate the analysis of the impact of financial markets and financial regulation on long term growth and resilience. This will strengthen OECD surveillance capability both at the general and country-specific levels.

Longer-term structural policies take time to bear fruit. An obvious threat is that the recession, if not addressed properly, could weaken support for reforms, especially if those most adversely affected perceive reforms as detrimental to their well-being. Thus, priorities like health care, education and innovation must be maintained and public budgets secured for these items. It will also be critical to strike

a balance between short and long-term responses. How to manage reforms and achieve needed changes will be an important challenge for governments, and the OECD will assist with this process as we move forward.

Policy makers will have to be very attentive to medium-term inflation trends and unsustainable accumulations of government debt. Correction of the extraordinary monetary easing implemented almost everywhere will have to be swift as recovery gets underway. At the same time, with high and rising public debt in many OECD economies, it will be equally important that a credible fiscal framework is in place to ensure long-run public finance sustainability, especially in the face of spending pressures associated with population ageing. Short-term responses should be timely, targeted and temporary. Efforts will be needed to ensure that fiscal policies remain supportive of long-term growth through innovation, environment support and infrastructure.

Another key medium-term challenge is to shift more forcefully from macroeconomic policy pro-cyclicality to strong, explicit counter-cyclicality, in order to reduce the likelihood of future bust and booms. This is particularly important for fiscal policy, where adoption of explicit counter-cyclical policy rules is encouraged, especially in those countries where automatic stabilizers are weak and political-economy factors contribute to pro-cyclical discretionary fiscal policy. This will also involve a better targeting of public investment, including better co-ordination of investment strategies at sub-national level, where much of the capital investment is made.

c) Fostering “green” and innovation-led growth

The post-crisis slowdown should not preclude or weaken policy efforts to achieve long-term, low-carbon economic growth. Delaying action might result in very large costs to our economies and societies. The crisis provides an opportunity and an incentive to improve efficiency in the use of energy and materials by getting the prices right (with due attention to compensatory social policies). This is also an opportunity to remove subsidies to fossil fuel production and consumption, which would benefit both the environment and public budgets.

In many cases, stimulus measures will include investment in infrastructure, which will remain for the long term. Thus it is

important that these packages do not lock-in traditional, polluting energy production, but instead promote cleaner, climate-friendly alternatives. Policies should encourage adaptation to climate change in an efficient manner. Also, investment in new eco-friendly technologies can represent an important new source of growth and “win-win” opportunities for both the environment and the economy. Putting a price on carbon emissions is essential as an incentive for the development and diffusion of greener technologies, but a mix of instruments is needed. New low-carbon technologies are also key to reducing the future costs of climate change mitigation. Work will build on the OECD’s longstanding work on the environment and on the economics of climate change.

Innovation is a key instrument to boost productivity and sustainable growth. Strong innovation performance is more important than ever in the current context. Stimulus packages should be designed in a way that supports innovation, including through: investment in broadband infrastructure; R&D in green technologies; and innovation of education and training systems. The OECD Innovation Strategy, currently under development, will provide recommendations to sustain and strengthen innovation under current conditions, including issues related to the culture of risk taking that influence individuals and firms.

d) Development

The impact of the crisis on developing countries will affect economic recovery in the OECD area and is raising questions about global governance. Developing countries risk being hit hard as the crisis spreads, with risks for their development prospects. In particular, the economic crisis could have implications for agricultural markets and prices and for the affordability of food in poorer developing countries. Following the principles of aid effectiveness, as most recently reaffirmed in the Accra Agenda for Action, and the DAC Principles for Engagement in Fragile States and Situations, will enable development efforts to produce higher-impact results.

e) Balancing markets and policies and fostering exit from public ownership

Co-ordinated fiscal stimulus has been an important part of the short-term actions to address the crisis. The immediate response has seen a major injection of public resources into the private sector, either

directly, through liquidity support or outright public capitalisation of banks and financial institutions, or indirectly, through increased use of public subsidies and guarantees. However, it must be kept in mind that such massive intervention could produce very undesirable consequences in the medium run by distorting the incentive structure for households, firms, and financial intermediaries; and by threatening to detonate protectionist and/or anti-competitive reflexes that could harm businesses and incite retaliation. It could also distort the structure and size of government budgets and debt, endangering fiscal sustainability and reducing resources for long-term growth, as social protection costs rise and incoming revenue weakens due to the downturn. These risks will need to be countered effectively, balancing short-term and long-term objectives.

It is for these reasons that the OECD has recommended that interventions be timely, targeted and temporary, with a plan for restoring the balance between markets and policies as more normal conditions return. This requires a horizontal approach to ensure that various measures do not offset each other in a damaging way, and because these issues are closely inter-related. Building on its comparative advantage in promoting whole-of-government approaches, the OECD will set up a process to monitor policy developments and assess the impacts and implications of short-term measures on long-term sustainability. It will also develop guidance for governments on designing and implementing an exit strategy for withdrawing from the private sector, once the acute phase of the crisis is behind us. Other international organisations have already expressed interest in collaborating with the OECD on this new area of study.

Annex: Deliverables

Short-term deliverables (before the G20 spring meeting)

Finance, competition and governance

a) Incentives

- Integrated review of incentive structures needed to underpin a well functioning and sustainable financial system (financial markets, insurance and pension regulation, competition and taxation policy, corporate governance policy and financial education and consumer protection policy). (March 2009)

- General Guidance and checklist for Effective and Efficient Financial Regulation and policy PHASE I (already available).
- A report on financial safety net interactions, with special emphasis on deposit insurance (already available).
- Part I of a special report on the financial crisis and private pensions and insurance policies. A special chapter in the Private Pensions Outlook in Issue 5 of the Pension Markets in Focus. Revised Guidelines on governance of pension funds.
- A report on resolution of weak institutions (already available).
- Taking a cross-sectoral regulatory governance perspective, a report on lessons from experience on how regulatory quality management tools contribute to financial sector regulation (Q2, 2009).

b) Corporate governance

- Overview of the international “regulatory” framework in corporate governance; main actors and the use of the OECD Principles. Report highlighting main weaknesses and how to improve monitoring and implementation. February 2009.
- Global Consultation and co-operation with other international organisations, non-member countries, business and stakeholders to discuss key weaknesses in corporate governance practices and joint efforts to improve monitoring and implementation of the OECD Principles. March 2009.
- Progress report to the FSF meeting in Singapore. March 2009; and Report to the G20 meeting on “immediate actions”, including the results of the global consultation (April 2009).

c) Taxation

- Reports on Collective Investment Vehicles setting forth recommendations for work to address the legal and procedural issues (February 2009).
- Contributions to MCM Report on interaction between the tax and regulatory environment (March 2009).

d) *Business environment and competition policy*

- Report on the impact of the crisis on SME financing and government measures taken to address the problem, to be discussed at the OECD High-Level Round Table on SME and Entrepreneurship Financing and the Global Financial Crisis (March 2009).
- *Impact analysis*. A report on the nature of the current crisis exploring whether it is a temporary dislocation in long-term structural change or a more fundamental shift. The report would look at the differential impact of the crisis, by region, sector, company, to better inform policy making.

e) *Consumer protection and education*

- Good Practices for Financial Education and Awareness on credit.
- Multi-country survey (50+ countries) on the potential impacts of the financial crisis on financial education and awareness, and on initiatives and measures that have been developed in response to the crisis. Assessment of the potential role of financial education and consumer protection as possible safeguards against similar market disruptions in the future.
- Report on issues that consumer protection agencies should consider when developing policies to help position consumers to make more informed, well reasoned decisions on financial products, taking behavioural biases, information deficiencies and financial market complexities into account.

Sustainable long-term growth

a) *Keeping markets open for trade and investment*

- Trade pledge by OECD members endorsing the Washington Summit commitments on open markets and a successful conclusion to the Doha round (November 2008).
- A statement on export credits by Members (and some non-members) that highlights the role export credits can play in the

efforts to overcome the current lack of trade finance, without undermining the level playing field across exporting countries (November 2008).

- A Policy Brief on the crucial role that open markets for trade and investment can play in bringing the economic crisis to an end and in the process of recovery and economic reconstruction (March 2009).
- The Council's Decision updating all Members' positions under the OECD Codes to ensure they live up to their legal commitments, including in respect to standstill and elimination of reciprocity (spring 2009).
- A report on *Globalisation and Emerging Economies*, assessing the trade performance of Brazil, Russia, India, Indonesia, China and South Africa and highlighting priority areas where further liberalisation has the potential to deliver improved economic results (January 2009).
- Launch of a new book entitled *International Trade: Fair, Free and Open?* (OECD Insights series), and communications materials on the benefits of open markets and the pitfalls of protectionism. High profile launches will take place in several capitals (Q1 2009).
- A report on building trust and confidence in international investment to be presented at the 2009 MCM. First draft December 2008.

b) *Macro, fiscal and labour market policies for growth and resilience*

General surveillance

- The November 2008 OECD *Economic Outlook* analyses the sources of the financial crisis, the likely consequences for growth, employment and inflation and the role for macroeconomic policy to minimise the cost of recession and restore growth. It also includes analysis of how the financial crisis will impact each of the OECD member countries, major emerging-market economies and the countries that are in the process of acceding to the OECD.

- A working paper on the features of the current crisis and how they compare to previous crises (January 2009).
- An assessment of measures adopted in OECD member countries to contain the crisis and to restore more normal financial conditions (January 2009).
- A policy paper reviewing the current treatment of corporate debt. (March 2009)
- A report on gauging financial conditions in the current climate. Since the summer of 2007, financial markets have been hit by a general repricing of risk and some segments of financial and monetary markets have ceased to work properly, pushing spreads in bond and credit markets to very high levels, paralyzing credit and money markets. At the same time, the flight to quality has pushed down government bond yields. These developments will affect GDP, but to what extent? The report will include an index that synthesises how these various factors influence growth in the major OECD economies (January 2009 and June 2009 *Economic Outlook*).
- Monitoring of financial market developments, their economic consequences and the implications for economic policy (ongoing).
- Strengthening the countercyclical stance of macroeconomic and macroprudential policies. A report that investigates how best macroeconomic policies can offset the effects of shocks bearing on the economy. The report will also examine how to structure counter-cyclical macroprudential financial policies. (March 2009 with Final report in early 2010).
- The 2009 *Going for Growth* publication will include special chapters on taxation and on infrastructure. The taxation chapter will examine how tax structures could be best designed to promote growth. The infrastructure chapter examines whether infrastructure investment has effects on growth that differ from other categories of investment. Working papers will also take stock of tax reform experiences in OECD countries and provide some indications as to which countries may benefit from augmenting infrastructure in specific sectors (March 2009).

- An issues paper on the relationship between financial market regulation and economic growth (March 2009), followed by a report which quantifies the links, drawing on indicators of financial market regulation and information on prudential regulations from existing sources. The study will focus on regulations related to competition and investor/creditor protection that have long-term impacts on output and take due account of financial stability concerns.
- An analysis of the relationships between fair value accounting and the financial crisis (March 2009).

Country/regional surveillance

- The 2008 OECD Economic Survey of the **United States** includes an indepth chapter with analysis on the origins of the crisis, the short-term measures to contain disruption and longer term crisis prevention policies, including recommendations on how to reform the supervisory and regulatory structures (December 2008).
- The 2009 OECD Economic Survey of the **euro area** will include an indepth chapter on financial integration, innovation and the monetary policy transmission mechanism, including analysis of how closer financial integration influences and changes the speed and the channels of monetary policy transmission in the euro area. It will also review the prudential and regulatory framework in the EU and the issues involved in managing systemic and cross-border risks to ensure financial stability in an integrated financial market. It will examine the scope for further simplifying and harmonizing the instruments and institutions for regulating cross-border financial flows (January 2009).
- Forthcoming examinations of **Iceland, Italy, the United Kingdom, Switzerland and others**, will include chapters on the financial sector and their financial supervision and regulatory frameworks (April, July, September 2009).

c) *Fostering “green” and innovation-led growth*

- Booklet “Climate change mitigation: what do we do?” (November 2008) and conference on the “Economics of Climate Change”

in March 2009 will provide policy recommendations to foster green growth.

- A report on designing stimulus packages which fuel growth and preserve innovation, including eco-friendly investment and innovation.
- A report on the role of regional innovation policies in economic recovery and restructuring (March 2009).
- The financing of innovation: implications of the financial crisis and policy responses. This report will look at current mechanisms to finance innovation and key policies to enhance access to capital for innovation. It will also examine and monitor current policy responses. (March 2009)

d) Development

- An aid pledge by DAC Members reaffirming their aid commitments and agreeing to maintain aid flows in line with these commitments (November 2008).
- Report on the role of bilateral donors to assist poorer developing countries in fiscal and financial distress (February 2009, in conjunction with IMF and World Bank).
- The Policy Monitoring and Evaluation in Non-Member Economies report will consider the impact of higher costs of borrowing, reduced foreign direct investment, and potentially lower aid flows on agriculture in developing countries (early 2009).

e) Balancing markets and policies and fostering exit from public ownership

- A report on the labour market and social policy response to the economic downturn will be presented to the Working Party on Employment (March 2009).
- A Policy Brief on short-run tax policy responses to the crisis that will not harm longer-term growth (February 2009).

- Building on regular work and enhanced monitoring, the OECD will formulate recommendations for exit strategies in the areas of social policy, competition, macroeconomic and fiscal policy (ongoing).

Medium-term deliverables

Finance, competition and governance

a) Incentives

- General Guidance and checklist for Effective and Efficient Financial Regulation and policy PHASE II.
- Reports on long-term savings (include life insurance and private pensions) and role of institutional investors. A Policy Brief and a special chapter in the next issue of *Pensions at a Glance 2009*. Part I of a special report on the financial crisis and private pensions and insurance policies. Revised Core Principles on regulation of private pensions, including revisiting regulation of investment, funding, etc.
- Revised Guidelines on governance of insurance companies.
- Reports on the regulatory treatment of financial innovation in general and securitization and on the interactions of the various safety net components in times of crisis.
- An Action Plan for Regulatory Management Quality to strengthen countries' practices when adopting or revising regulations in financial sector regulation, increasing accountability and transparency. It will include guidance on how financial regulators can adopt or improve their use of regulatory quality and risk management tools (Q2, 2009).

b) Corporate governance

- Report to the OECD Ministerial Council Meeting, including a roadmap for medium-term actions to improve corporate governance (June 2009).
- Report and recommendations on effective implementation of risk management, board practices, governance of the

remuneration process and the exercise of shareholder rights (November 2009).

- Thematic peer reviews on priority issues such as implementation of risk management and the quality of the regulatory framework. First round April 2010. Second round November 2010.
- Launch of an OECD web-based clearing house for regulatory impact analysis in the area of corporate governance (summer 2010).

c) *Taxation*

- Study on the role of banks and financial institutions, structured financial products and tax compliance (May 2009).
- Interim report on tax haven work to the G8 and the G20 (June 2009).
- Incorporating recommendations from existing and new projects into the next update to the Model Tax Convention (2010).

d) *Business environment and competition policy*

- Risk taking. A report will provide recommendations for governments in their efforts to sustain or restore confidence and entrepreneurial and innovative behaviour.
- Report and action plan on “globalisation, entrepreneurship and SMEs” including analysis of SME financing policies in the aftermath of the crisis (October 2010).
- A report on competition policy, examining four areas: (May 2009).
 - Principles: financial sector regulation and competition policy. Competitive solutions must take into account fundamentals of financial sector policy and the role competition has played in achieving policy goals in these markets.
 - Crisis: role of competition policy in financial sector rescue and restructuring. Recent emergency and ad hoc

measures by governments have included investments and guarantees, asset purchases and time-sensitive mergers. Competition authorities must consider how to safeguard competition principles in these emergency settings without hampering policy measures that may be necessary to avoid the costs of a slump and of erosion of trust on the financial sector.

- Real economy: challenges and negative spillovers for competition policy in periods of retrenchment. In the wake of financial crisis, governments are under pressure to support distressed industries through subsidies and protections. Competition authorities may in turn be under pressure to loosen enforcement standards in an effort to favour economic recovery.
- Going forward: adaptation of competition rules, processes and institutions to current financial sector issues. Looking beyond emergency actions to stabilise financial markets, competition authorities will need to take appropriate action about competition issues in these markets in the medium and long term.

e) *Consumer protection and education*

- Reports on risk transfers to households and their impact in the context of a crisis.
- Stocktaking and comparative analysis of market conduct regulatory regimes and financial consumer protection provisions (e.g. disclosure, usurious interest rates, consumer complaint and recourse mechanisms, business practices, etc). across OECD countries and identification of good practices.
- Report on the role of financial institutions and intermediaries in consumer protection and awareness – identification of the main policy issues related to “financial advice, marketing and promotion vs. financial education and mandatory disclosure” (conflict of interest, due diligence obligations, remuneration structure of intermediaries, principal-agent problems, etc). and implications for the protection and awareness of the most vulnerable consumers. Identification of good practices and elaboration of guidelines.

- Analytical report and good practices on the role of credit reporting and credit counselling in informing and protecting financial consumers.

Sustainable long-term growth

a) *Keeping markets open for trade and investment*

- Preliminary reports on a Services Trade Restrictiveness Index (STRI). First results of work on the STRI for three pilot sectors, *i.e.* construction, telecoms and business services in June 2009.
- Opening the OECD Codes for adherence to interested non-OECD countries to protect all parties against protectionism.
- Monitoring and assessment of changes to investment policy frameworks against G20 commitments not to raise new barriers to investment (ongoing).
- A report on “Keeping markets open to foreign investment in harsh economic times: Lessons from Fifty Years’ Experience in the OECD and Past Crises” (2009).
- A comprehensive evaluation of all OECD investment instruments in light of developments since their adoption and policy challenges emerging from the financial and economic crisis. This could lead to recommendations for improvement or replacement, including a possible update of the OECD Guidelines for Multinational Enterprises – a key instrument for fostering public trust in globalisation.

b) *Macro, fiscal and labour market policies for growth and resilience*

- A special chapter on how labour market and social policies can help counteract the rise in unemployment and worsening living conditions of low-income families (*2009 Employment Outlook*). It will examine labour market impacts in specific sectors (*e.g.* construction, financial services, segments of manufacturing) and for those groups (youth, low-skilled, immigrants, older workers) more likely to bear the brunt of

the economic downturn. It will also assess how current labour market and social policy settings are geared to tackle growing unemployment and possibly poverty. The paper will also monitor the special labour market programmes put in place to help the unemployed, and assess the likely effectiveness of such measures.

- Report on effective ways to achieve policy reform. This report will explore the political economy of reform in policy areas key to sustainable growth, such as social services and pensions, fiscal and tax policy, education, health systems, the labour market, public administration reform, product market reform, regulatory reform, competition policy and the environment, and identify the factors that contribute to successful reform. Preliminary findings: July 2009; Final report: end 2009.
- Housing markets have been at the source of the financial crisis. An issues paper will identify the main channels of housing policies, their fiscal implications, the ways they may interact with other social policies, and the likely consequences on housing prices, credit to households, savings and construction activity. It will also address the impact of the financial crisis on accessibility to credit and interventions aimed at supporting home ownership and well-functioning rental markets (October 2009).
- A report on the policy determinants of resilience and the impact of the financial crisis.
- A report on the long-term growth implications of the financial crisis, the channels through which they operate and the policy settings that will minimize negative impacts on long-term growth.
- Report on how regulatory reform and management can foster competitiveness and growth. Analysis of regulatory reform as a tool for recovery from crisis, based on the examples of selected countries (*e.g.* Sweden, Japan, Korea, Mexico) (first results Q2 2009).
- Extended publication on taxation and growth incorporating recent country experiences (July 2009).

- Report on the “Role of Innovation Policy Instruments in Countering Cyclical Downturns in Business R&D” (summer 2009).
- A presentation of strategies to return to long-term fiscal sustainability based on the advantages of spending-based fiscal rules over deficit-or debt-based rules (June 2009).

c) *Fostering “green” and innovation-led growth*

- Analyses for Phase 2 of the “economics of climate change” project, focusing on identifying least-cost policy mixes, carbon leakage and competitiveness impacts, financing possibilities and elements for building a world carbon price (mid 2009).
- Report on “The Economics of Adaptation to Climate Change” in 2010.
- Selected papers of the OECD/IEA Annex I Expert Group on policies and approaches to address climate change in a post-2012 framework (e.g. incentives to reduce emissions from deforestation, scaled-up use of the Clean Development Mechanism, sectoral approaches, etc.) in 2009-10.
- Indicators of innovations in eight areas of environmental policies (2009).
- A synthesis report on eco-innovation (Q4 2010).
- Country Innovation Policy Reviews (Greece Q1 2009, Mexico Q1 2009, Korea Q1 2009, Turkey Q3 2009, Russia Q4 2009, 2010 reviews tbc); synthesis report of reviews and monitoring of implementation of existing reviews (Chile, China, Norway, Hungary, New Zealand, South Africa, Switzerland, and Luxembourg – 2009). Reviews of Regional Innovation Policies (Mexico, Italy Q1 2009; Spain Q4 2009).
- Interim report on the Innovation Strategy with policy recommendations to support innovation- driven growth (May 2009).
- A report on Demand-Side Policies for Innovation and Global Challenges (end 2009), focusing on the role of public

procurement, regulations, standards, and public-private partnerships in “pulling” innovation performance.

- Report on expansion of high-speed broadband infrastructure as an economic stimulus (June 2009).

d) *Development*

- Analysis of the current and future impacts of the financial crisis on agricultural markets will be published in the 2009 OECD-FAO *Medium Term Agricultural Outlook*, (mid 2009).
- A discussion of the implications of the economic crisis for the global food and agriculture sector, and for related policies, will be included in *Agricultural Policies in OECD Countries: Monitoring and Evaluation 2009* (mid-2009).
- The *Global Development Outlook*, to be published in 2010, will explore the fallout of the global credit crisis on the developing world. The regional outlooks (Africa, Latin America) will include a macroeconomic outlook chapter that will be devoted to the region-specific fallout of the economic crisis.

e) *Balancing markets and policies and fostering exit from public ownership*

- A background document for the G8 Labour Ministerial meeting in mid-May 2009. Based on the planned work for the *Employment Outlook*, as well as the monitoring of policy initiatives that Member countries may undertake.
- An analysis of measures undertaken in member countries in response to the crisis in the area of industry, innovation and entrepreneurship policy, including best practices.
- A report on governance of strategic public investment across levels of government (Q4 2009).
- Recommendations for exit strategies in the areas of financial markets, debt management, insurance and private pensions markets.

Organisation for Economic Co-operation and Development*

The OECD is a unique forum where the governments of 30 democracies work together to address the economic, social and environmental challenges of globalization. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Commission of the European Communities takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

Revista de Administración Pública



Mexican economic policy before the worldwide crisis: opportunities and weaknesses

Francisco Suárez Dávila*

I. Introduction

Mexico has a wide experience suffering and confronting many economic and financial crises. In 1982, after the announcement that Mexico was not able to meet debt services, it provoked a crisis on external credit that affected almost all the world and resulted in the so called "lost decade" for Latin America. In 1994, Mexico required again of a great financial international rescue known as the "first crisis of the new millennium". The effects over other countries were identified as "The Tequila Effect". This time, 2009, Mexico did not start this new worldwide economic and financial crisis, but will suffer it with a growing intensity.

The paradox is that now we have not yet had the devastating effects the others had, even though, for the industrial world it looks like the worst crisis since The Great Depression. The negative

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numbers appearing proves it. Its curious that some of the causes and political mistakes that the industrialized countries and the international organizations once criticized us in the past are now the same they have committed, such as: a loose monetary policy, a severe imbalance in the fiscal policy, an unsustainable deficits in their Balance of Payments; inconsistent and insufficient adjustment policies and “complex” political factors.

Some of the Mexican experiences such as the 1982 nationalization and in particular, the 1995, banking rescue (FOBAPROA), show us some similarities and good and bad lessons for the advanced countries in their actual situation.

This essay attempts to analyze the impact of the world financial crisis over Mexico, the Mexican government policies implemented to confront the crisis, its deficiencies and insufficiencies. But, most importantly this crisis shows the lags that our economic development is carrying by virtue of mistaken policies of many years. It offers a great opportunity to redirect our process of development and at the same time fight the short term emergency. The overhauls that are happening at world-wide level in relation to the dominating economic paradigms show these opportunities.

II. Crisis its global character, depth and long duration

There is no need to mention the causes of the present crisis, on which “rivers of ink” have been written. It is only worthwhile to emphasize the more relevant present manifestations for Mexico. First its global and integral character, at first we thought it was only a financial crisis transmitted from its epicenter USA through the [mortgage](#) epidemic to the European financial centers. Nobody foresaw the virulence and rapidity with which it would contaminate the real economy. One thought that the great emergent countries, like China and India, considered as motors of the world-wide economy, would be “decoupled” from these phenomena. Today we know that the crisis affected every single corner of the world with no exceptions as it happened in 1929. The IMF and the World Bank estimated¹ the world economic growth will be negative for the first time in 60 years. The GDP of the USA will be -2.6% in 2009; -3.2% in Europe; -5.8%;

¹ IMF Global Economic Prospects and Policies, Note for the Group of Twenty, March, 2009.

in Japan and in China will get as low as 6%; 8% their authorities say; 5% for India. The global growth for developing countries which in the past was favorable now it's lowering from 6.1% in 2008 to between 1.5 and 2.5% in 2009.

	2008	2009	2010
Advanced economies	0.8	-3/-3.5	0/0.5
USA	1.1	-2.6	0.2
Euro zone	0.9	-3.2	0.1
Japan	-0.7	-5.8	-0.2
Emerging and developing countries	6.1	1.5/2.5	3.5/4.5
Global production	3.2	-0.5/-1.0	1.5/2.5

FMI / March, 2009.

The depth of the crisis is yet unknown; it has not reached bottom. We are impressed by the huge –multibillion– amounts of the programs put up by the Bush administration and the new programs of Obama's administration, as the fiscal stimulus on the economy in general; and the financial stabilization program, oriented to “repairing” the banking system; to reestablish its health and, to resume the flows of credit. They have not had the desired impact in the markets. The factor of confidence has not been reestablished. The Obama administration has demonstrated, in its beginnings, weaknesses and errors.

It does not seem that the crisis is going to be of short duration, as it would be a probable recovery in “V”. Rather it seems to be a long “L”, a fall and later a long period of sluggish growth, as it is already anticipated for 2010. The structural problem of a high indebtedness and low savings of the American consumer that represents 70% of the GDP, its large fall of wealth because of the collapse on the real estate and stock markets, and the amount of their pensions will take time to recover and rebalance. Now the economy is being stimulated but the fiscal cost for the United States will reach 12% of the GDP, the highest since The Second World War. The inexorable fiscal adjustment will take time it will be painful and will affect the chances of a smooth recovery worldwide.

It is said that The United States and the Global Economy may experience a “lost decade” like that one suffered in Latin America and Japan, after its banking crisis. It could have very low levels of economic growth for several years, with its serious social and political consequences.

The crashes of industrial production in all countries in the first quarter of 2009 are dramatic.

	GDP 2009	Industrial Production (January)	CURRENT ACCOUNT % GDP
China	6.0	+ 3.8	+ 6.1
Reino Unido	-3.1	-11.4	- 2.0
España	-2.5	-23.6	- 7.8
India	+5.0	- 0.5	- 3.7
Sud Corea	-5.9	-25.6	+ 1.2
Singapur	-7.5	-29.1	+15.4
Argentina	-2.8	- 4.4	- 0.5
Brasil	-0.4	-17.2	- 2.2
Chile	+0.4	- 8.9	- 3.4
México	-2.6	-11.1	- 3.4

Economist / March.

Along the way “the successful economic models” have collapsed. Ireland, the praised “Celtic wolf”, with his rapid growth based on their exports of high technological content, this year will drop a 5% of the GDP, and a fiscal deficit of almost 10%.

Spain who had his successful model based on “Bricks”, the investment in real estate development, tourism, infrastructure, has the largest drop since its democratic transition and even the Civil War, with falls of over 2% GDP, a 15% unemployment and a fiscal deficit of 5%.

The Asian miracle export-oriented models have also shown their vulnerabilities. Japan, Korea and Singapore have suffered major declines in GDP. China’s economy, had adopted measures oriented towards its domestic economy. Finally, the successful economic model of the European Monetary Union with the Euro is in danger as well.

Its “backyard” of Eastern Europe and the Baltic region has serious problems in their balance of payments and banking. Their high debt threatens the banking systems of various countries already in trouble as Austria, Italy and Germany. The Euro itself, is in serious trouble because of the fiscal and balance of payments imbalances in its southern belt: Portugal, Spain, Greece and Italy, all with complicated political and social tensions.

This is the storm that is looming over Mexico. The epicenter of the global crisis is at our northern border, no one escapes its scope, a

profound crisis that has not yet touched bottom, probably a lasting crisis, with an prolonged worldwide slump certainly until 2010.

III. Current state of the mexican economy

The Mexican government initially underestimated the extent of this crisis. At first they said it was a simple “cold”, that our economy with its macro-economic strength was “shielded”. Later when President Calderon was at Davos he understood the magnitude of the “epidemic” and accepted we had “pneumonia”. Recently, the Secretary of Finance referred to the crisis as a real “Tsunami”, that the external impact was serious, that we were in a “hole” and surprisingly, that the measures of the anti-crisis policy were not enough. The problems before mentioned were labeled as “catastrophic”.

The government sustained, earlier this year that the economy would grow a 1.8%, but it was a bad choice of sign. The Bank of Mexico estimated a decrease -1.8%; other analysts, like GEA and Banamex estimated the fall could be -2.3% and Morgan said it could be a -4%. Now, in May, the Ministry of Finance estimates a fall of -5.5%.² These predictions are more realistic. With an estimated fall of the industrial production of USA, in January 2009 of 11% –that affects directly our economy– our industrial production fell at the same rate. In Mexico employment fell in March to 300.000 workers, in 3 months, 100,000 monthly. We could lose 800,000 jobs in 2009. This numbers resemble or even surpass the ones in 1995, which were rapidly reversed because of the boom in the USA and the fresh positive impact, of the TLC, up on our exports. This effect is now the opposite.

The external balance of payments in general, is solid, but the trend is negative. In 2007, the commercial deficit was US\$11,000 million; for 2009, is estimated at US\$26,000 million; the current account deficit numbers for 2007 was US \$8,000, 0.8% of the GDP, now estimated at \$26,000, (3.3% GDP). We now have to add the negative effect of the influenza, particularly serious in tourism. This amount could be easily financed in normal markets. It’s not that easy when the International credit dries-up. Some enterprises of the private sector have important refinancing problems. However, FMI recently announced a special support

² The text was written originally in March 2008, some of the main numbers were updated in May.

credit, and the Federal Reserve a “swap”, both totaling US \$90,000 million.

Foreign Investment decreased from US\$27,000 in 2007 to US\$19,000 in 2008, and nearly US\$10,000 in 2009, and the dollar worker remittances, the second source of foreign currencies are also reduced. No need mentioning the drop of the price and production of oil. At the end of the year, there is a deficit in our petroleum account, including oil, gasoline and gas.

Inflation was considered one of our strengths. We had the lowest inflation of Latin America. Now, inflation in 2008 was of the 6% and in the beginning of 2009 it is estimated to maintain those levels. The “Basic Food Basket” increased nearly 8%.

This puts pressure over wages that had maintained levels of the 4%. The problem looming over inflation is the 30% of depreciation of the peso over this period.

International Reserve levels, despite loses in the lasts months, still provides a cushion of nearly \$80,000 million. Debt also offers safety margins, since the external debt (net) of the federal Government does not exceed US\$40,000 million (4% GDP) and an internal debt of the 18% of GDP.

The big Mexican private banks came out of the 1994 crisis with a strong position. They are now well capitalized with reserves. We can say: it does not have the problems of other countries.

This is the balance of “lights and shadows” that our economy has to offer in 2009.

IV. Mexican economic policy before the crisis: inadequate, deficient, “more of the same”

Mexican economic policy to counter the crisis has been inadequate, deficient, in its design “more of the same”. The programs designed by the Mexican government against the crisis recalls the book “*La sombra del viento*” by Ruiz Zafón, that refers to a “graveyard of forgotten books”, but in this case it’s a graveyard of forgotten programs.

First of all, we have the National Development Plan, that was made by a consulting firm in 2007, Secretary of Finance, Carstens,

unburied it for the recent Forum with the Senate “what to do to grow” (January-February 2009). The Plan estimated that by 2012 “we would grow at a 5% annual rate”. In March 2008 they announced an economic support program (PAE). This mentions on its remarkable 6th program “the creation of a website providing job offers. That’s really helping the employment problem! In October 2008 they announced the Employment and Growth Program (PICE). In January 2009 they presented the agreement in to support the Household Economy and Employment (HES) which actually was not an agreement between the social sectors, but another government program asked to be signed by governors, syndicates and enterprises, within 48 hours.

By February, Congress issues its conclusions after the Forum mentioned above which is in essence just another program, which has all the proposals presented by the Secretary of Finances. All this programs are inadequate and are all “more of the same”. They contain a lot of improvisation and marketing elements with very questionable numbers.

We need to recognize they rescue two forgotten concepts, kept hidden in the closet of the “forgotten instruments of economic policy”:

1. The concept of counter cyclical fiscal policies, which had been hidden in the closet in recent years.
2. Strengthening the development banks, that had been systematically dismantled. As the credit of private banks, had been insufficient to support productive business activity, they were unearthed as a tool.

What were the main Government policy instruments?

- 1^o) **First of all the impulse given to infrastructure investment.** The Federal Budget has an important share channeled to investment in infrastructure. A few months ago the National Infrastructure Fund was created. BANOBRAS has allocated considerable resources to provide direct loans and guarantees, public or private. The amounts are very important, but will have to see to what extent they are effective.

The Household and Employment Support (HES) Agreement says:

- *“The investment on infrastructure by private and public sectors will reach 570 billion pesos in 2009.”*
- *Resources allocated to public investment on infrastructure will increase by more than 30 billion pesos from what already was authorized for 2009.*
- *BANOBRAS and the National Infrastructure Fund will grant loans and guarantees for more than 65 billion pesos*

Implementation capacity has been remarkably weak: there is a lack of well evaluated executive projects, there are institutional weaknesses of evaluators and engineers, there are usual institutional constraints: the rules for tendering and executing public projects, the Ministry of Public “Dysfunction” and their multiple controls complicate decision making, there is an industry of agitators who manage to block the licenses of use of land and who trespass public lead.

In regard to public-private projects the resources of credit are getting scarce. Unlike the successful FARAC I (Public Road Projects that are auctioned to private firms); FARAC II was declared void and Punta Colonet project delayed.

- 2º) **Employment support.** The support to special employment programs has been insignificant. The Agreement considered \$2,000 million for temporary employment; another \$2,000 million in case of a temporary work stoppage; \$2,600 million on extended medical coverage for the unemployed of the Social Security Institute; \$1,250 million on national employment service. Resulting a total of \$8,000 million that are supposed to protect 500,000 jobs, which is generated when there is a growth of 4%.
- 3º) **Household Economy Support.** The biggest support was controlling gas prices. This was possible by the international fall of petroleum prices. The major effect was over public finances, because it eliminated a subsidy of \$45,000 million. The program offered a direct support of \$ 750 million for the substitution of energy saving electro-domestic appliances for high consumption old ones for families of scarce resources.

- 4º) **Housing support.** This meant expanding the resources of The INFONAVIT, FOVISSSTE and “Sociedad Hipotecaria Federal” directed to housing. In this particular case it is an “old regime tool” that has work well through time for the promotion and financing of social housing, achieving an important social objective for families and creating jobs.

- 5º) **Support for small and medium enterprises (PYME’s)** Development banks, particularly NAFIN and BANCOMEXT, had been encouraged to support PYME’s. Theoretically the above mentioned incremented their direct support, but an important has been channeled through guarantees. Its efficiency is questionable because they are built upon banking credits where banking volumes have been inadequate.

The Ministry of Economy continues its financing through the PYME Fund and recently added another trust fund called “Mexico Emprende”. The adequacy of a Department of State operating as a Bank is very questionable. The reported numbers are high, raising skepticism.

The Program “will provide technical advice for PYME’s giving them resources through the trust “México Emprende” with \$7,000 million pesos stimulations support of \$250,000 million pesos in loans through the next 4 years.”

“Nacional Financiera and BANCOMEXT increased the direct and indirect financing for enterprises by 21% reaching a total of 176 billion pesos.” “Direct credit was promoted by development banks, which will increase by over \$125,000 million pesos in 2009, representing a growth of 26%.”

- 6º) **Other support through development banks.** Countryside it’s not included on this special programs. Nevertheless, the credit lines increased a 10% through FIRA the Rural Bank, reaching a total of 84,000 millions.
- 7º) The Secretary of Finance spoke at the Forum of Congress proposing an legislative agenda to eliminate obstacles in the execution of infrastructure works, empowering the Federal Commission of Competiveness, changing the banking law and promoting labor reform, etc.

V. Mexican policy, compared to the action of other countries against the crisis

Advanced countries have announced large counter-cyclical expansionary programs, which have some common elements. The main objectives were to increase aggregate demand, to avoid the fall in output and employment, and to stabilize financial systems, to resume the flow of credit. To do this, they have adopted and implemented the following instruments of economic policy.

1. Monetary Policy has reduced the interest rate to almost zero.
2. Central banks have opened the rediscount window to buy paper from public, private banks or companies to inject liquidity into the economy.

Monetary policy has almost exhausted its instruments.

3. Fiscal policy's programs had increase public spending to create jobs, through investment in infrastructure for public works, increase social programs in education and health, social security and housing. These programs have been generic or targeted at specific sectors.
4. Some countries have reduced taxes. There is general agreement that this has little effect because, given the imbalance of financial companies and individuals, a tax cut is aimed at rebuilding balance sheets. Social spending targeted to low-income groups is more effective.
5. The use of international reserves and exchange rate policy has been important, especially in emerging countries.

The amounts of these programs have had a significant expansionary effect and have affected the balance of public finances. In the European Union, nearly all countries exceed the Maastricht rule for deficits not to exceed 3% of GDP. We have seen how fiscally orthodox countries like Spain, Ireland and England, have deficits who have reached 5% of GDP. United States could have a historic deficit of 12% of GDP.

How to quantify the impact of Mexico counter cyclical and expansionary programs?

The Mexican programs, as discussed, have not been enough. It's difficult to quantify the actual amount of additional programs before a veritable statistic dance of announced figures. The Program that promotes Growth and Employment said that "in the infrastructure program will be a "fiscal stimulus" of \$90,000 million equivalent to 0.7% of GDP. It mentions a program of additional spending on infrastructure of \$65,000 million, which includes the opening of a refinery".

Significant changes in national accounting have been announced making it difficult to compare the numbers:

- a) PEMEX's investment is now out of the budget balance.
- b) Pidiregas (PEMEX special projects) are now considered public federal government debt.

The fiscal balance has increased to a 1.8% of GDP deficit, instead of 0.1% in 2008 and the financial requirements of the public sector (PSBR) are 2.8% of GDP instead of 2.0%.

The refinery spending of \$12,000 million, mentioned above will be financed by the Oil Stabilization Found. But it is doubtful that this refinery will have any impact this year.

Otherwise stated, the only real impact is the \$ 53,000 cash invested in additional infrastructure programs of rapid execution in schools, hospitals and country roads. The good news from the energy reform its that PEMEX has \$40,000 million cash to start the year. Its impact will all depend on the execution of each project.

Many of the "millionaire numbers" depend on vague concepts. How much is direct spending, which can be used quickly, how much is induced investment by private sector, which now no longer has sufficient funding. How much of the development banks support are guarantees that depend on private banking credit and how much is direct credit?

It is possible that the electoral appending will act in first half of the year, like a powerful incentive so that the Federal Government and the States compete to have electoral impact. How much have the federal government and the States saved? The problem of falling revenues could be a worry in the markets if the fiscal deficit is greater than the predicted one.

As can be seen from the above figures, the panorama is quite confusing on what is other real the expansionary impact of the announced measures.

Secretary Carstens said in his speech, where the Agreement was announced: *"If the announced "counter-cyclical" measures for 2009 are considered jointly, including the PICE and the Agreement, they imply a fiscal stimulus of 1.8% of the GDP similar or greater than the programs announced in other countries"*.

This has been questioned. The calculation seems to include the new "creative accounting", the cancelled oil subsidy, by the lower prices, initially considered in the budget for \$45,000 million. But to cancel a subsidy does not stimulate the economy. Some experts consider that the effect of foreseeable stimulus at this moment is less of 1% of the GDP.

A recent IMF study on the incentives given to their economies by the G-20 countries, which includes the effect of "automatic stabilizers" (which Mexico lacks) and the discretionary measures, Mexico, even if executed as promised, is at the bottom of the table. Stimuli from United States joined by the double effect is 4.6% of GDP, Canada 3.6%, China 3.4% India 3.8% Korea 5.1%, South Africa, 3%, UK 6%, Mexico 1.3%; Brazil, in contrast, accumulated 1.1% savings.

Qualitatively programs carried out by the Government of Mexico do not differs much from these applied by other emergent countries.

The document "the Response of the Governments of Latin America and the Caribbean against the International Crisis" (synthesis up to the 30 of January of 2009), is summarized as follows:

"The countries of the Region reacted with the implementation of measures of diverse nature against the evidence of the gradual worsening of the international and the financial crisis whit the certainty that, even though the macroeconomic foundations of most of them are quite stronger than in the past, the region is not immune to the impact of the crisis and will require an effort in terms of policies to counter as much as possible the projected decrease of regional growth".³

³[The reaction of governments in Latin America and the Caribbean face the international crisis](#), a summary of the policy measures announced until January 30, 2009.

In Mexico, as noted, we have adopted counter-cyclical policies that aim to increase spending in infrastructure, on social spending and social security and to use the development banking for sector programs.

Monetary policy has other characteristics in Latin America and Mexico. The first concern is about inflation and the exchange rate, preventing an aggressive lowering of the interest rate, although there has been some reduction at levels of around 5% by the Central bank. Nevertheless, the rate only affects in a limited way the rates on credit and rather it acts to promote domestic and external savings.

One of the important aspects that have been used to evaluate the economic policies against the crisis is the leeway that countries had at their disposal at the time the crisis erupted. Particularly, the fiscal monetary and balance of payments margin of action. What leeway does Mexican economic policy have to act?

a) Margin in public finances

Mexican authorities have assumed that they have great strength in its public finances. That is, there is a primary surplus and a balanced fiscal balance.

At the end of 2008, according to the Report of Public Finances, they have a deficit of 0.1% of the GDP. This means balance. Also it means that, actually, during 2008, already in the heat of the crisis, the Government really did not follow a contra-cyclic policy. There is an additional problem, for some analysts, who consider that the real measurement of the fiscal situation of Mexico is the FRPS (the financial requirements of the public sector), that is near to 2%. This includes Pidiregas (the debt of PEMEX in specific projects), FOBAPROA (the banking rescue) and, mainly, the contingency for Pensions. With the accounting changes, the fiscal deficit is, as mentioned above, about 1.8% of GDP and FRBS goes to 2.8%. Another concept of debt has been invented, "the historical balance of the FRPS" that, mainly to take into account pensions goes to 34% of GDP.

The fiscal problem is now more serious. Tax revenue fell by 22% in the first quarter and there is a fiscal GAP of more than 2% of GDP for the year.

We have been victims of our myths and our “creative accounting”. According to these figures, we would not have as much margin to man-oeuvre. We have, of course less margin than lower than Chile and Brazil, which have a high fiscal primary surpluses. But there is more leeway compared to the fiscal efforts of the industrial countries, especially through increased placement of internal debt.

b) Margin of monetary policy

With interest rates of the Bank of Mexico, 5%, there is in comparison with the industrialized countries, more margins. Nevertheless, the interest rate in Mexico fulfills another purpose; it helps retain domestic and external savings, but has little impact on the rates of credit for credit that can be higher than as in consumer credit distend. Lowering the interest rate puts pressure on the exchange rate.

With the mono-legal objective of the Bank of Mexico to take care of the stability of prices, this does not leave the possibility of injecting liquidity via financing to the government, the private or development banks.

c) Margin in the balance of payments

As said before, although the deficit in current account of the balance of payments has increased, it can be financed, including the international supports agreed by the G-20 (the IMF). The level of international reserves, high by our historical experience, is nevertheless inferior to countries like Brazil.

VI. To face the crisis and to reorient the economic policy and our process of development

The crisis revealed the degree of institutional destruction Mexico has experienced in the last quarter century, and particularly in the last decade. There are severe limitations to the capacity that the Mexican State has to act through its institutions, and economic policy instruments. More serious has been the distortion of the vision and the basic conception of how to drive the development process.

This institutional and mental destruction has the impact of what we could call the 7 deadly plagues: 1) Adjustment programs against other

crises that significantly reduced public investment; 2) the priority of “stabilization” over growth, carried out by the governmental group of “stabilizers”; 3) the neoliberal dogma and commandments of the Washington Consensus; 4) the governments of Fox and Calderon, who leave a weakened the state; 5) the wasted oil boom; 6) the dramatic international scene; 7) the government without a majority in Congress and the “partycrats”

Currently we have a precarious fiscal situation, with low taxation and patronization of incomes that affects not only the federal government, but the 3 orders of government (states, municipalities). Foreign control of the banking system, which provides primarily for consumption and housing rather, than productive activity, development banking distorted and dismantled. A deindustrialized country essentially turned into a giant in bond industry with highly concentrated exports, a country heavily dependent on the United States economic cycle. Destruction of the middle sized companies and prevalence of some major companies, many small and micro companies. Lag is farming. Many entrepreneurs have become “rentiers” and have sold their businesses, increasing weight of foreign investment, strong private monopolies and oligopolies that are now beyond of the power of the State.

Also an overhaul of the process of structural reforms must be realized, some have failed and created structural destruction. To continue insisting on making more “structural reforms” as the solution of our problems, is a worn out solution. Today, the field of action for a state that is well managed is enormous. “More government and less politics”, as Don Porfirio Díaz, would say. But rebuilding the state’s ability to act, and follow another path of development will take time and requires one step after another.

Some tasks, that are, required to reorient the development process and to rebuild our institutions:

1. “De-petrolize” Public Finance: Tax Reform

It is clear that Mexico needs a real fiscal reform and a reform against the excesses of fiscal federalism, sometimes converted into fiscal feudalism. Mexico is in danger of facing a fiscal crisis after the elections of July 2009 and the end of oil hedges combined, added with the fall of oil prices and the Cantarell oil deposit. Recession will deflate the normal income tax the electoral competition will increase public spending.

The Budget and the Revenue Act for 2010, has particularly complex challenges. There is some margin for maneuver, stabilization funds, the effect of currency depreciation and the profits generated by the Bank of Mexico.

On the other hand, it seems to me that only a crisis will enable us to achieve a fiscal reform that affects all its components, VAT, income tax for individuals and companies, public service fees, particularly water, the border must involve all actors equitably.

This reform should be prepared with a government “whitepaper” with a good diagnosis, to identify the various alternatives to raise income and their impact and identifying the costs and benefits for each social group, as well as the general benefits for the country. Essentially, it requires a pact as the Spanish Moncloa Pact or the Chilean transition, which will be necessary to establish certain mechanisms for social compensation.

2. “Re-Mexicanize” Banking and a Banking Redesigned Model

It is clear that having a financial system with more than 70% foreign ownership implies a vulnerability to Mexico which the crisis has made evident. Also shown are the major weaknesses of the banking model proposed by the banking authorities.

The financial system in foreign hands has meant that credit was directed to the consumer and to high-margin mortgage. Little credit has been given to the productive activity, to businesses and even less to agriculture. Given the problems of the “head-office-banks” swamped by the crisis, the temptation will be that the branches have to transfer funds and therefore affect the exchange market, and in any case, reduce the credit. The authorities have done almost nothing to monitor rates and fees or to overview the sector focus of the credit. Banking supervision that ran smoothly in boom times, with adequate capitalization and reserves, is weak under current conditions. There will be surprises regarding assets that seem performing, but the truth is that some may be in trouble.

It also seems a mistake, that with the objective of stimulating competition, many bank and non bank institutions have been created: Sofoles, Sofomes; savings associations, credit unions and niche banks that depend on market funding, which has been closed,

but have no stable base of resources. With limited supervision, they are the vulnerable part, of the financial system.

It is an opportunity to “re-mexicanize” the private banking in a wide sense. I emphasize, one does not require “statism” or much less, to expropriation. The option to “mexicanize” the 2° most important bank of the country: Citibank- Banamex, seems warranted. With the partial nationalization by the Government of the United States, of Citigroup, Banamex was in a situation of illegality, as Mexican law and the TLC states that a foreign government cannot take capital directly or indirectly, in a Mexican bank. The consequence should be to be sold. Taken the political decision, there are various options of financial engineering at could be carried out by a direct purchase of a private Mexican group or during a transition period for the creation of a sovereign wealth fund, using reserves from the Bank of Mexico, Nacional Financiera or by creating a trust. There should also be guidelines for banks to increase their amount of credit to productive activity. They must sell increasing proportion of their shares in the Mexican stock market, which owned increases supervision “by the market”.

In short, the current banking model’s inadequate, based on its 3 elements:

- a) Banking across the country by boosting consumer credit, thorough credit card offerings, banking concessions to department stores or to create niche banks.
- b) Reduction of margin intermediation through greater competition, driven by the creation of more financial institutions to compete with other banks.
- c) Strengthening private banking and non-bank financial intermediaries, reducing the importance of development banks, dismantling some institutions. Transforming the development banking model as the World Bank proponed by creating or budgetary resources, such as the Financiera Rural, which limits lending?

The three theses have been proved wrong at first, and the problems are now magnified by the crisis. A financial system should encourage savings and investment, not consumption through debt.

3. *Reindustrialize Mexico*

With the accession of Mexico to the North American Free Trade, Mexico adopted a different model of economic development, including industrial development. This model is directed to exports, discarding the old system of import substitution. With the momentum of NAFTA, Mexican exports increased dramatically, the weight of oil was significantly reduced. This initial phase of creating commerce helped us recover from the crisis of 1995.

However, imports also grew very rapidly, decreasing the amount of value added, the Mexican economy became a giant in bend industry, many productive chains were broken.

The north of the country grew faster than the national average, the center, below and south lagged even more. The levels of per capita income of Mexico and U.S. did not “converge”. Over time it has exhausted the initial benefits of the NAFTA. We did not put in place compensatory policies, like the European Union, which worried allow us to reduce the gap. It was said “the best industrial policy is “no” industrial policy. This had a high cost.

The Mexican economic cycle is now a reflection of the U.S. in manufacturing output, as if it were a state of the American Union. Paradoxically, the largest and most dynamic export items were the automotive sector, heritage of the old industrial policy, which promoted trade “the maquiladoras” without industrial policy, has not been able to integrate domestic chain productions.

Recent studies indicate that in Mexico there are some large national and transnational companies, and a high percentage of small and micro enterprises, many in the informal sector, but little development of the basic medium, signal firms.

The energy sector was an engine of development and it depended 2/3 on the production inputs of the domestic industry, now is depends on the same proportion of the foreign industry. At the same time, the great works of infrastructure, mainly roads, now are made by foreign companies, mainly Spanish.

Therefore it requires a policy of industrial development. Nacional Financiera and Banco Nacional de Comercio Exterior must retake the role of basic tools of this policy. The National Development Bank

of Brazil does this. In general, priority should be to reorient economic policy towards strengthening the domestic market.

4. *Rebuild the social safety net, “Reformalizing” the Economy*

Historically, Social Security –IMSS– was created as the primary instrument of social security of the Mexican State, ensuring public health and pensions for its workers. The ISSSTE, later established, fulfilled the same functions for the federal bureaucracy.

The reforms to the pension scheme from a system, financed by contributions to an individual accounts system, creating a System of Savings for Retirement, with the Afores and Siefores, was an important reform. True, this system is far from universal coverage in health and pensions.

To solve the problem of giving a greater coverage to health, another system, was devised, the ‘Seguro Popular’, which has been growing at the expense of Social Security. As proved by Santiago Levy’s recent work, “Good Intentions, Bad Results”, this system rewards and encourages the development of the informal economy at the expense of the formal sector. It is a system of patronage, in many ways duplicates the formal social security. International agencies have been critical of how costly it is to have several systems.⁴

A deep reform would represent the integration of the Popular Insurance to the formal system of security of the IMSS and to consolidate the ISSSTE system into one system, a national social security system.

In this context, Reforms have to consider the creation of unemployment insurance, through gradual implementation, linked to a national system of training workers, also consolidating scattered efforts.

5. *Retrain Mexicans with a quality education system*

One of the major achievements of the Mexican State was to create a system of free secular education, which has achieved wide national coverage in primary and secondary schools, although there are

⁴ Santiago Levy, *Good Intentions, Bad Outcomes*, Brookings Institution, 2008.

still significant levels of illiteracy, around 6 million. This “extensive system” has suffered a great deterioration in its quality. The numbers of years of education are 7, when comparable developing countries exceed 11 years. In comparative studies PISA, the OECD examined students aged 7-14 years: in math, reading comprehension and science we are at the bottom of the study. Around 50th place.

It is not a problem of the amount of resources devoted to education. This represents about 6% of GDP, which is comparable to OECD countries such as Korea, which has very high standards. The problem is we don't use it well. Much ends on administrative costs of the bureaucracy and the teachers unions.

Higher education has serious problems as well, that are closely linked to our low technological development. The spending of Mexico on research and development is about 0.3% of GDP, done mainly by public institutions, such as the UNAM. In developed countries must be at least 2%.

In these fields we required to undertake substantial reforms that raise the quality of education and training, “throughout life” and encourage technological development: to ensure that Mexico gets into “the Information Economy”.

6. *Re-Make the Agrarian Reform and Re-Development the Rural Economy*

Agrarian reform and rural development remains a challenge in Mexico of the 2nd millennium. As the economy of the “Porfiriato”, in the XIX Century, there is a thriving commercial farming in the northern, northeast and northwest, part of the country, with now a good irrigation system. But in other areas of the country there prevails rain fed and subsistence agriculture. In the rural country side lives the poorest and most marginalized Mexicans. In the lower income states, like Oaxaca, Puebla and Guerrero, the problem is magnified, because in the countryside and the mountains, there are children, women and the elderly; young people have gone to work to other areas of the country and especially to the United States.

There are an estimated 4 million units of rural production, but only 6% represent commercial agriculture, 60% of owners have less than 5th hectares. Out of 30 million hectares, only a fifth is in irrigation districts. This situation of subsistence agriculture has not

changed much in decades. It is fair to recognize that systems like “Oportunidades”, a targeted support to poor farmers, have received international recognition. But, as PROCAMPO and other programs, subsidies do not reach the poorest farmers. In the Agricultural area we see the destruction of some of the institutions. Some institutions have been eliminated, even agreeing to some of the excesses and abuses of the past, they contributed to social stability and to reduce poverty. Banrural disappeared to be replaced by a small “Financiera Rural”. Eliminating a sectorial credit policy, banking in foreign hands, stopped giving credit to farmers. Agricultural insurance has been eliminated. There is insufficient storage system; there was a system to stabilize prices first CEIMSA, then in CONASUPO.⁵

Investment in farming is even weaker than in the rest of the economy. Mexico did not benefit like other countries. The recent period of boom in prices of raw materials, which preceded the crisis, we abandoned the goal of food security.

The budget for the agricultural sector has always had important increases. But the resources thanks to the incompetence and inefficiency of the Secretary of Agriculture have been poorly spent. There is a long list of programs and funds, many of them highly politicized and strongly clientelistic. The government has maintained an expensive system of state offices to oversee federal spending, resented by the State Governments.

The development of the most marginalized areas of the “subsistence” agriculture will not succeed unless measures are taken outside the “strictly speaking agricultural development.”

The Financiera Rural should reform, to become a full fledged, development bank, which can be financed via the placement of debt and not a mere “agency”, designed by the World Bank to place budgetary resources. Agricultural insurance must also be restored.

7. *Rebirth of Strategic Planning for Sustainable Development*

Article 26 of the Constitution provides a mandatory organization of a democratic planning system. This, however, has become a

⁵ Basic information appeared in Article by Enrique de la Madrid, Director of Financiera Rural, in Ideas of Universal Newspaper, Saturday March 28, 2009, quoting data from recent agricultural census.

formal exercise done at the beginning of a presidential term and, at times, far from being a truly integrated route planner to work for the administration, it becomes work given to external consultants.

It's a good opportunity to redesign a new vision of the country, from a strategic planning for sustainable and viable development. Brazil, aware of its importance, has a Ministry of Planning and recently established a Strategic Planning Unit with the rank of Ministry. This is an urgent task to face the crisis. In Mexico, this unit could be created depending on the Presidency. It should prepare the Strategic Plan of the Government, update it, ensure its implementation and make a systematic review. Bureaucratically it should be a small unit, but high level and quality. One task that showed is entrusted to it are strategic programs of multi-year public investment, as did the former Investment Commission, under the President, which worked smoothly.

Within the planning system, there should be a territorial reorganization, including regional planning, to encourage State and urban planning. This last one is a neglected subject, with very negative consequences for investment in a good urban transport system and a due attention to the environment.

Urban and regional planning, with ecological sense, is urgent for the beaches and coastlines. Where there are no programs of FONATUR (the tourism investment trust fund), they have been subject to predators. It also needs to design a program for national borders. In the northern border it should have the support of Nadbank. The Strategic Plan should be discussed and approved in its broader outlines by Congress.

As part of this planning exercise an Economic and Social Council should be established, as it operates in other countries such as France and Spain and/or a Council of Economic Advisers for the President as in the US. This is particularly important to build national consensus to cope with the crisis. The government is too closed within itself and requires to openly vent its policies.

8. Redirect Relations with Foreign Countries

The current administration has corrected some deficiencies in our foreign policy during the Government of President Fox. The new

administration has succeeded in starting a new relationship with United States: the first meeting in Washington of President Obama with a foreign head of government; his visit to Mexico accompanied with Secretary Clinton, the priority given to the issue of drug trafficking and organized crime, and arms deals, within a context of shared responsibility. There has been some restructuring of the damaged relationship with Latin America. They are, however, changes in the surface which have yet to pay off.

We lack of a long-term strategic agenda and the institutional resources to design it. We do not have it toward the United States. The NAFTA is exhausted in its effects and we do not know where to redirect it. Moving towards a Customs Union or a North American Economic Community seems "suicidal" at this time. Rather we need to redress inequalities and the setbacks that NAFTA showed, create policies and institutions to take better advantage of proximity to the United States. How do we prepare to reduce the gap in income levels with United States and Canada?

In relation to Latin America, we have lost, in favor of Brazil, our influence in the Caribbean, particularly Cuba and Central America.

We have no major initiatives and leadership in regard to the reforms of the international architecture of the multilateral agencies, either the UN or the IMF and the World Bank and the G-20. We have limited influence among the emerging countries and so-called "Brics".

Mexico needs to create a publicly supported institution jovially, with academic participative and private enterprise, a "think tank" to help prepare a long-term international agenda for Mexico.

9. Re-administer the Government and Reform the State

State and administration reform, has a very broad scope. In this essay I will only refer to some economic aspects. There are aspects that need to be reformed with respect to relations between the 3 powers and the 3 levels of government. As some examples, the city administration must be extended to 6 years, the number of "plurinominal" congressman in the House of Representatives, must be reduced; eliminated in the Senate, but not, in my view, to establish the reelection system.

Our country is currently “under administered”. When structural and legal reforms and legal, are proposed to advance in our development process, the truth is that a great margin of progress can be achieved through better use of the administrative capacity of the state. At the same time, we are lacking some institutions and others could disappear. The present administrative structure is poor. There are too many Secretaries of State. Some should be consolidated, as the Interior and Public Security Ministries. It is not clear what Secretariats, should only set policies and regulate, but not operate. Some secretariats, such as agriculture, have a large web of inefficient programs, which are duplicated or unnecessary or useless. The State has been deprived of its core functions with the proliferation of regulatory commissions, with high wages, often captured by “special interests”. There is waste in spending and bureaucracy. This allowed the squandering of oil surplus. Federal resources are transferred to the States to be wasted or, worse, without transparency and accountability. This requires an Administrative Reform of the State.

VII. Re-developing and rebuilding Mexico

During this millennium, Mexico has been characterized by a mediocre growth. It is true we enjoy price stability, well balanced public finances, low debt levels. But, when the United States achieved an unprecedented boom, we were unable to exploit it. Emigration to United States and the informal economy have been the escape valve to our lack of job creation.

The Bicentennial of our Independence and the Centenary of our Revolution is an occasion to review our advances and our downfalls. What are the institutions we showed preserve which we modernize, which do we lack? We showed be building upon the debate of ideas, that is happening in the world. There is an unanimity that the capitalist system of the last 2 decades has failed and must be reformed. There is a need for a new state-market relationship. In this historical review and modern discussion, the conviction will emerge that Mexico needs a modern state as a driving force of our development, regulating and making use of the necessary impetus of the market.

The system, that worked best in Mexico, which gave us 6% annual growth from 1935 to 1970, was the “development”, designed and

promoted by a developmental State. This prevails updated in China and India. We must move in that direction. It must indeed be a “development” which combines a strengthened foreign and domestic competitiveness. It must be complemented by an active policy to correct social inequalities.

The crisis forces us to effectively address the economic emergency, but gives us the opportunity to redesign our economic and social strategy for the long term. Given the complex and difficult situation we face in the coming years 2010, an emblem of the Bicentennial, we must prepare ourselves to celebrate. Not by making grand buildings, but by developing a new social pact a new consensus and vision, in which all the stakeholders assume their responsibilities in a new “Road Map” for the country, which will lead us down a path of shared prosperity.

The challenges that the Mexican economy faces to achieve high growth in the medium term

Guillermo Ortiz Martínez*

I. Introduction

This article discusses the causes of the low growth that Mexico has exhibited in recent decades, in order to identify possible courses of action that could be taken to boost the potential growth of the economy in the medium term.¹ This analysis has become particularly relevant in the context of the current global crisis. In the absence of structural changes that may boost the potential growth rate of the economy, Mexico's growth rate could actually decrease if the potential growth of the United States diminishes due to an adjustment to the spending patterns currently being observed in that country.

The central argument that is derived from the analysis in this paper is that the low potential growth of the Mexican economy responds ultimately to an institutional framework that leads to adverse incentives. In particular, this institutional framework has tended to

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¹ The potential growth of the economy can be defined as the maximum growth that can be achieved in an economy, its given available resources, without generating inflationary pressures.

reward rent extraction relatively more than the search for new and better production methods, and has led to low rates of investment in physical and human capital. Obviously, this leads to low economic dynamism, greater income inequality, and increased poverty.

This paper is structured as follows. The second section describes the growth that Mexico has exhibited in recent decades, compared with that observed in more successful emerging economies. The third section identifies the immediate factors that have led to the Mexican economy's low potential growth.

The fourth section describes the deep institutional factors behind the low performance of the more immediate determinants of growth. The fifth section discusses the possible effects on the potential growth of our economy derived from the current global economic crisis. The sixth section outlines courses of action that could change the incentive structure that currently characterizes the economy and thereby have a positive impact on competitiveness and growth. Finally, the last section presents some conclusions.

2. Low growth in Mexico, 1960-2007

From 1960 to the present, Mexico has registered a poor performance in terms of its economic growth when compared with other regions that started this period with similar levels of development. From 1960-2007, Mexico's average GDP growth rate reached 1.9%. In contrast, the average per-capita annual GDP growth rate in East Asia was 5.2%, while the most recently developed countries in Europe, such as Greece, Ireland, Portugal and Spain, achieved annual growth rates of 3.3%.²

Due to this performance, Mexico has lagged considerably in terms of living standards. While Mexico in the 1960s saw GDP per-capita levels similar to those of Chile, Spain and Ireland and higher than in countries such as Korea, in 2007, GDP per capita in Mexico was well below that of these countries. A comparison between Mexico and Korea is particularly illustrative: while in 1960 per-capita GDP in Korea totaled 42% of that of Mexico, in 2007 the situation was exactly reversed—GDP per capita in Mexico accounted for 42% of that of Korea. Mexico's deficient growth performance is important

² Asian countries considered include Korea, Hong Kong, Malaysia, Singapore, Thailand, and Taiwan.

when considering the fundamental role that growth plays in opening up opportunities for the alleviation of poverty.

**Table 1: Per Capita GDP Adjusted by Purchasing Power Parity
(2000 Dollars)**

Levels						
	1960	1970	1980	1990	2000	2007
Mexico	3,695	5,109	7,201	6,877	8,082	8,752
European 4	4,629	8,690	11,594	14,459	18,578	21,475
East Asia	1,530	2,589	4,641	8,387	12,947	16,664
Latin America Excl. Mexico	3,733	4,896	6,648	6,275	7,058	8,089
Annual Growth Rates						
	1961-1970	1971-1980	1981-1990	1991-2000	2001-2008	1961-2007
Mexico	3.3	3.5	-0.5	1.6	0.8	1.9
European 4	6.5	2.9	2.2	2.5	1.6	3.3
East Asia	5.4	6.0	6.1	4.4	3.3	5.2
Latin America Excl. Mexico	2.7	3.1	-0.6	1.2	2.1	1.7

Note: Regional averages weighted by population.

Source: Penn World Table 6.2 and World Economic Outlook, IMF.

3. Factor accumulation, the efficient allocation of resources and productivity as growth determinants

The average low growth in the Mexican economy registered in the period 1960-2007 partly reflects the stagnation during the "lost decade" of the eighties. However, as shown in Table 1, this is not the only factor associated with this poor performance. On the one hand, since the sixties, growth in Mexico was significantly lower than in European countries and the newly industrializing countries of East Asia. On the other hand, even after the "lost decade" and the achievement of a stable macroeconomic environment, the Mexican economy continued to register growth rates lower than those observed before the turn of the eighties and displayed by other developing countries. It follows that, apparently, the economy has a problem of low long-term potential growth.³

³ As shown in Table 1, the Latin American region as a whole is also characterized by low long-term growth. In this regard, Cole et al. (2005) conducted a study for this region and arrive at similar conclusions to those presented here in the particular case of Mexico. Indeed, as is stated in this article, these authors concluded that the stagnation in Latin America is not only a consequence of the debt crisis, but of an unsatisfactory performance in terms of growth in Total Factor Productivity (TFP) that has characterized the region for a long period of time. Consistent with what is stated in this article, the authors suggest that this could reflect inefficient production resulting from the presence of high barriers to competition in the markets of the region.

Banco de México has conducted several studies to estimate the country's potential growth. Regardless of the techniques used, the finding seems to be that potential growth is currently located within an interval ranging from 3% to 3.5% annually. This potential growth should be considered as low, given the level of development of Mexico. For example, given its population growth rate, the Mexican economy would have to grow about twice its current potential growth to achieve by 2020 the current levels of per-capita GDP in Korea.

It is also important to emphasize that the potential growth of 3-3.5% estimated for Mexico is supported by a potential growth of around 2.7% for the United States (Congressional Budget Office, 2008). As discussed in Section 5, it is feasible that the potential growth of that country will decrease in the coming years as a result of the longer-term consequences of the current crisis. This would have a negative impact on potential growth in Mexico and highlights the urgency of implementing the reforms needed to offset this effect through a greater impulse to the economy's potential growth. Obviously, it is essential to first identify the factors that prevented Mexico from growing faster in the past.

On the basis of the concept of a neoclassical production function, it is possible to identify the most immediate causes of the country's low growth to a combination of: i) a low accumulation of factors of production; ii) an inefficient allocation of these factors; or, iii) the use of a low-productivity technology. The importance of these factors as possible determinants of the country's low growth is discussed in the following three sections.

3.1 Accumulation of physical and human capital

Mexico has shown much lower rates of savings and investment in physical and human capital than those of other emerging economies between 1960 and 2007. Mexico invested about 20% of its GDP during this period, while European countries and newly industrializing countries in East Asia invested 26% and 28% of their national incomes, respectively. Similarly, domestic savings rates in Mexico during this period, which averaged 19% of GDP, compare unfavorably with the figures of 22% and 28% in European countries and newly industrializing countries in East Asia, respectively.⁴

⁴ Calculations based on Penn World Table 6.2 (Heston and Summers (2006)) and World Economic Outlook (WEO) (IMF (2008)).

Similarly, Mexico also exhibits a poor performance in terms of human capital accumulation, which in turn has limited the possibility of our country's escalation in the value chain. Indeed, both in terms of quantity and quality, the accumulation of human capital in Mexico has been inadequate. Although improving in recent decades, the average schooling of the population, both as the proportion of students completing secondary education and entering tertiary education, remains low compared to other countries with better economic performance (See Table 2 and Figures 1 and 2).

Table 2: Average Years of Schooling
(Population 25 years and older)

	1960	1970	1980	1990	2000
Mexico	2.4	3.3	4.0	5.9	6.7
European 4	3.7	4.5	5.2	6.2	7.2
East Asia	3.3	4.1	5.3	6.9	8.1
Latin America Excl. Mexico	3.3	3.5	4.0	4.7	5.5

Source: Barro and Lee (2000), weighted by population using Penn World Table 6.2.

Figure 1
Secondary School Complete
(% of Population 25 years and older)

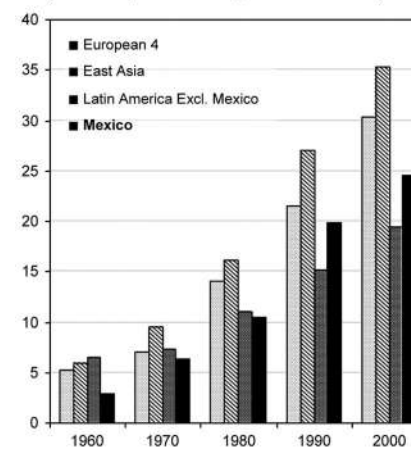
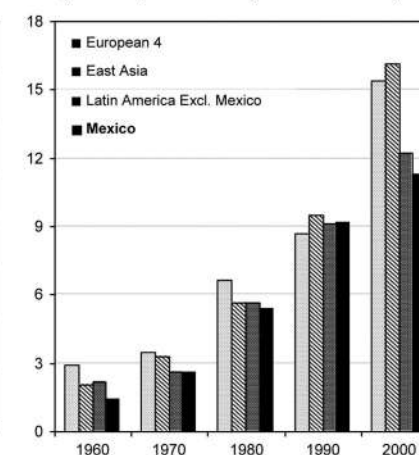


Figure 2
Higher School Attained
(% of Population 25 years and older)



Source: Barro and Lee (2000), weighted by population using Penn World Table 6.2.

Also, the low quality of the education system is clearly manifested in the results of standardized tests performed in several countries, like the PISA study, in which students in Mexico have shown the worst performance of all OECD countries in math and science (see OECD, 2004, 2007 and 2008).

This, however, does not mean that the low accumulation of physical and human capital is necessarily the deepest cause of Mexico's low growth. Actually, it could be the result of factors that influence both the accumulation and the allocation and productivity of these inputs.

3.2 *Efficient allocation of resources*

Indeed, even taking as given Mexico's production factors endowment, these inputs could be allocated more efficiently. In particular, there are various barriers and market distortions that hinder the efficient allocation of resources in Mexico (Conway et al., 2005, and World Economic Forum, 2006, 2007 and 2008). This prevents the full exploitation of the country's comparative advantages, and leads to low levels of productivity. These barriers and distortions appear to be of particular importance in the labor market and in sectors known as suppliers of inputs through networks. A discussion in greater detail of these issues follows.

3.2.1. Distortions in the labor market

Various rigidities and adverse incentives in the labor market have led to inefficient allocation of labor. Indeed, Mexico stands out negatively in various international comparisons in terms of high barriers to labor mobility (Botero et al., 2004, and Heckman and Pagés, 2000).

For example, as shown in Figure 3, in an international comparison the Mexican labor market is characterized by relatively high dismissal costs and a high degree of stickiness in contract creation. In particular, we can distinguish three types of distortions that tend to keep the allocation of labor away from its optimum:

- First, there are rigidities in the way that companies can establish, modify or terminate an employment relationship. Examples are: i) the limited capacity of firms to hold temporary contracts; ii) the absence of the figure of probation contracts; and, iii) the use of seniority scales as the criterion for promoting workers inside the company. Regarding contract termination,

costs are particularly high due to i) compensation for unjustified dismissal; ii) the payment of years-of-service premiums; and, iii) dismissal notification rules.⁵

- Second, there are distortions emerging from the bargaining power of trade unions in sectors producing nontradable goods. This distortion, coupled with limited competition in these sectors, tends to generate a pattern of rent sharing that translates into high prices, low service quality, and restrictions on the creation of productive employment and investment in human capital and modern technologies. This leads to a loss of consumer welfare, low business competitiveness, and high levels of informal, low-productivity employment.
- Finally, distortions exist from high non-wage labor costs which do not translate into equivalent welfare gains for the worker. Specifically, non-wage costs are composed primarily of a series of benefits for workers that are forcibly incorporated into the contract; *i.e.*, workers in the formal sector cannot stop paying for any of those benefits even if they do not require them (Inter-American Development Bank, 2006). Also, the amount of non-wage labor costs is a very important part of what the company spends per employee.⁶

According to Levy (2008), some social protection programs, originally designed to support the most vulnerable Mexican labor segments, provide social security benefits to the informal economy without most of their costs being covered by employers or workers in this sector. In this way, the current scheme could be inducing an increase in the proportion of workers in the informal economy. (See figure 3)

These distortions in the labor market have direct consequences in terms of economic growth and persistent poverty and income inequality. In particular, i) they inhibit labor mobility to sectors or regions where productivity is higher, ii) they discourage the adoption

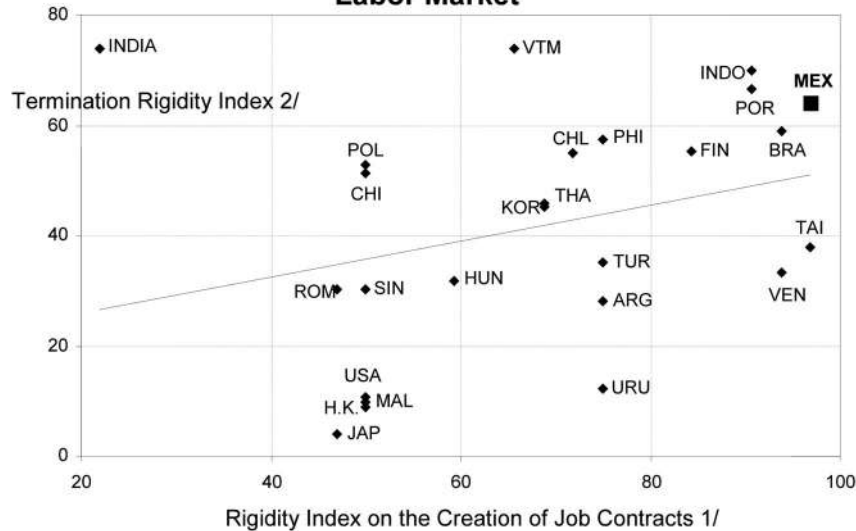
⁵ Undoubtedly, the protection of workers during periods of unemployment is crucial both from a standpoint of social welfare and market efficiency. However, the design of mechanisms for the protection of workers against dismissal do not necessarily have to be based on high severance payments. Section 6 discusses an alternative.

⁶ Non-wage labor costs total over 30% of the salary of the employee (Levy, 2008).

of advanced technologies and investment in human capital (Parente and Prescott, 2002), iii) they mainly affect women and young people, because these workers often require more flexible recruitment and working –hour schemes (Feldmann, 2008), and, iv) they promote the expansion of a low productivity informal sector.

Figure 3

Labor Market



Higher levels of the index show higher rigidity on labor markets. ¹ Corresponds to the value of the index of the creation of alternative job contracts. ² Corresponds to the average of the dismissal costs index and the dismissal procedures index.

Source: Botero *et al.* (2004).

3.2.2. Distortions in sectors that provide inputs through networks

Another type of distortion that has affected the efficient use of production factors and reduces competitiveness to the Mexican economy is the fact that there are still sectors where inputs are supplied through networks in which current regulations do not guarantee quality and generalized non-discriminatory access. Some examples are telecommunications, financial services, and electricity. Network sectors have four key features (see Shy, 2001, for a formal treatment of this topic):

- First, there are complementarities in the use of more than one product and therefore, the need to address issues of compatibility and technical standards. For example, there are complementarities between cellular phone providers and suppliers of equipment receivers, and between content providers and providers of broadband networks.

- Second, there are consumption externalities where the benefit of using a particular service is increased to the extent that other users consume the same service. This type of externality is clear, for example, in the case of mobile telephony.
- Third, users face high switching costs for changing suppliers, as, for example, in changing banks or changing providers of fixed or mobile telephone services.
- Finally, the provision of services through networks usually has high economies of scale. In particular, the installation of the network (telephone, electric, transportation, water or gas) usually involves large investments (high fixed costs). However, once the network is in place, the costs of providing additional services and connecting new users appear to be very low (low marginal costs). This feature leads to significant economies of scale and scope.

Together, these characteristics mean that, in the absence of proper regulation, dominant suppliers generally capture a large share of the market, allowing them to offer the service at higher prices and lower quality. In particular, the dominant suppliers may limit generalized access to inputs and exploit externalities that can be used to erect barriers to entry for other industry suppliers and to design strategies to extract rents at the expense of consumers and the competitiveness of industries using these inputs intensively. It is noteworthy that in these sectors, demand for services is generally inelastic, making for a high degree of market power and leading to particularly high rents that can be drawn from consumers.

Therefore, it is essential to achieve reforms to the regulation of these sectors to ensure a supply at competitive prices and an efficient use of resources by companies engaged in the provision of these inputs. In this context, it is important to mention that most countries are now directing their efforts towards promoting competition by regulating such markets adequately.

3.3 Modern production technologies

It is important to emphasize, however, that while the problem of barriers to entry may be particularly evident in suppliers through networks, lack of competition may be a more widespread feature

of the economy. As discussed below, this issue, combined with the lack of free mobility of factors mentioned above, are perhaps the features that lead Mexico to a low adoption of advanced technology and efficient work practices. This, in turn, translates directly into low productivity.

Indeed, the extent of the adoption of modern technologies leading to high productivity, depends on the institutions that influence the degree of flexibility and competition in markets, as well as in general on the incentives for the investment in research and development. Certainly, the economic literature has identified a formal relationship between the degree of flexibility and competition in markets and the use of productive technologies and efficient working practices (see, for example, Parente and Prescott, 2002, and Bergoing et al., 2002, for a formal treatment of this topic). When there are no barriers to market entry, the agents who decide to participate in an activity make investments based on the use of modern technologies. Barriers to entry, in contrast, allow the firms that dominate the market to obtain monopoly rents from the use of inefficient technologies and thus reduce incentives to adopt more productive technologies.

Moreover, incumbent firms may interfere with the design of public policies and try to influence the regulation in order to block the entry of new competitors with more productive technologies. Thus, in markets that do not operate under competitive conditions, there are significant losses related to an inefficient resource allocation and an use of less productive technologies. The value of these losses is generally higher than the rents received by those sectors protected from greater competition. This leads to two implications: i) decreased public welfare due to lower efficiency; and, ii) a deterioration in income distribution. It is precisely due to the latter that many of the competition policies in developed countries have emerged or been considerably strengthened, with the firm intention of preventing monopolies from influencing state institutions.

4. Deep Determinants of low productivity, slow accumulation and inefficient allocation of productive factors

It follows from the above that the performance of the accumulation of factors and productivity, as well as the efficiency with which these factors are allocated to different productive activities, should not be taken as exogenous factors that determine economic growth.

Rather, they are endogenous consequences of the incentives faced by economic agents and policymakers. In particular, the deepest and most fundamental determinant of economic growth is the institutional framework that defines the incentives system establishing the extent to which economic agents invest in physical and human capital, the degree to which they adopt modern technologies and efficient work practices, as well as to what extent public policies do correct for market failures.

On the basis of the above discussion, one can conclude that what has led to low productivity growth and consequently to low competitiveness in Mexico, has been an institutional framework that has failed to promote more competitive and flexible markets, as well as the lack of adequate incentives for the adoption of modern technologies and efficient work practices. This has been reflected in various indices that seek to rank countries in terms of competitiveness. For example, in the World Economic Forum's 2008-2009 Competitiveness Index, Mexico ranked 60 out of 134 countries. If one takes as a basis the 131 countries that were ranked in the 2007-2008 edition of this index, Mexico lost 7 positions. By component, Mexico is most unfavorably rated in labor market efficiency (placing 110), level of institutions (placing 97), propensity for innovation (90), and higher education and training (74). Obviously, the country's most apparent weaknesses within this index are consistent with the previous discussion. Specifically, an inappropriate institutional framework that generates various distortions and imposes high barriers to competition, and lack of flexibility in some markets, such as the one for labor, inhibit both innovation and adoption of improved technologies and the investment in human capital.

In this context, four institutional elements follow which, if reformed, could have a major impact in boosting the country's competitiveness. Section 6 discusses areas in which these elements can be improved for this purpose.

- a) To promote competitive conditions in markets for inputs of widespread use, inputs provided through networks, and final products

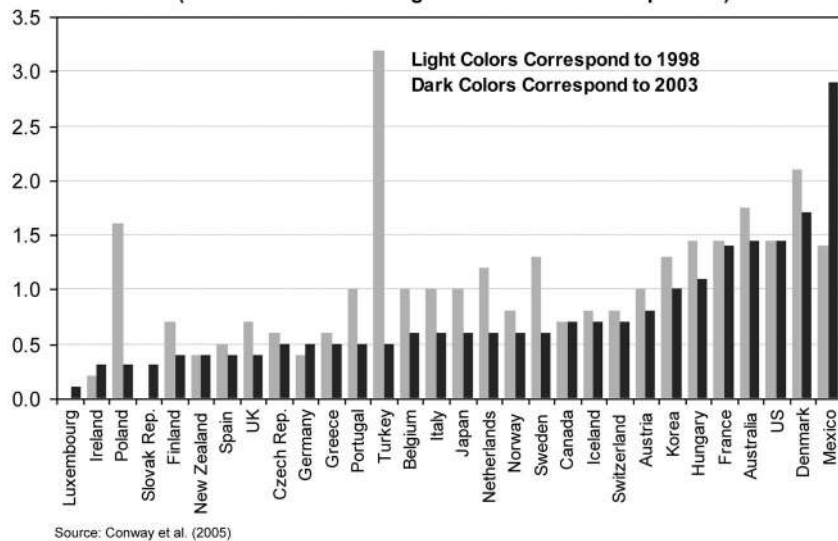
As mentioned, both economic theory and international experience show that when an economy operates under competitive conditions: i) a higher rate of innovation is induced and firms adopt the latest

technologies and the most efficient work practices; ii) consumers have access to a greater variety and quality of goods and services at lower prices, and iii) the population has more opportunities for jobs that pay according to their productivity.

In this context, according to the OECD (Conway et al., 2005), Mexico stands out negatively in terms of barriers to competition, as it has shown a clear deterioration from 1998 to 2003, years for which this measurement is available (see Figure 4).

Figure 4

Barriers to Competition
(Lower Values Show Higher Promotion of Competition)



b) To promote flexibility in resource allocation

As mentioned, rigidities such as those in the labor market cause an inefficient allocation of resources by limiting the movement of factors to their most productive uses. Additionally, these rigidities also tend to hinder the adoption of modern technologies and investment in human capital.

c) Efficient application of public policies

Public policies also have an important role to play, participating actively in those areas of the economy where social returns exceed private returns. Clearly, in order to achieve an effective implementation of

public policies, we need the individuals responsible for designing and implementing those to face appropriate incentives to maximize the social returns of these policies.

d) Promoting the rule of law

There is an extensive literature on the link between institutional quality and economic growth (Acemoglu et al., 2004, and Acemoglu and Johnson, 2005). In particular, a weak rule of law increases production costs and, therefore, affects a country's competitiveness.

Loss of competitiveness is especially important in those sectors that are inherently more dependent on the provision of an efficient institutional framework. Examples include sectors with a larger number of contracts with suppliers to produce a final good or service (Nunn, 2007, and Levchenko, 2004). In this context, these sectors show lower production levels in countries with weak institutions. This is particularly important because these activities are typically located in a higher position in the value chain, and they lead to a higher rate of innovation. This implies that countries with an inefficient institutional framework allocate proportionally more resources to less dynamic and productive sectors, thus generating a lower potential growth.

5. Possible long-term effects of the current crisis

It is still too early to predict the magnitude of long-term consequences of the crisis we are experiencing globally. Indeed, there is uncertainty regarding the balance of growth that each country should maintain. In particular, it seems increasingly clear that several countries require adjustments in their consumption patterns towards a more sustainable path. One country that is clearly in this situation is the United States. In this context, given that the United States remains the main market for Mexican exports, if the potential growth of that country diminishes as a consequence of this needed adjustment, keeping other factors constant, this would lead to a further reduction in Mexico's potential growth.

Long-term adjustments in the United States would have permanent effects on Mexico's potential growth. First, U.S. private consumption could decrease not only in level, as has been the case since August 2008, but also in the rate of long-term growth. This would be due mainly to the fact that recent U.S. household consumption was fueled by a

perception of household wealth based on increases in both financial and real estate asset valuations which proved to be unsustainable. Following the collapse of these asset prices, the general opinion of financial analysts is that once markets touch bottom, the rate of price recovery will be lower than rates observed in the last decade. The latter is a consequence of a necessary process of financial system deleveraging and of ongoing changes in regulation and supervision, as well as a generalized loss of confidence, which will recover only with the passing of time.

Second, the production model of the U.S. auto industry seems to be wearing out. Currently, the American automotive industry is attempting to reform itself quickly, but there is a high level of uncertainty about this transformation. In this context, the fate of U.S. automotive firms will clearly impact Mexico's automotive sector and hence its industrial sector.

Finally, potential long-term effects from the current crisis are linked not only to conditions prevailing in the United States, but also to other factors. On the one hand, policies implemented by some countries to counter the negative effects of the global crisis have focused not only on fiscal and monetary measures, but also protectionist policies have resurfaced, mainly in the form of higher barriers to international trade. It is too early to tell the extent of the use of trade policies and by whom, especially when the G-20 countries have expressed a commitment not to raise barriers to trade. However, it is important to note that trade distortions suffer from a bias towards the status quo; *i.e.*, once a protectionist policy is enforced, it is difficult to reverse it. The greatest barriers to trade result in a less efficient allocation of resources and, therefore, a lower rate of global economic growth.

It should also be noted that the international financial crisis has contracted international capital flows dramatically and even more for emerging economies. This implies, at the margin, smaller sources of funding for productive activities and infrastructure. The level of persistence of the reversal of capital flows is still a question. The answer will depend on the new architecture of the global financial system and the speed of the deleveraging process mentioned above. A possible source of easing of this restriction in the medium term are the actions recently announced at the meeting of the G-20 in April 2009 to triple the financial resources of the IMF, and to increase the lending capacity of the World Bank. In this context it

is noteworthy that in April 2009, Mexico received approval from the International Monetary Fund for a Flexible Credit Line (FCL) in an amount of about US\$47 billion. The FCL, which has no ex-post conditionality, can be granted only to countries with sound economic fundamentals. In the current global crisis, the FCL will help protect the Mexican economy and reduce the risks to growth that persist with the possibility of unfavorable conditions in international capital markets.

As illustrated in this section, there are risks from the current global context which could affect potential growth in Mexico. In this environment, it becomes even more urgent to take measures that could counteract the long-term effects of the crisis and, more importantly, contribute decisively to achieve a higher potential growth than the growth Mexico has experienced in recent decades.

6. Lines of action

From the discussion held in the previous sections, it is possible to conclude that to a large extent, Mexico's poor economic performance reflects the fact that it has an institutional framework that prevents competition and perpetuates a series of distortions that reduce market flexibility, causing an inefficient allocation of resources and discouraging investment and the use of modern technologies and more efficient work practices.

In this context it is clear that to boost growth, what is needed is to change the system of incentives, replacing schemes that have allowed the extraction of rents with a new framework that promotes competition, flexibility in resource allocation and adoption of modern and efficient technologies and work practices. Additionally, it is especially important to remove the existing distortions in various markets in which services are provided through networks. These points are discussed in more detail below.

6.1. Competition policy

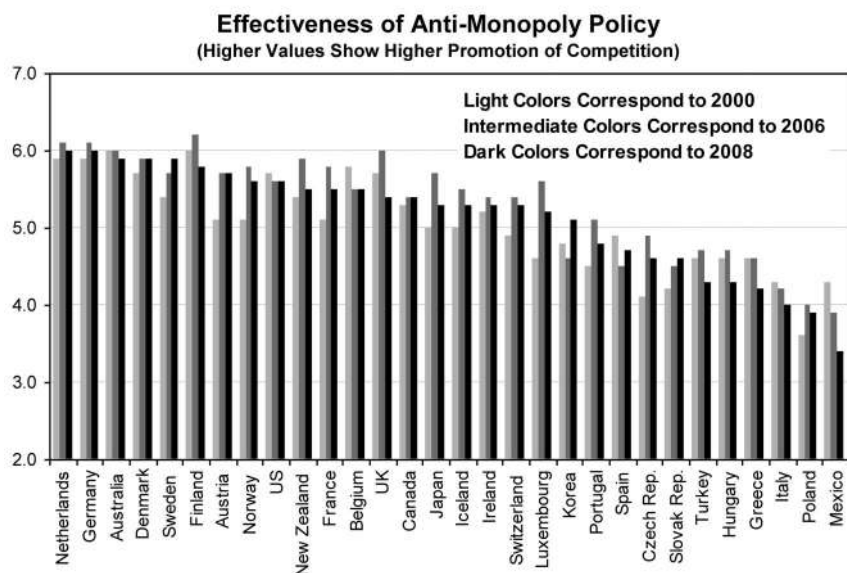
It is clear that a key strategy for economic growth is a more active promotion of competition. The key challenge is to avoid pressure from powerful groups which seek exemptions or preferential treatment by influencing the design of the country's regulations. It is also important to increase the costs faced by the economic agents engaging in anti-competitive practices.

Recently, important progress was made in the promotion of economic competition in Mexico, through the reform in 2006 of the Federal Economic Competition Law. This reform gave additional powers to the Federal Competition Commission (COFECO), specifically to: i) increase the number of typified monopolistic practices that can be prosecuted; ii) carry out immunity agreements with companies that cooperate with its investigations; and, iii) increase its capacity to obtain relevant information. Additionally, COFECO is now able to tackle barriers or taxes on interstate trade, and the federal government is required to consider its views on economic competition.

However, key areas remain within the field of competition where additional progress can be made. Indeed, despite the reforms, according to the World Economic Forum, the Effectiveness of Competition Policy in Mexico decreased significantly from 2006 to 2008 (Mia and Lozoya, 2008, see Figure 5).

In this regard, it is essential to give COFECO more and better legal instruments to enable it to carry out its activities and decisions in a more autonomous, expeditious, and decisive way. COFECO should be considered by all economic agents as a defender of consumer

FIGURE 5



The Anti-Monopoly Policy Effectiveness Index goes from 1 to 7 and measures the effectiveness of the Anti-Monopoly Policy of a country: 1= the anti-monopoly policy is relaxed and does not promote competitiveness effectively and 7= the anti-monopoly policy is effective and promotes competitiveness.

Source: WEF (2000), (2006) and (2008).

rights and not just a promoter of economic competition. In particular, it is essential to take action in the following areas:

- **Autonomy.** It might be appropriate for COFECO to be operationally autonomous and independent rather than to be located under the umbrella of the Ministry of Economics. Countries with success stories in the implementation of competition laws have fully independent competition agencies that report directly to Congress.
- **Competition and Consumer Protection.** Ideally, as seen in other developed economies (e.g., Australia and the United States), COFECO and the Federal Consumer Protection Agency (PROFECO) should be merged into a single institution, given the inherent relationship between competition and consumer welfare.
- **Resources.** COFECO needs greater financial and human resources. COFECO currently has 175 employees, while its Australian counterpart has 723 (Federal Competition Commission, 2009, and Australian Competition and Consumer Commission, 2008).
- **Protection and Judicial System.** “Amparo” judgments have hindered the implementation of the Competition Act. These have been used extensively by the companies surveyed by COFECO as a tool for delaying investigations and, in most cases, to evade resolutions. In this context, the current judicial system is considered by several studies as an obstacle to the implementation of competition laws (Avalos, 2006, and OECD, 1999, 2004b and 2006).
- **Penalties.** When compared with other countries, Mexico is still far behind in this vital area.⁷ In this context, an increase in the fines applied by COFECO has been promoted in order

⁷ For example, the maximum fine for absolute monopolistic practices in Mexico amounts to little more than 75 million pesos, while in other countries fines for this kind of practice are imposed for up to nearly 7 billion pesos (91 times more than in Mexico). In the case of relative monopolistic practices, the maximum penalty possible in Mexico is about 46 million pesos, while other countries have come to punish such practices with fines up to the equivalent of nearly 6.7 billion pesos (an amount approximately 147 times greater). In fact, in other countries, there have been several cases in which executives have gone to prison when found guilty of deliberately orchestrating anti-competitive practices.

to have the sanctioning and dissuasive effect expected from an economic penalty. In particular, it is necessary to establish fines as a function of the firm's assets and income as opposed to fines based on a certain amount of minimum wages, which produce fines that are insignificant compared with the benefits agents derive from monopoly practices. In this regard, COFECO has already proposed more effective penalties.⁸

- **Competition Culture.** Finally, it is necessary to actively promote in society a culture of both pro-competition and consumer protection through various means.

6.2 Labor market

The Reform of the ISSSTE Law (Ley del ISSSTE) enacted in 2007 was an important step in the Mexican labor market, converting state employee pensions from a defined-benefit to a defined-contribution system by means of the creation of individual accounts. This reform favored market flexibility by allowing workers to maintain their savings even if they change sector of employment. Another important development is the recent Alliance for Quality Education (Alianza para la Calidad Educativa), which may in the future have a beneficial impact on levels of workers' human capital formation and on the quality of education.

However, given the above discussion, it seems particularly important to conduct a comprehensive reform of labor legislation that promotes greater labor market flexibility.⁹ Among other goals, this reform should focus on achieving the following:

⁸ In particular, an amendment is proposed to Article 35 of the Federal Economic Competition Law as follows: i) absolute monopolistic practices should be fined for up to 15% of the value of assets or total annual income; ii) relative monopolistic practices, or concentration practices 9% of assets or total annual income, and iii) in cases of backsliding, 20% of assets or total annual revenues.

⁹ Mexican labor law is characterized by a high degree of job protection. This legislation is based on the development model of import substitution implemented in Mexico in the past, when companies had a high degree of market power, which could adversely affect worker welfare, especially if firms' market power allowed them to exercise monopsony power in the labor market. In this context, the labor law was established as a mechanism for redistributing to the workers part of the rents obtained by firms from trade restrictions. The important changes that have occurred in the Mexican economy since that time, in particular trade liberalization, have not been reflected in amendments to the Federal Labor Law. Indeed, the Federal Labor Law has not been substantially amended since its inception in April 1971.

- Lower rates of informality. This would result in better use of labor in more productive activities, a more equitable distribution of income, and greater tax revenues.
- Increased coverage of major social security and welfare programs.
- Better incentives for human capital formation and adoption of new technologies.

In this context, two particularly important courses of action (among others) should be evaluated in the analysis of a reform to make the labor market more flexible:

6.2.1. Review the current social security scheme. According to some studies (e.g., Levy, 2008, and the Inter-American Development Bank, 2006), it seems appropriate to assess whether all the benefits associated with mandatory social security are truly valued by employees in a manner consistent with the cost involved. Additionally, it may be desirable to decouple public health services from the labor market. A gradual move from a public health system financed by contributions from wages to a funded system with stable sources of income (*i.e.*, income or consumption taxes) could be implemented. This move would avoid conditioning access to public health to the status of the worker (*i.e.*, formal or informal), would tend to reduce incentives for informal employment, and would maintain a policy of universal health care without creating distortions in the labor market in Mexico.

6.2.2. To assess the feasibility of replacing current dismissal costs with a system of unemployment insurance or a separation fund.

This action could increase market flexibility by reducing the costs of labor mobility. In this context, using the existing infrastructure of the Savings for Retirement System could facilitate implementation. A similar system was implemented successfully in Chile in 2002. In this regard, Acevedo, Eskenazi and Pagés (2006) argue that the main advantages of the new Chilean system would be that: i) it reduces companies' labor costs; and, ii) it reduces the problem of moral hazard induced by traditional unemployment insurance schemes. The authors also argue that this system could be implemented in other emerging countries that have a relatively developed financial sector, such as Mexico.

6.3. Sector of inputs provided through networks

Important linkages exist between labor markets and final product sectors that provide inputs through networks. The particular characteristics of these sectors often lead to more bargaining power for unions, generating rent-sharing schemes at the expense of price, service quality, and sometimes, public finances. Blanchard and Giavazzi (2003) developed a theoretical model of an economy with these features and highlight the importance of coordinating competition policies and regulatory sectoral policies with labor regulation. Indeed, effective regulation that would translate into an increase in competition in the market for goods would generate a reduction in monopoly rents and thus could reduce the power of unions, thereby facilitating changes in employment regulation. Among the most important challenges in these sectors, the following may be stated:

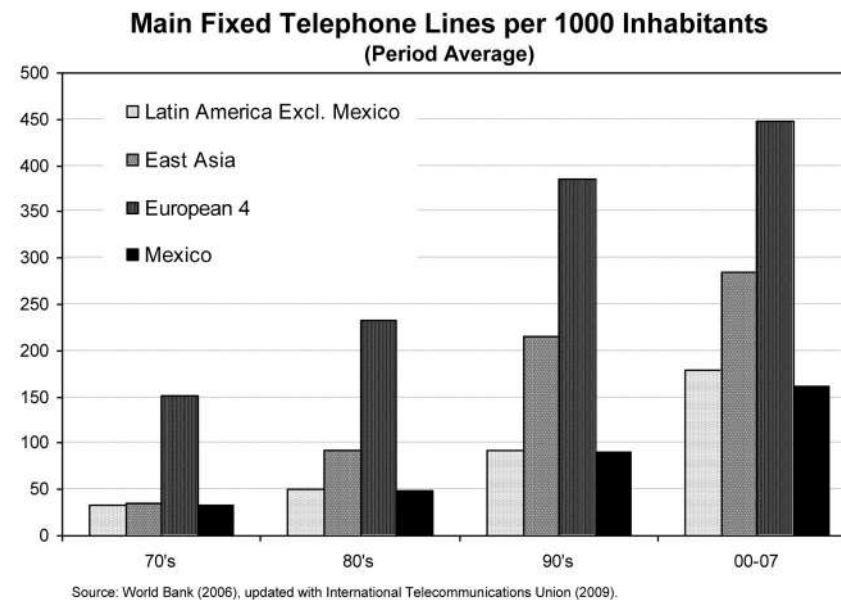
- Monitoring the network infrastructure. Without proper regulation, the firms that control the network tend to vertically integrate the business segments that are in the network nodes as a strategy for capturing monopoly rents. Currently, the international trend in these sectors has been to separate the ownership and operation of the network infrastructure. For example, in some countries it has been the case that companies lease their telecommunications network capacity to others. In the electricity industry, some countries have established independent bodies comprising other companies in the sector for the operation of the transmission network.
- Interconnection regulation. The welfare of users is increased if different networks or new entrants in the industry are able to interconnect themselves. To promote competition among networks it is necessary to regulate the practices of interconnection to ensure non-discriminatory access and standard pricing. This problem has been evident in Mexico in various sectors such as telecommunications, transportation, and electricity.

Other more specific problems of these industries in Mexico are the following:

- Telecommunications: While there has been progress in introducing competition in this sector, Mexico continues to

compare unfavorably with other countries in terms of prices and the fixed telephony penetration levels (Figure 6) and broadband (See Figure 7). While several initiatives have induced more competition in recent years, many have been blocked by legal means, making it necessary to redouble efforts in the legal field to complete these initiatives.

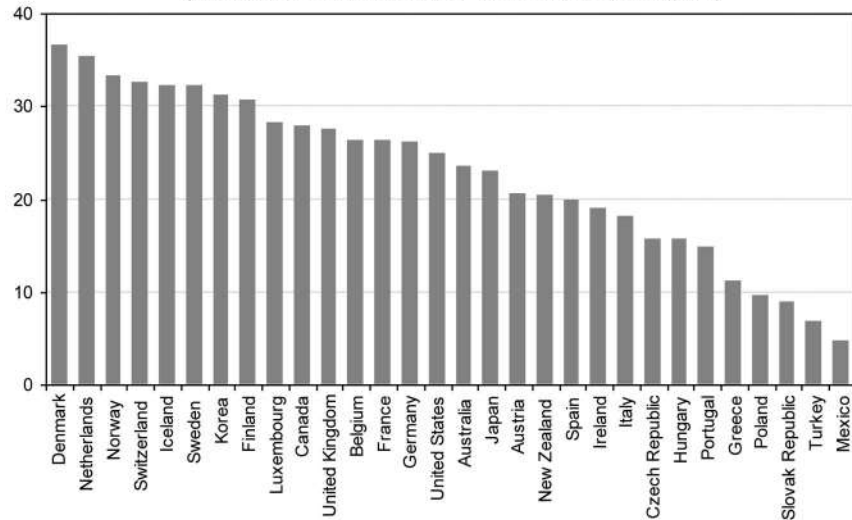
Figure 6



- The electricity Industry: Mexico's situation in terms of energy infrastructure, quality, and the price of electricity has been unfavorable, as compared to major competitors in the international market. The challenge facing the electricity industry in Mexico is to create mechanisms to induce cost reductions and improve service quality. A first set of actions to undertake, given the current institutional framework, is the reorganization of the sector. These include: i) aligning the incentives to reduce costs and improve service quality, including containment of union pressure; ii) creating an independent body to oversee the operation and performance of the two electricity companies, CFE and Luz y Fuerza del Centro (LyFC); iii) separating the accounts of the various segments of public enterprises; iv) separating the operation of the electricity network from the providers, and v) strengthening the regulatory powers of the Energy Regulatory Commission.

Figure 7

Broadband Subscribers
(Number of subscribers per 100 inhabitants in 2008*)



* Data up to June 2008.

Source: OCDE (2008b). Broadband Statistics.

Another set of appropriate measures might be to modify the institutional framework so as to allow greater private sector involvement.

- **Transportation:** International comparative indicators, as well as perceptions of the companies located in Mexico, point to serious problems in freight transportation and infrastructure, even when comparing with similar economies with which Mexico competes internationally. A common problem in the sector is the lack of infrastructure, which leads to congestion and high transport costs. Other problems include a lack of competition and a lack of legislation and regulation.
- **Banking System:** The banking system is the primary means of access to financial services in the country. It is therefore necessary to ensure competitive conditions in this sector. To achieve this and to ensure that the benefits of the non-discriminatory access to the payments system infrastructure transferred to users, a regulation that promote transparency and cost reduction to a higher extent is needed.

7. Conclusions

From a medium-term perspective, Mexico's economy has shown an insufficient growth rate compared with other countries with similar characteristics. This largely reflects an institutional framework that, in relative terms, tends to promote the extraction of rents instead of driving the search for activities that create value and promote economic growth.

Specifically, the current institutional framework fosters an environment of lack of competition and perpetuates a series of distortions that reduce market flexibility, causing an inefficient allocation of resources and discouraging the creation of value. In particular, barriers to competition and to the efficient allocation of resources generate a low rate of adoption of new technologies and investment in human capital and therefore, low growth.

The urgency of implementing structural the mentioned reforms is shown in the view of the current international situation the Mexican economy is facing. Indeed, the proposed measures would help Mexico adapt more quickly to this environment and thus, offset the costs that the current global economic crisis could impose on Mexico's future performance. They would also bring a renewed impetus to the exploitation of Mexico's full potential growth.

In this context, it is of fundamental importance to eliminate the existing barriers to market entry and to allocate resources more efficiently. This would be facilitated to the extent that:

- Greater market competition and flexibility is promoted, and
- Productivity and efficient allocation of resources are encouraged in strategic sectors, given their market characteristics (those with inputs provided via networks) or due to their importance in output and trade.

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Repairing an International Financing System: A Budding Work

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Introduction

The purpose of this document is to review the context of the current financial crisis. It particularly seeks to familiarize the reader with the main background topics, related to the amendments required to achieve a new stability in the international financing system. Given the complexity of this matter, it is intended to discuss here only *some* of the elements that have an influence in the regulation and supervision of financial entities within a global context.

For this purpose, the article starts by featuring some background to the nature of financial markets and a brief review of previous financial crises. The current crisis is approached in the section following. The economic policy steps adopted for facing the crisis and relieving

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its effects are discussed in the third section. In section four, the recommendations derived from G-20 are outlined. In section five, the aspects of the international financing system that the International Monetary Fund (IMF) has considered for amendment are presented. Finally, some preliminary conclusions are considered.

I. Background

The current International financial crisis is a reminder that *confidence* is the most important intangible asset required for any financial system (global, national or local) to work. Confidence is one of the main ingredients needed for stability within financial entities; without confidence it is nearly impossible to imagine that the task of intervening in third parties' savings flow in order to conduct them to other economic agents can be done.

As it has been widely expressed in economic theory, financial intermediation grants different opportunities in an economy, compared to another one based on barter and saving in kind, or that has a financial sector that is limited to offer only a payment system.

The evolution of financial systems will be reflected in the extent that they allow saving. This will be captured, on the one hand, in the variety of financial instruments, which vary according to the period, benefit and risk, and on the other hand, in savings beginning to create a market of funds for lending to a variety of creditors; from those who are trying to equalize and smooth their consuming profiles with their incomes, to those with projects in need of capital and who are therefore willing to share the profits or losses of their projects.

Thus, from a theoretical perspective, financial sector contribution for better resources assignment and better risks dispersion is sought. Since the nature of their activity is to hold third party savings and lend them with very little support from shareholders' capital via a financial mediator, financial systems and markets have required the building of a whole institutional infrastructure for creating confidence, supported by property rights, legal framework duress and detailed, timely and relevant information availability, to mention the most important.

Confidence is what encourages investors to contribute their capital or savings, with the understanding that they will have access to, and

be able to recover their capital plus profits or losses yield from their investment. Nevertheless, confidence is not a spontaneous condition but a very complex phenomenon which requires, at least, access to relevant financial information with the necessary openness for it to be considered trustworthy for decision making.

The reputation of, and credibility in the regulating and supervising authorities are also gained through the financial entities' achievement of measurable parameters. Confidence is the essential element for starting the "virtuous circle" of economic activity needed to regenerate a country's growth and development.

The optimism generated in financial markets after a long period of economic growth with little volatility and low interest rates, allowed financial systems to develop new structures and create new financial instruments that, at least initially, yielded high benefits with controlled risks. Nevertheless, recent experience has shown that these instruments contained higher risks than those they replaced in the savings market.

In the case of the current financial and economic crisis effecting the "global" economy, as characterized by synchronous recessions in the majority of the national economies, a combination of the three kinds of "crisis" that lead to a recession can be observed; One; those with their origins in a drastic reduction in the granting of credit, Two; those that derive from strong falls in stock markets, Three; those which result from a contraction of assets prices, such as the real estate market (see Claessens, Kose and Terrones articles, where they measure the relation among a set of macro-economic and financial variables regarding 21 ODCE countries financial and business cycles during 1960 to 2007 stage).

Once the "virtuous cycle" is broken, the big question is; "how can the markets' confidence in financial instruments, risk valuation approaches, financial institutions' disclosed information and the regulation and supervision by financial authorities, be restored?"

The common denominator in financial crises is found in the excesses and omissions of various market participants. In the current case, these have been the regulating and supervising authorities, financial mediators, investors and multilateral financial organisms. An example of an "omission crisis" occurred between 1918–1919,

when the American Congress declined the country's participation in the new global institution known as the League of Nations. This contributed to a relative paralysis of the world's commerce and unstable financial relationships among countries, unfortunately culminating in a great economic depression (Boughton, James M.).

Another example of economic crisis, this time due to excess, occurred when the United States decided to finance the Vietnam War through an expansive monetary policy. This produced an increase in inflation that led countries such as France and England to ask for conversion of their dollars into gold at a rate of \$35 USD per ounce. However, this dollar-gold exchange rate did not corresponded to reality and in 1971, with a refusal of the countries to adjust their currencies to a new exchange rate, the Bretton Woods Agreement collapsed [Mishkin, Frederick S.].

In Mexico, during the 1970's, an economic crisis occurred following a program of social improvement via increased government expenditure, financed through public debt. Through the seventies and the beginnings of the eighties the government retained the policy of spending more than it received through income, financing this deficit with a predicted future income derived from the discovery of oil deposits and trusting that the international oil price would remain high, which did not happen.

The 1994-1995 financial crisis in Mexico was characterized by an excessive expansion in the granting of private sector credit, after banking nationalization, as well as an excess in risk concentration through placing public debt in the short term indexed in dollars (Tesobonos) and in a semi-fixed rate exchange context, which provoked a strong reserves loss, and with it, one of the worst crisis in its history.

II. The current crisis

Since 2007 an important segment of the International financing system has fallen into an intense crisis. Its detonator was an increase in the "deferment indexes" in the lowest quality mortgage credits in the United States, known as "subprime" [2007 Financial System Report by the Bank of Mexico], which impacted productive activities and employment in developed economies as well as in emerging economies.

The current crisis did not only dramatically impact the world stock markets, but virtually eradicated an iconic Wall Street industry. Investment banking as such is now history in the United States.

This crisis is explained by a combination of a series of exceptional events and factors that have happened one after another, exposing excesses and abuses that were not evident until the speculative "bubble" in the real estate market burst and leading to the non-fulfillment of financial "obligations" by the financial entities.

It is also worth mentioning that global crisis synchrony and scope are the results of high leverage levels that the now extinct investment banks had in a parallel financial market without regulation and supervision.

If these high volumes of credit had been known to have been given without their corresponding capital backup, its effect would likely have been substantially lesser. Likewise, it was not appropriately assessed how the *credit default swaps (CDS)*, *asset backed securities*, and the *mortgage backed securities* issued such leverage. Nor how this parallel financial system linked through insurance companies and examining agencies.

The lengthy term of stability, with long-term low interest rates in the international financial markets, incentivised greater risk-taking with financial entities seeking efficiencies of scale that would compensate investors. Likewise, price rises in the United States real estate market, particularly regarding homes, contributed towards feeding an unstoppable financing appetite for satisfying three kinds of clients; i) speculators buying up real estate for re-selling in the near future with high profits, ii) people without any credit history or with bad credit re-payment histories attracted by very low interest rates and minimum down payments for acquiring a house and iii) those encouraged to obtain a second mortgage, backed up by the appreciation of the real estate they already owned, for "levering up" towards a higher consuming level.

As uncertainty materialized, the International financial market experienced extreme confusion, agitation and commotion, that led to a general distrust within the trading, investment and financial intermediary banks, to such a degree that they stopped lending money among themselves.

Given the losses that started to be recognized from the operations of special vehicles of investment, from derivatives and from the whole gamut of structured financial instruments, fear about not being able to recover inter-bank loans was unleashed.

In these circumstances only those banks holding liquidity or those who could find new partners contributing fresh capital to face numerous losses and give them back their credit capacity could survive.

The inconsistency of the United States' financial authorities at having "rescued" some of the main participants, including an insurance company, whilst not rescuing a bank such as Lehman Brothers, turned September 15th, 2008 into a watershed of the current global financial and economic crisis. With this event, global risk perception and uncertainty regarding the quality of some assets under the financial institutions' control intensified. In turn this affected the inter-bank credit cost as well as the liquidity of the financial markets [Bank of Mexico Annual Report, 2008].

Contagion spread rapidly. This was reflected in production and employment deterioration. Transmission mechanisms, through financial markets and international trading, surprised authorities with the speed of the damage contagion, when at the beginning the United States financial authorities considered that the issue was encapsulated within the real estate and high risk mortgages market, known as *subprime*. Nevertheless, within the financial markets, supposedly protected by their structures, the so called "toxic assets effect" started to be noticed. In fact the mis-usage by which the real risks of derived instruments, both in the United States financial system as well as in the main European economies, were under-assessed, exponentially multiplied the losses.

Now that we find the global economy in the low economic cycle, without exactly knowing how long it will last, it is recognized that the crisis has had a great geographic coverage. Given the fast and intense intervention of central banks, which have lowered their funding interest rates, and the fiscal supporting steps adopted by governments, it could be considered that the free-fall has stopped and that the crisis is near to "bottoming out".

The synchrony with which economic activity has fallen, means that no economy in the world can boast of not having been affected by

the collapse of the United States' financial system and of important flops in the United Kingdom, Germany and France. This is the first global crisis in which the biggest, most important world economy has dragged along the rest of the world to a cliff-edge, which compels a re-think of the international financial system so that a similar situation never occurs again.

III. Adjustments in the world financial market

In order to stop the free-fall of the financial markets, the central Banks have had to work hard, wearing-out the use of their traditional currency policy instrument, the interest rate. Today the interest rate in the United States is very close to zero, and the rest of the world's central banks have also cut interest rates according to what inflation control space has allowed.

Now many have become Keynesians, precisely because it has been observed that in similar situations currency policy loses its capability for fostering the added demand. In this crisis what has been expected from the currency policy is more its contribution in safeguarding the payment systems and in re-establishing confidence in national economies. For this purpose, central banks have carried out justifiable, unorthodox emergency operations, particularly to recover liquidity and rebuild the confidence required in order to re-establish the normal operation and trading role of the inter-bank credit markets. These operations have included the re-purchase of government assets issued by the Treasury to private institutions, as well as the direct purchase of the assets of problematic institutions, with the objective of strengthening their financial balances.

Other unorthodox emergency measures that have been registered, but that could be classified as part of a fiscal policy, are the nationalization of banks, such as in the case of Northern Rock in the United Kingdom, or the temporary *de facto* nationalization of mortgage entities such as Fannie Mae and Freddie Mac in the United States, and the capital inputs to the main commercial banks. This particular measure follows a financial logic rather than an ideological one.

There is no economic agent that possesses financial statements able to accommodate, in a single blow, the kind of large damages incurred by the financial entities, except for the government that

accounts with its country's tax burden as backup for smoothing costs in the long term. This has been done with the public indebtedness issue. Of course, the economies that have bigger margins are those which have a proven reputation and history of a high tax burden, as well as a low public indebtedness quotient to gross internal product. Fiscal authorities have also allowed the diminishing of some taxes in some cases, as a palliative measure, in order to prevent abrupt falls in consuming patterns. However, debts acquired today shall have to be paid in the immediate future. This leads one to think that, in the future, some measures will have to be adopted to raise the public savings of a specified country by increasing collection and reducing expenditure.

IV. Organization for adopting coordinated measures. G-20 and their recommendations

The dimensions of this crisis have compelled a re-think of the International financial system and led to the proposal of structural measures designed to bring back stability to the world's economic growth, diminish imbalances between countries with high surplus in their checking account and those with high deficits, and to begin the recovery of international trading.

The G-20 group, comprising the twenty largest world economies, was formed in response with the purpose of co-ordinating global efforts for achieving stability in the international financial system. Among the questions posed by the group, the following are highlighted; "how to re-establish the confidence of economic agents?", "how to regulate and supervise banks and trans-border operations in a global economy?", "how to strengthen international financial system transparency?", "how to strengthen international cooperation?" and "how to foster integrity in the financial markets?"

G-20 working groups issued twenty five recommendations for answering these questions, grouped into fourteen general topics: 1) A global system approach for financial regulation performance; 2) regulation scopes; 3) crediting qualification agencies supervision; 4) transparency of regulation regimes' assessments; 5) pro-cyclicality; 6) capital; 7) liquidity; 8) infrastructure for derivatives; 9) remunerations schemes; 10) risks administration; 11) transparency; 12) regulations coercion; 13) building technical support and emerging, and 14) markets' abilities.

Financial markets have globalized but regulating and supervising authorities have lagged behind. They are the only ones with the ability for monitoring issues in a local or regional way. The challenges they face are enormous. Among them it is highlighted; the international organisms' and financial authorities' task for adjusting the valid norms to allow an effective monitoring of the financial entities and a more efficient identification of systemic risks.

After the regulation limits have been identified, it would be required to periodically review them in order to re-align them to the constant changes experienced by the financial markets and the development of new instruments and financial products. In this respect, the importance of a regulation norm, applicable to trans-border financial entities in order to avoid possible arbitrages regarding regulatory differences between countries, is highlighted. It has also turned out to be indispensable, improving approaches for best calculating local, regional and global risks. Likewise, it has become necessary to develop better channels of communication and cooperation between international organisms and local financial authorities, with the purpose of offering global alternatives to emerging financial issues.

For this purpose, strengthening the international organisms that arose from the Bretton Woods Agreement is considered (IMF and World Bank). This implies widening the emerging countries' participation. Given the role and confidence that they once had, it is borne in mind to seek mechanisms for monitoring the credit qualification agencies, with the purpose of identifying possible conflicts of interest, avoiding them and ensuring transparency and quality in qualification processes. It is considered prudent to promote capital-creation and accumulation within financial entities during times of economic expansion, in order to use them in times of economic stress, thereby avoiding pro-cyclicality.

By virtue of the fact that employee's incentives were not aligned with the long-term interests of the financial companies, mechanisms that allow for the adjustment of the remuneration systems of financial institutions will be sought (see G20 Working Group on Enhancing Sound Regulation and Strengthening Transparency. Final Report, March, 2009 for a closer analysis on the recommendations being considered).

V. Discussion topics for reaching world financial stability: the agenda proposed by IMF

As was discussed at the beginning of this work, one of the causes of the crisis was the optimism generated within the markets. This time of “bonanza” was not exploited towards developing control mechanisms through a financial regulation that could avoid risk concentration in several financial sectors. A “perverse” system of incentives, generated from the financial innovation boom at the beginnings of this century, grew up. Local and international financial authorities were not aware of the systemic risks within the financial systems. They did not forecast that the real estate issues in the United States would have the penetration we now see world-wide. Once the crisis was detonated the financial authorities’ fragmented surveillance and supervision system and their corresponding inability to detect vulnerabilities in the inter-relations of several financial sectors were evidenced.

The International Monetary Fund has analyzed the international financial crisis with a three-dimensional prevention focus: financial regulation, macro-economic policy and the global architecture¹ of the international financial system for accomplishing financial stability. These points are discussed as follows.

Financial Regulation

The scope of financial regulation and supervision should be broadened to ensure that all the risks contained in the economic activities be covered and known by the corresponding authorities. Institutions where the potential of generating a systemic risk is detected shall be obliged to disclose information to regulators with the purpose of finding schemes that would mitigate the risk of contagion to other institutions and, in turn, to the productive economies of the original country and to those of other countries. All institutions considered to be a systemic risk shall be under a prudential supervision that allows: surveillance in the capitalization liquidity levels, early intervention by authorities and, if necessary, the institution’s orderly exit from the market.

Regulation and supervision processes shall be improved in order to avoid any kind of arbitrage by the institutions. The approach to

regulation should not be based on the kinds of institution but in the intrinsic risks from the activities they generate. Better “macro-prudential” supervision schemes, which allow for the analysis of issues that might be present in the *whole* financial system and not only separately examining each of the sectors that integrate it, should be developed. Likewise, robust markets, where accounting registers and dispositions regarding the economic activities they perform are clear, should be promoted.

Strengthening regulation and supervision shall expedite the development of different sectors in the economy, strengthening the market’s discipline and its transparency processes through the recognition of its origin, locality and limiting its risks.

One recommendation that has originated with this crisis is about modifying the public institutions and organisms that form the governments’ supervisory sector commands, so that they consider financial system stability as a clear objective.

The great global challenge presents itself in the development of efficient mechanisms that allow national and international authorities to jointly assess systemic risks within the world financial system which, in turn, expedite the countries’ coordination of response policies in order to mitigate issues generated in their economies.

On the other hand, international standards of capital and liquidity should be improved and additional capital reserves should be fostered, as well as the provisions in “bonanza” times, in such a way that the capital is able to absorb the corresponding losses in tougher economic times. These standards of capital and liquidity “adequateness” shall be coordinated through international mechanisms to create a common international framework. Additionally, this framework should be periodically reviewed, internationally validated and published [IMP, February, 2006].

Macro-economic Policy

During the long period of optimism and low interest rates, as well as the rising of the institutions’ assets, especially those related to homing, the world’s central banks focused on the stability of pricing levels within their respective economies (the old economic evil of the late-20th century) whilst, as revealed in the analysis of economic

¹ International Monetary Fund, refers to this term as the official mechanisms that expedite financial stability and that ease up the goods flow, services and capitals among countries.

activity, under-estimating the concentration of systemic risks within the financial system. The central banks also over-estimated the effect of a diminution in interest rates, in case that the boom in assets' prices ended. Regulatory and supervisory authorities trusted on the control mechanisms contained in the valid norms of that moment.

It is clear today that the international organisms, central banks and financial authorities should analyze and supervise the movement of assets' prices, credit granting schemes, institutions leverage and, very specifically, the concentration of systemic risks. One lesson from this crisis is that in "bonanza" times government deficits should be reduced so that countries have a larger margin for manoeuvre during times of economic crisis.

Another important factor that has to be considered is the current imbalance present in the United States' checking account deficit and the corresponding surplus in the checking account in Asian countries, particularly in China. This could effect the direction of the great capital flows, turning from the United States towards Asia, and in this way impacting the dollar exchange rate. It was precisely these large capital flows towards the largest economic power in the world that allowed low interest rates, thus provoking a quest for larger profits through more risky investment of assets.

Mechanisms and schemes should be analyzed that will allow the timely correction of the great imbalances present in the checking accounts of the United States and China in order to find economic policies that allow an efficient growth and distribution of the world's savings and investments, whilst considering at all times the generation of prudential measures that will allow a reduction in the systemic risks inherent in large capital flows. [IMF February 2006].

International financial system global architecture

An essential factor in supervising the financial system should be indentifying and disclosing those system elements that concentrate risks, with the purpose of developing a concrete answer for each kind of risk that could materialize in the real economy of any country. What is important is that the risks are shown in the institutions' financial statements. In other words, each risk shall be fully identified during early vigilant action, as well as during resolution procedure.

International organisms and financial authorities shall compile information covering the areas where regulation and supervision practices, accounting norms, audit and deposit insurance, converge. Likewise, it should be guaranteed that temporary measures taken for re-establishing financial stability and confidence have the least distorting effect on real economies and that they are developed in a timely manner.

The great political challenge, at an international level, is to generate the necessary conditions to coordinate the international organisms' efforts so that they allow efficient supervision of worldwide financial stability. One of the most important documents requiring elaboration is the one relating to the behavioral code between nations, with the purpose of expediting the resolution for trans-border institutions. Another really complex and very important document shall be the one for trans-border institutions' risk assessments methodology; risk assessments that might be undertaken by supervisors of different nationalities and in which the required corrective measures are agreed and the fiscal burdens distributed among the countries involved.

International regulating organs shall take responsibility for formulating regulatory and supervisory policies. They must be aware of, and be able to respond quickly to evolution within the financial markets and to new, innovative financial products. Without any doubt, authorities shall supervise substantial changes in assets prices and the consequences to the financial system and the real economy [IMF, February 2006].

Some preliminary conclusions

Conceptualizing, land (?) and achieving the reforms to the international financial system are "Titanic" undertakings. Not only because of the required international consensus, but also because it requires work at various levels; in the international financing organisms; in regulation of the national financial entities in the context of a global operation; and filling gaps in regulation and supervision, particularly for the trans-border operations that shall characterize the intermediate financials operating on a global scale.

The difficulty also rests on finding solutions that reduce the elevated deficit in checking accounts such as the ones that the United States,

United Kingdom and Spain had before the crisis. This is that these economies satisfied their lack of savings needs with the rest of the world, through the Asian economies and Germany savings, which have been characterized by growth models boosted by exportation. However, the accumulation of these balances was possible while, on the other hand, taking account of the demands of the ultimate consumer; the United States. In the end these imbalances should have been corrected through the exchange rate mechanism but this did not happen.

The repair of the financial system will not be immediately achieved, since it depends heavily on:

- The time it takes for the main world economies, through their representatives in international organisms, to define precisely what it is that is wanted;
- A great political effort from the countries in order to improve communication channels as well as the coordination for identifying and solving upcoming financial issues;
- Measures resulting from international organisms' coordination planning and execution times, which allow improvement in the regulation and supervision of financial markets;
- The development of new schemes that will allow the timely identification of accumulated systemic risks in the international financial system, and
- The regulation of international accounting information of financial entities that will allow a better analysis of business alternatives.

The current crisis represents an opportunity for upgrading the regulation and supervision of financial entities, which has lagged behind the financial innovations of globalization. Undoubtedly, this financial crisis exposes the need to improve the coordination of international organisms and of local and regional financial authorities. If this is not done the global economy will fall recurrently into this kind of crisis, induced by the inconsistencies of the incentives presented by the economic agents performing in financial systems.

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World crisis in Mexico: a glance forward

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Introduction

The expression “the hopelessness of Mexico” encompasses in a few words all the problems that the country faces.

Crime, financial and economic crisis, exacerbated by a health emergency seems to be the culmination of a Mexican drama.

However, we should ask if Mexico However one has to wonder if this economic recession indeed presents an opportunity? An opportunity to bring consensus on structural reform that would allow Mexico to overcome all the problems that limit its development.

By simply identifying the key national problems we can start finding solutions:

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- Financial reform, for example, would help define the fundamental factors to recover economic growth.
- The global financial sector that should in a local context be subordinated to controls and regulation of the Mexican State.
- The definition of the role that the State should play in the recessive phase of the economic cycle that the country is living.
- Commitment of banks and other financial intermediaries to support the country through deployment of credit to foster economic growth, starting by reducing the excessive spreads they charge to lenders.
- Reform of public administration with improved transparency to advance in the modernization of government and the efficiency and success determinants of public policy.
- Tax reform to strengthen public finances that supposes a change in fiscal policy and a reduction of public deficits.
- Reform of health services to reduce the economic and social impact of health threats such as the Influenza Pandemic threat in 2009.
- Education reforms, that will democratize the teachers union, overcome the low level of studies of the students and professors, elevating the quality of learning and assurance of access to free education to all the population.
- Changes in economic policy that allows a high growth of GNP and the subsequent growth in employment. There is an urgent need of "anti-crisis" plan, that is well structured and programmed that would allow the coordinated action of the three powers and of society.

Without capacity of the government to respond to problems, without leadership, education, health and security Mexico will continue to lag the most developed countries in the world.

Crime represents a very high social and economic costs, its complexity and dimensions forces to seek a higher level of international cooperation.

Mexico has a large territory with around 107 million inhabitants, a far cry from the 8 million people whose needs were attempted to be solved by the Constitution of 1857 and the 15 million that lived in 1917 when the constituents of Queretaro designed from the basis of a free and sovereign country the design of a new country with a modern legal framework.

It would be unviable to expect change in Mexico, to emanate from the central power.

The challenge lies is that reform can not be a simple redefinition of current public policy, but a complete change in national will that gives answer to needs at all levels of government based on division of power and proper representation of the interests of the States and Municipalities.

Mexico needs to legitimize its basic structures as a fundamental requirement of Public Administration, where civil servants should be the first to accept the responsibilities from the new times.

When we talk about consistency, when we outlay the urgency of respect for the law, of electoral fairness, of the need of an increased citizen participation, we are really talking about the Rule of Law as basis of the mobilization of society, of the equilibrium among the parts, of division of power, of the opportunity that Mexico and the Mexican State have a meaningful participation in the XXI Century.

Reform shall be based on the rule of law as cornerstone for national mobilization, opportunity lies in breaking away from the old centralized decisions building towards the growth of a larger middle class by fighting inequality and poverty.

I. World Context

After World War II strategies of economic growth led some countries to unite and improve their living standards and others to increase the poverty gap that separates them from the first.

In the early twentieth century some poor countries such as Singapore achieved increased levels of richness, and some rich countries such as Argentina fell to the level of poor countries.

Nevertheless, the world today is living the consequences of the excessive liberation of the market and the absence of managed regulation from the State in the financial and economic system. We are in the presence of a world-wide crisis with catastrophic costs, economic, financial and social, without a clear idea of what the magnitude and duration will be.

The balance registers failing mortgages and financial bankruptcies, banking interventions of the State, nationalizations, destruction of value in the stock markets and a deterioration of the global economy reflected in recessions of economies around the globe.

The world-wide economic growth forecast ranges from zero to not more than 1.0% of Gross National Product GNP during 2009, except China that will growth at a 6% GNP.

Diverse opinions point out that the magnitude of this global crisis will surpass the Great Depression, in the United States, credit as percentage GNP was 160% in 1929 this figure grew to 260% in 1932 and 1933, as a result of deflation and the downturn of the economy.

In comparison, in 2008 credit was 360% of GNP and in the next years it could reach up to 500% of GNP resulting in increased risk of deflation and depression much as it happened in the 30's.

The current economic debacle challenges the thesis that free self regulated markets is the only efficient way for market economies to function, several key economic players now plead for markets with stringent rules and controls and a state that guarantees the distribution of wealth, without creating the structural imbalances we are seeing today.

The situation in the world-wide banking system is chaotic and there seems to be a lack of hope that could lead to recover the confidence required to get back in track of economic growth. For that reason different countries are analyzing what would the best course of action be in the middle and long term, to face this crisis leading to the question of how far should state intervention go to ensure stability of the markets and for how long.

In the United States new regulation and financial supervision is seen with good eyes, aiming towards an absolute control of Hedge

Funds¹, of the mortgage businesses and the strict prohibition of banks to venture in excessively risky businesses.

Around the world, banks became rich, speculating with innovative financial instruments that had no clarity with regard of their systemic riskiness. This boldness apparently was exacerbated by the "too big to fail guarantee," implying that the ultimate price of bad investments, the bankruptcy of a company, shall be spared by the contributors in order to safe-guard the system of payments, reason why, governments will be forced to limit the freedom enjoyed by financial institutions in the past.

In the United States, the government of President Barack Obama, indicated that he will not tolerate "speculative business" and apparently he is on the threshold of promoting a set of new rules portrayed as: "the most severe rules of the game".

In other developed and developing countries around the world, governments and their central banks have been forced to focus their efforts on implanting new regulations to a worldwide financial system highly interconnected with the real economy, looking to limit the collapse of credit by recapitalizing the banking system through the division of toxic or non-liquid assets in to a "bad bank" "good bank" configuration.

II. Mexico's Case

The history of economic crises in Mexico in 1982, 1987 and 1994 seems to provide Mexicans with a particular perspective on the current situation. On the one hand, there is certain difficulty to grasp the international magnitude of the current crisis, due to the lack of the "usual" effects of economic crisis of old. Mexicans have not seen the massive bank failures, or blunt nationalizations, or the International Monetary Fund (IMF) led emergency liquidity loans. Even the former weak Mexican Peso has proven very resilient to current economic pressures and recently has regained much of the value lost at the end of 2008. On the other the effects although not as severe as in the past have indeed been hard, making evident the

¹ Hedge Funds: private equity funds usually have a type of coverage, specialized in one or several kinds of speculative investment, use investment strategies of high risk, derivatives, arbitrage (is the practice of taking advantage of a price differential between two or more markets), short sales, etc.

danger of the extreme dependence to the US economy and to oil prices. Mexico still shows vulnerability and a limited internal market, but with stronger institutions and a much improved stability towards shocks in the market.

Economic growth. While in May 2008 several analysts predicted economic growth of around 2.1% of GDP, eight months later, in January 2009 the estimated annual growth of GDP was lowered to zero and by April a new adjustment to the economic forecasts places GDP at an annual range of -2.8% and an increase in the fiscal deficit placing it at 2.1%.

The fall in exports, the decline in industrial activity, the decline in family remittances, the drop in tourism revenues, the falling oil prices, the reduced flows of foreign direct investment and a reduced availability of credit, coupled with the impact of the health crisis, led a contraction of the economy to (- 8.0%) of GDP more severe than the decline during 1994-1995 crisis. The current situation has forced the government to curb public spending. In fact, the federal government announced a cut in current spending of 85 billion pesos.

The international crisis “has showed us the deficiencies and weaknesses” of the Mexican economy, “dragged towards one of the deepest recessions of last 15 years”, declares the American firm, Moody's.²

Looking at the obvious vulnerability of the Mexican economy leads us to ask ourselves the most basic of questions: What determines economic growth? Economic growth is determined among other things by the improvement of life standards, of education, health, of social and political structures.

Economic growth is not only the result of the export capacity of a country, their major or minor diversification in the world-wide market, or its natural resources, and infrastructure, but also the result of qualitative factors such as its organization, innovation, efficiency, quality, motivation and discipline.

Some of the problems that ail Mexico and other developing economies such as: high unemployment, bad education and bad health services

should not only be seen through the lens of the social problems they create, but also as economic factors that end up creating the vicious cycles, that in turn create, corruption, crime and the break-up of the social fibers required to create a stable society. This vicious cycles inevitably end up damaging the global *competitiveness* of countries placing them in a more disadvantageous position to peers escalating the hurdles to achieve economic development.

In The 20th century, Mexico was not able to overcome these problems that inevitably resulted in more severe economic crisis than otherwise could have resulted.

During his tenure at the World Economic Forum, held in Davos, former President Ernesto Zedillo stated, “*the rescue of the banking system of Mexico at the net present value from 1995, represented 20% of Gross Domestic Product (GDP) exceeding the estimated cost for the financial rescue package for United States*”.

“Telling people that you’ll spend all that money in rescuing banks is not easy at all, also because of the extreme poverty in Mexico,” “Not Only we had to do that, but also, tell people that we had to be more austere and we had to cut social spending”.³

At the end of the first decade of the twenty-first century the balance of Mexico continues to be negative with severe structural problems as some indicators suggest.

Mexican migration to the United States

If the Mexican economy continues to lag in job generation, population dynamics will continue to push people to migrate to the North, even if the United States has a prolonged recession. In the United States 26.8 million residents are of Mexican origin of which 17 million are born in this country and 8 million are Mexicans with illegal immigration status.

High correlation of both economies does not deter migration on the grounds of economic conditions. Also quality of life becomes a key driver, as migrants prefer poverty in the US with basic services than poverty in Mexico with no access to basic living standards.

² Oil-Price Petróleo.es/ Mexico 28-05-2009.

³ *El Universal* newspaper. Thursday April 30 2009, p. B1.

The global crisis will force governments to review immigration policy, more stringent economic conditions in developing countries usually translates into higher migration to developed ones. Reaction in the past has been to strengthen migration policies to limit labour competition from illegal migrants, in the light of high unemployment.

This exacerbates the old migration problem between Mexico and the United States, with no realistic, politically sensible solution that acknowledges the fact that in the long term, labour demand in the US requires Mexican supply.

Both countries need to channel a legal response to the Mexican migration problem that will improve working conditions, control of movement of workers and eliminate the increasing problem of human trafficking.

Migrants as Drivers of Change

The new generation of Hispanics of Mexican origin, is now the fastest growing minority in the US, with more schooling and fewer ties to their home country than their parents, this new generation is turning out a myriad of social leaders, government officials, congressional representatives and businessmen, this so-called “young cats” are now a factor of change from the “Mexico of despair” that led to their departure to the “Mexico nostalgia” of a home country where you no longer belong.

This population segment has become increasingly important not only for the US but for Mexico also. Remittances from these people to their families are now an important part of Mexico GDP, and during the Fox years the single reason why poverty levels were improving throughout the country.

The hopelessness of “Change”

Mexico as other countries in the world including Britain or Spain really gave the socialistic economic approach an opportunity. The system of centralized and interventionist economy prevailed for most of the 20 Century. Some decades, fuelled mainly by high oil prices gave the illusion of an efficient and successful system. This mirage ended abruptly at the end of the Jose Lopez Portillo presidency with

the last socialist act of a Mexican Government: the nationalization of the bank system and implementation of foreign exchange control.

From that point on, and following the trend of other Latin-American countries mainly Chile, Mexico has gradually ended the dominant presence of the state in the economy through a process of privatization and strengthening the free market economy.

However, despite this 180 degrees turn in economic focus, Mexico has not been able to achieve the economic growth to increase its level of income or to generate the jobs that its population demands to say the least. This makes us question the way Mexico has chosen to embrace a true market economy. Makes us wonder that maybe Mexico’s single party system had more similarities with China than with Chile? That political reform should have come after economic reform and not at the same time? That Mexican institutions were not strong enough to manage a brand new economic system and a new democracy? But these questions only serve to put into perspective the challenges that lie ahead, and maybe provide a framework to think of solutions to the problems Mexico faces.

The participation in GDP of the rich 10% part of the population increased from 32.8% of GDP in 1984 to 38.0% of GDP in 1989 and to over 45.0% of GDP in 2005, deepening inequality forcing the middle classes tighten their “belt line” and the poor to sink further into misery.

III. The Change in Mexico

Additionally more democracy has not translated into less corruption, or more effective government; on the contrary it seems that the Mexican state has weakened with signs of drug cartels permeating all layers of government and political parties turning into power centres preoccupied with short term political gain, always with an eye on the next election, forfeiting the political cost or difficulty that long term decisions require for the benefit of the country.

Spending on political campaigns and the promotion of democracy has multiplied exponentially over the years while, spending on education, health and social care has fallen from 8.4% to less than 6.4% of GDP in five years with real wages and per capita income also fallen sharply.

This lack of structure for political reform with weak governments incapable of reaching political consensus has left Mexico with no meaningful changes in over a decade. Dependant on the achievements of past administrations Mexico today relies, basically on key reforms from the past, NAFTA, the pension system and an independent Central Bank among others, as key pillars for growth, however there is limited economic advantage over other countries but oil, geographical location and not so cheap unqualified labour.

The global crisis provides a reminder to Mexico of the time lost to promote true change and foster growth. The total dependency on the United States is reflection of the failure to strengthen economic relations with other developed countries and have a diversified trade platform. Government has failed to promote a meaningful energy reform to curb the permanent decline in oil production. At the same time competition from other economies is growing, with many a factory once based in Mexico now producing in mainland China, and Mexican government failing to provide fiscal stimulus to retain this jobs.

Brazil, Chile and Peru with trade relations comparatively more diverse and broader than Mexico are showing a better stance to weather the global crisis. In summary Mexico's political landscape and structure provides a limited support to improve on the economic framework required to promote growth.

A recent report by the United Nations (UN) stated that Mexico represents a failure in terms of general political decisions that has resulted in economic and social immobility.⁴

Mexico needs to avoid on the one hand the extremes of demagoguery and authoritarianism and suffocating state intervention and on the other the excessive release of the market and extreme deregulation that would inevitably lead to corruption.

IV. México. A glance forward

The solution of the economic crisis has seen isolated efforts from the Mexican Government lacking common goals and clear leadership. This stresses the need for a national plan from the government

with clear policy in areas such as: fiscal stimulus, infrastructure, monetary policy and employment. Also stands out the need of regulatory reform of the financial system that aims to limit future financial crisis. Among the actions that the Federal Government could start pursuing:

- Tax incentives, cuts in energy costs, investment in road infrastructure and petroleum extraction and refining infrastructure, as well as strategies to extend health coverage and provide temporary jobs to the unemployed.
- Programs to support small businesses, reactivation of credit, the role of banks in credit matters and in particular the timely response to the credit needs of the productive sector.
- The recovery of confidence in government and the financial and banking system.
- Define the role of state and municipal governments in ensuring a continued stimulus of local economies.

The duration of the crisis and its impact in Mexico will depend on the financial and organizational capacity of government to safeguard the economic, financial and social factors in the short term.

The crisis offers an opportunity to advance reforms in finance, banking, energy and a review of intergovernmental relations. Public opinion, pressed from the economic side, could force the opposition to allow political negotiation and agreements, overcoming obstacles and aligning interests.

There is also an opportunity to see increased credit in Mexico, as most financial institutions in Mexico are owned by foreign banks that have suffered heavily with the economic debacle. These institutions now rely more and more on their healthy (and by comparison better structured) and profitable Mexican operations, case in point is BBVA Bancomer, with a 27% loan market share, the company is leveraging its dominant presence in the market over the medium term. In the current economic environment the company managed the highest ROE of any banking institution in Mexico, almost 2.0x larger than the average of the system, owing to, among other things, to very low costs of funding.

⁴ Report of the United Nations, UN, Annual Report, 2009.

The bitter international experience forces banks in Mexico to be a prudent. However there are signs of overcompensation, as loans-to-GDP in Mexico stand at just 29%, 54% below as a percentage of GDP the levels of 1994. Commercial bank lending has been reduced from 40% of GDP in 1994 to 12.5% today. Although commercial banking lending has increased by 50% as a percentage of GDP since the 2004 lows, it still offers significant medium-term upside. The industry, is oligopolistic in nature with seven players having a combined 88% market share, thus sooner or later, especially the smaller players should seek to gain market share through more aggressive lending.⁵

A national plan would mobilize resources, increase capacity and encourage good governance. This requires the optimal use of these resources, doing more with less, to build only those projects that meet people's needs.

Without a plan, without agreement, without consultation, without responsibility, the crisis and its adverse effects will last much longer in Mexico.

The question is not only whether there is political will, but if there is financial and administrative capacity to deal with the crisis and resume a sustained growth of the economy over the medium term?

Opportunity for a Reform in Education

Education in Mexico throughout its history shows both great setbacks and great advances. The purpose of this document is not to make a balance of the progress of education but to highlight some aspects that could lead to reform one of the largest obstacles to development in Mexico.

The Draft of the Constitution of 1917 incorporated and enriched the theory of liberal education, free education and secular education.

The solution to the historical problem of Church-State relations was based primarily on the church-state separation, the secularization of civil society into a free society, in the appropriation of the fundamental spiritual freedom of man.

The solution claimed supremacy of state and established state regulations regarding the social effects of religious worship and political action of the clergy.

The constitutional reform of January 28, 1992 took 180 degree turn, returning several rights to religious institutions, including the right to own assets, operate schools and provide religious education, this reform also resulted in increased political power for religious institutions, specially the Catholic Church.

Reforms of 1992, where in fact an acknowledgment of common practice, where through grey areas of the law, or simply lack of enforcement by the State, religious institutions owned assets, provided religious education and had significant political influence.

The 1992 reform undermined the liberal theories enshrined in the Constitution of 1917, including:

- Separation of Church and State.
- Freedom of belief.
- The understanding of secularism as the independence of man, society and the State against any church or religious influence.

However, education reform in Mexico should take more of the thinking of Jaime Torres Bodet,⁶ where he believes education must encourages diversity in the faculties of men, education should be able to develop democracy, ensure fundamental freedom and encourage the exercise of rights based on the rule of law that makes a decent society.

Mexican education should values at length its heritage, should not tolerate injustice and should promote democracy to help society define their destiny.

Although there are significant challenges in education, we have to recognize that progress is undeniable. For example, the national

⁵ Source Banco de Mexico.

Torres Bodet, Jaime, *et al.*, *México 50 años de revolución*, 1ª Ed., FCE, México, 1963, XXXII + 502 pp.

crusade against illiteracy and national integration led by Jose Vasconcelos, or the efforts by Torres Bodet to achieve national coverage of the educational instruction.

This past experiences, have undeniably helped to consolidate the Republic and strengthen unity and identity with a common language and history. They provided the settlement of special schools for the ethnic communities with the purpose of integrating them into the national culture.

The extraordinary struggle of many years against the centralization of education paid off, without stating that education decentralization is a finished process.

If we consider that in 1940 there were only six universities outside large cities and eighteen in 1961 we could understand better the lag of university coverage in rural areas.

The influence of technical schools has also been significant, both in government, industrial and economic development in general.

However, the reality shows that the population remains poor with a low educational level; the government must address this reality because only with increased coverage and quality in education can Mexico achieve growth.

But the spending on education as a percent of GDP on the last 15 years increased only from 6.2% in 1994 to 6.5% in 2009.

Spending per student is low and the educational level is below the performance of students in other countries.

According to the Program for International Student Assessment of the OECD (PISA) dedicated to measure scientific knowledge, the performance of Mexican students was placed at the bottom of the OECD member countries.

However, teacher salaries are above the OECD average but its performance remains very low. Increasingly, the country needs well-trained teachers dedicated to their profession.

There are many and diverse problems of education, however, a comprehensive reform of the education system requires national

leadership, pragmatic policy to overcome obstacles and navigate the political risks it entails. On clear source of conflict is managing the teachers union the SNTE, the 1.5 million strong organization is leveraged by its leaders for political power, undoubtedly the SNTE is one of the key participants to achieve education reform in Mexico.

Opportunity for Administrative Reform Tax

The impact of the global crisis in public finances presents several challenges to governments to:

- Ensure sufficient tax revenues at a time of economic recession and unemployment.
- Advance a more progressive and fair tax system.
- Prove a highly competitive tax structure that encourages investment with acceptable risk profiles and appropriate work incentives.
- Advance a simpler and more efficient tax system.
- Make taxes less onerous.
- Advancing effective administrative reform to ensure the success of tax policies.

Mexico tax revenues reached 10.3% of GDP (0.3% refers to import duties), implying that the current public sector funding of around 23 percent of GDP, is corrected to 8.3% of resources originating from oil, 2.6% from revenue of state owned companies (excluding PEMEX), 1.4% of social security contributions, and the rest 0.4% from other rights and concepts.

Characteristics of the Tax System

- Low tax burden of 12.9% versus 32.3% on average in OECD countries.
- A high fiscal dependence of 40% on oil.
- Low tax compliance.

- A growing informal sector.
- A loss of revenue, equal to half of the tax base.
- A federal census of less than 20% of the workforce.
- Audits with low coverage and results.
- Very high level of tax debt.
- Human resources of low professional level.
- Managing Tax Reform Proposal.

General Objectives of the Tax System

- Mitigate the impact of the crisis in public finances.
- Ensure the success of fiscal policies "anti-crisis" from increased efficiency in tax administration.
- The development of a tax system that generate certainty to taxpayers and facilities.
- The implementation of best practices in collections and the overall impact of technology.
- The reduction of tax evasion and tax avoidance.

Specific objectives of the Tax System

Improve tax collection efficiency, through proper organization of the attributions, processes and collection systems.

Improve institutional coordination and fiscal coordination, with state and municipal governments, using best administrative practices and state of the art technology.

When Mexico opened its economy to international trade, the needs for control and coordination of tax collection systems required significant changes to adapt them to the requirements of foreign trade. Mexico had to increase compatibility with other countries

of aspects such as fiscal stimulus to foreign trade, control of tax heavens and support to low cost manufacturing ("maquiladora").

Collections efficiency is conditioned by the economic recession and changes in the foreign sector, also depends on the design of tax policy. Currently, tax policy has been geared towards achieving simplification of the complex tax laws and processes that hamper proper tax collection. Initiatives like the elimination of the asset tax, homologation of the different VAT rates and decentralization of tax collecting responsibilities from the Federal Government to the States aim to simplify and increase tax collection.

Still pending are reforms towards elimination of current income tax laws that require less cumbersome approach. Also the VAT presents a very limited base and in contrast with other countries, provides a much lower source of funds with a much higher rate.

Property taxes, and water rights also present a low level of income or the government, this low collection level has been exacerbated by the economic crisis. Municipal governments could start implementing their own programs of tax administration reform that would allow them to limit the impact of reduced property tax income.

Changes in fiscal federalism could initiate new forms of collaboration based in the strengthening of collecting abilities with incentives designed specifically to advance fiscal decentralization with new schemes to strengthen all fiscal enforcement tasks, processes and incentives.

Elements of a Tax Administration Reform Program

The reform of tax administration in Mexico should be placed in the context of tax policy in an environment of crisis and global economic recession.

Its objectives are the modernization of the tax system, increasing collection and resolving the needs of taxpayers reducing levels of corruption of administrative complexity and create a culture of transparency and ethics in service.

Tax reform, assumes the reorganization of the tax system and requires technological modernization and a comprehensive program

of institutional strengthening with increased professionalism of public service.

Elements of reform should address issues of improved service to contributors and increasing the degree of decentralization and should put an end to the excesses of the regulatory authority, simplifying tax compliance.

The reform involves an organizational review of institutions, beginning with defining a new body that will operate as a collector with delimited functions and a degree of autonomy. This new institution would allow the organization of the administration by separating and specializing functions.

Important elements of the reform are the strengthening of control and collaboration agreements for joint supervision of Federation - States, including the definition on the control of different types of taxpayers.

The authority can decentralize certain activities of care for the taxpayer, both regional and procedural. In this sense new tools can help provide a tracking system for applications and procedures, even in geographically distant populations.

Another key element is the customs system, actions conciliation procedures, international treaties, money laundering and tax compensation between sectors.

The taxing authority requires a redefinition of authority to decide on its legal and regulatory re-configuration and tasks of internal reorganization with clear indicators for measuring the performance and efficiency of tax collection.

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**Towards a new model of fiscal federalism in
Mexico for the long run:
Lessons from other federations within the OECD**

José Antonio Ardavín*

The current Mexican tax system has evident shortcomings. The proof is that from start to finish in the past administrations, the priority has been and remains the adoption of a tax reform that gives the state greater ability to perform government functions and enhance social and economic development in Mexico which, with the current framework, is strongly limited.

However, the limited efforts and victories that have been achieved in taxation have had the urgency to obtain some additional points of GDP in revenue in the short term, beyond the important thing is, the redesign of public finances in long term to have a tax system more inclusive, fair and simple, with a broader tax base, less reliance on oil revenues and a new balance in the fiscal responsibilities of the states and the federation, according to the greater responsibility for spending the states and municipalities and the new era in the political relationship between them and the federation.

This last point, that of fiscal federalism is the one which this article addresses in more detail. Precisely because, in general, is one of the least discussed, in part because of its political complexity and

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partly because of some "comfort" with the *status quo* for the different stakeholders, but mainly because I believe that the solution to the problem of public finances passes through the Local arena and the design of a new fiscal federalism in the long run will bring not only more robust public finances, but also a platform for economic growth and regional competitiveness, which have not been entirely successful in recent years.

While the so-called "Fiscal Convention" a few years ago, addressed this issue, in practice it has been neglected in the political agenda. The only progress in this field occurred in the context of the reform made at the beginning of his administration by President Calderon, whereby incentives for local fundraising were incorporated into the formula of federal grants.

This progress, while it is in the right direction, it stays in the area of the "achievable reform", in the short term. The purpose of this analysis is to propose the construction of a long-term vision that allows delineating the "desirable reform" that should be followed in a horizon of probably 10 or 15 years in the field of fiscal federalism.

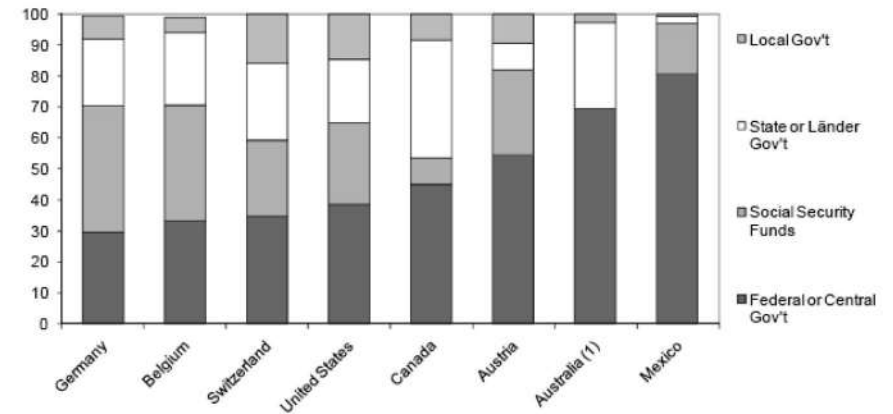
For this long-term view, it's worth giving a look at existing systems and at the trends in other OECD countries, particularly other federations or federal systems. Mexico's membership of the OECD allows here, as in many other subjects, the comparison with the most developed economies in the world. While this comparison is not always comfortable, as was evidenced in the case of the PISA test and other comparisons in different areas, that does not reduce its relevance, especially if the intention is to learn from these comparisons and improve.

In the issue at hand, despite it could be argued that each country sets its tax rules in the way that best suits its interests and that there is not necessarily a better system than another, it is relevant to ask:

Why is Mexico an exception when compared with other federations in relation to the collection derived by local governments?

Figure 1 shows the revenue by level of government in eight federations in the OECD in 2004. As can be seen there, in almost all of these countries, local taxes account for between 15 and 45 percent of the total revenues of the State. In contrast, in Mexico

Figure 1
Level of tax revenues by type of government
2004



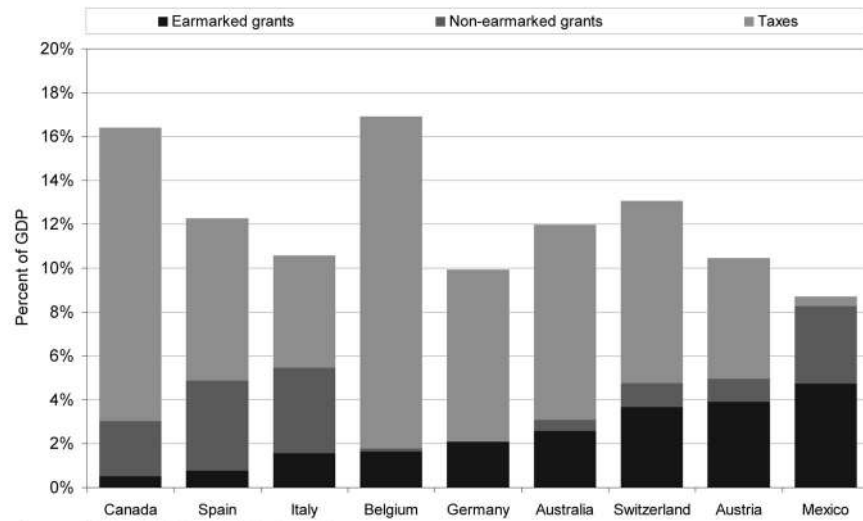
Note: VAT is charged by the government federal and entire collection is assigned to the states and territories.
Source: OECD (2006) Revenue Statistics.

local revenues (state and municipal) does not exceed 5% of total revenues, in other words, virtually all of the collection is central. Figure 2 complements this comparison, from the local point of view. It shows the composition of the resources of local governments in many federations in the OECD. As it can be seen, Mexico stands out for two points. First, because as a share of GDP is the country with fewer resources, which is not surprising since it is the OECD country with lower tax revenue as a proportion of national GDP. Second, because unlike federal systems under consideration, where local taxes make up most of local resources, in the case of Mexico, virtually all the revenues of local authorities depend on central government transfers, whether earmarked or non-earmarked grants. (See Figure 2).

Wouldn't the low revenues be related to the extreme centralization?

International experience, economic theory and logic would seem to indicate so. Generally the case for raising taxes centrally is argued on the basis of efficiency, economies of scale and, in the case of Mexico, commonly, the inability of local governments to raise their own taxes. However, rarely the opposite is argued, *i.e.* the central government's inability to collect taxes from all corners of the country and incorporate large segments of the population into the formal economy, ability that certainly would be higher, if the responsibility would be with the authorities who are closest to the citizen.

Figure 2
Composition of subnational revenues, 2002 (1)
% of GDP



Source: OECD (2006) Territorial Reviews: Yucatan.

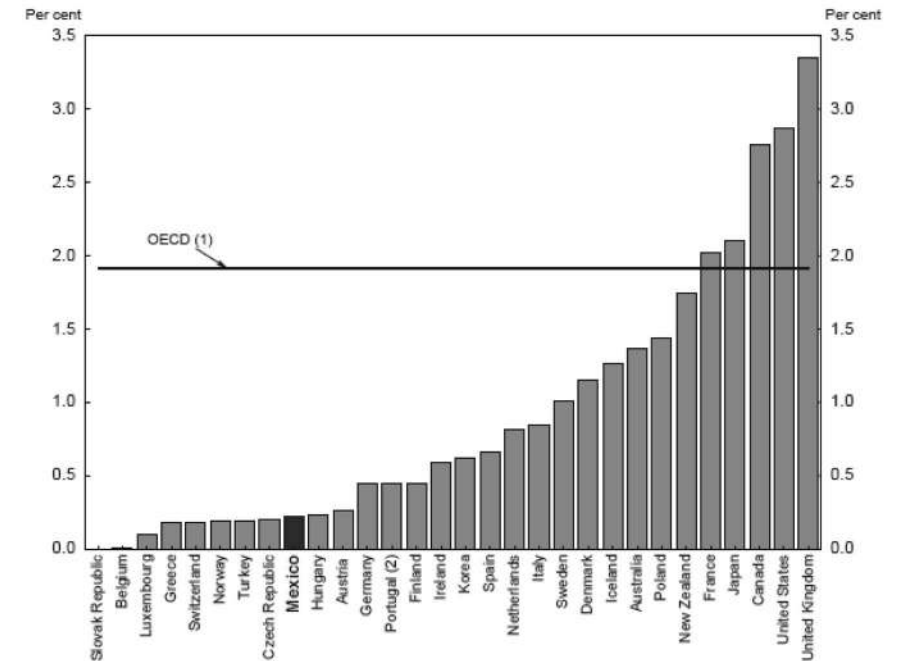
This discussion has also a component of political economy. Basically, the collection of taxes by the State is grounded on a “social contract” whereby citizens agree to give the State a proportion of their income in exchange for a series of “services” ranging from security to education, health and other public services. In this discussion, sometimes with great ease, Mexico is compared with countries like Belgium, or Austria or Switzerland, when really any of these countries could well be compared in territory or population with one of the states of Mexico. A fact that is little known, but it is very telling is that 14 OECD countries have a smaller territory to the State of Chihuahua and 16 OECD countries have a population smaller than the State of Mexico. Well, if Belgium, Austria and Switzerland, have solid grounds as federations to provide a degree of autonomy to their regions in its local revenue collection, the greater the grounds for country of the size and population of Mexico, especially if it is established for more than half a century as a federation.

Why in Mexico local governments do not collect enough, not even what they have powers to levy?

Now, returning to the argument of the inability of local governments; in a way this is an argument based on the poor results that already have local governments collecting taxes within its jurisdiction. The

clearest case is the property tax or “predial”. Figure 3 shows that Mexico actually has a very low collection of this tax as a percentage of GDP compared with other OECD countries: while in Mexico is lower than 0.25 percent, the average in the OECD is slightly less than 2% and in the European Union closer to 1.4%. Obviously there is a very large rooms for improvement in this aspect, which is related to many factors, (which I will not go into greater detail) from the low capabilities of local authorities to the lack of definition of property rights.

Figure 3
Recurrent taxes on immovable property in OECD countries
2001



Note: Weighted average using 2000 GDP at purchasing power parity.
Source: OECD Revenue Statistics 1965-2003.

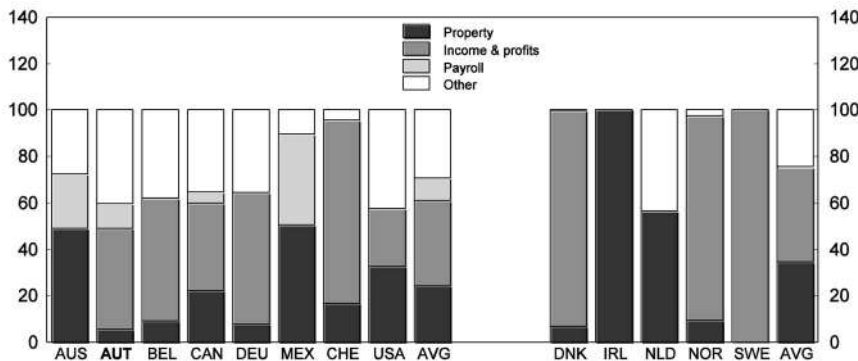
What’s about incentives?

In a framework as the one shown in Figure 2, where around ninety percent of the local resources (with differences between institutions and municipalities) are made up of central government transfers. What source of revenue would local governments seek to increase every year? Obviously the transfers and oil revenues and everything else they can gain by making noise. But if a higher proportion of their resources depended on their own collection, that is, if they were

granted some additional tax powers, we might be surprised of how efficient they become, perhaps raising the predial or any other tax.

What does international experience shows in this regard? If you focus on the distribution of local revenues by type of taxes in figure 4, it appears that in most federal countries, local governments have a major proportion, in many cases most of their income derived from taxes on income and profits. Exceptions to this pattern are Mexico and Australia among the federal countries (left side of the graph). So are Ireland and the Netherlands, but these are unitary countries (right). At this point it is worth to link this discussion with the issue of regional competitiveness. While there is significant debate in the literature about the pertinence or not of tax competition from regional entities, which sometimes translates into a “race to the bottom” and a variety of tax rates that can become of an enormous complexity, on the other hand, the ability of local governments to raise income taxes for individuals and businesses (at least in some proportion), allows local revenues to be linked to the performance of the local economy and thus benefit directly of the results or failure of a regional development strategy.

Figure 4
Composition of tax revenues of subnational governments, 2002 (1)
 % of total revenues

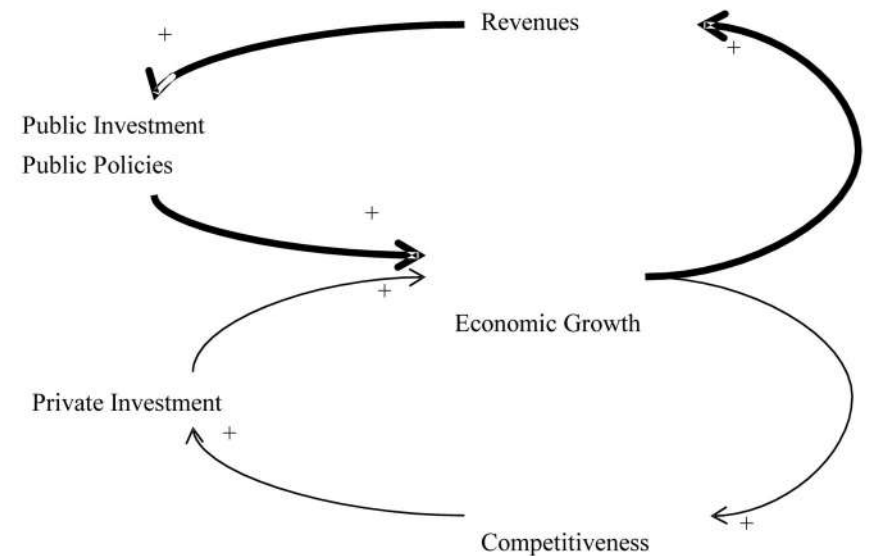


Note: Federal countries on the left, unitary countries on the right. The average (AVG) is the average of each group of countries.
 Source: OECD Revenue Statistics.

We all know examples of cities and towns in Mexico that have a significant industrial growth or success in any particular economic specialization, including significant clusters, and yet have a major deterioration in its urbanization, utilities, public safety, education, etc. One example, which I can speak of since I had the opportunity to experience personally and which I think

it is very evident, is the one of the municipalities producers of avocado in Michoacán. During the early years of this decade, there was an extraordinary inflow of resources throughout the area derived from the opening (first partial and then full) of the U.S. border to Mexican avocados, after more than 80 years of prohibition. This would not have been possible, of course, without the international negotiations of the federal government, but also thanks to important investments that producers and packers made to ensure the required quality. Through exports, an increasing number of producers received a price much higher than the domestic price. This huge inflow of resources has had a major impact on regional development, in terms of private wealth, investment, business creation and job creation (lower virtuous circle in Figure 5). Unfortunately, however, the ability of local governments to prop up the local development and public investment to turn this flow of resources into better schools, better streets, better public services is almost nil.

Figure 5
Linking local revenues and local economic growth
 System Diagram

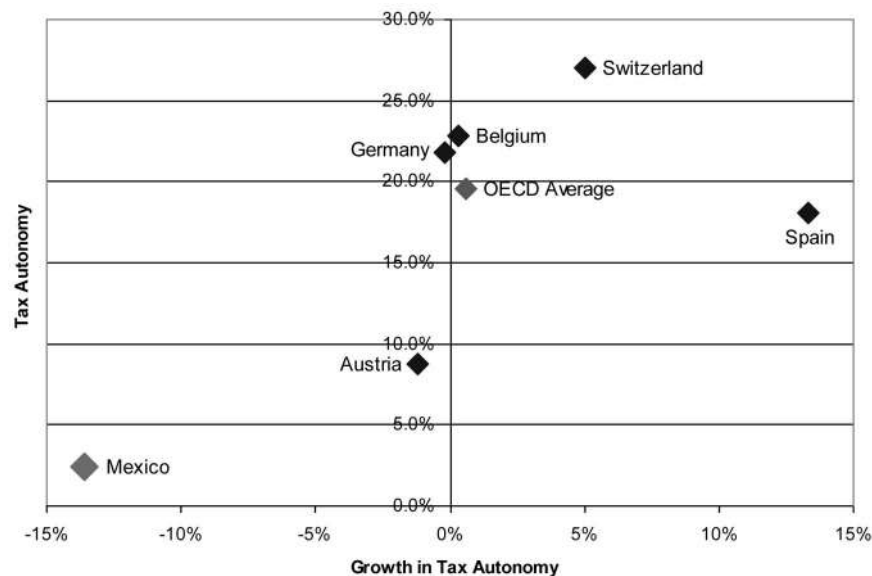


Local governments may well be a lever for regional development through public investment and public policy from their own collection (top virtuous circle in Figure 5), but currently, they do not have the key incentive that any government (*i.e.* entire collection entity)

should have: only if the economy grows, the collection grows. This is true nationally, but not locally, and in my opinion, should be true in a country as big as Mexico. From this standpoint, the lack of competitiveness and economic growth in Mexico could have also among its causes the brake that represents the absence of proactive local governments directly involved in the development of their localities.

The era of globalization turned local governments into key actors in the competitiveness of their regions. In most countries, this has been translated into a process of decentralization, giving local authorities greater powers of expenditure, but also, as shown in Figure 6, greater fiscal autonomy. While the former has occurred in Mexico, the second, far from being the case, follows the opposite trend. As the chart shows, in Mexico the fiscal autonomy has been reduced by 14% in the last decade, increasing dependence of local federal transfers. The OECD has stressed repeatedly that while expenditure decentralization has brought successful innovations in the management of public services, the system transfers to state and municipal governments in Mexico, far from promoting more balanced regional development, has perpetuated the disparities in

Figure 6
Evolution of tax autonomy of selected OECD federations 1995-2002

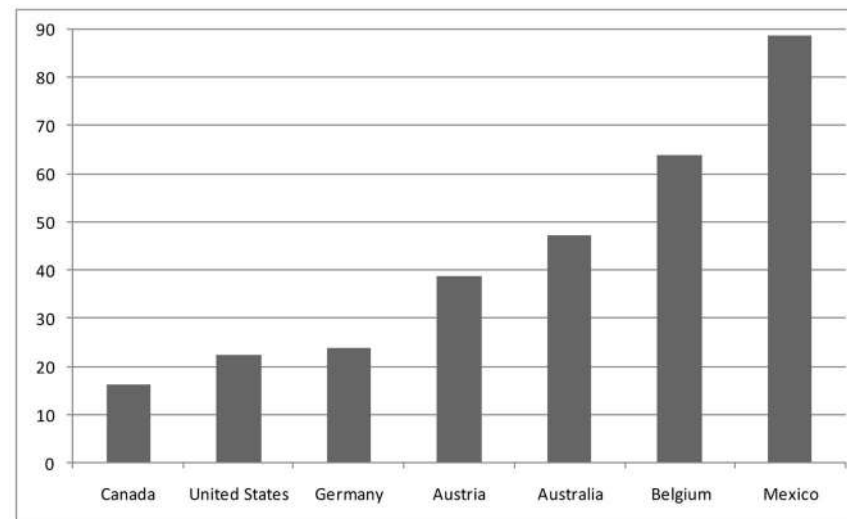


Source: OECD (2006) Territorial Reviews: Yucatan.

access to public services. At the same time, the dependence on transfers has decreased rather than increased accountability on the part of local public servants. A different story would be, if they were held accountable for raising their taxes.

The result of an unbalanced process of decentralization, favoring spending over the collection, places Mexico as the country with the highest vertical fiscal imbalance among the countries concerned. While in countries like United States, Canada or Germany, the proportion of local spending is higher than the proportion of local revenue by only 20% in Mexico is around 90% (See Figure 7). The lack of balance between the competences in terms of expenditure and in tax collection of local countries is a key element of “desirable reform” of fiscal federalism, that in the medium and long term should consider.

Figure 7
Vertical fiscal imbalance in selected OECD federations As a percentage of local revenues, 2003

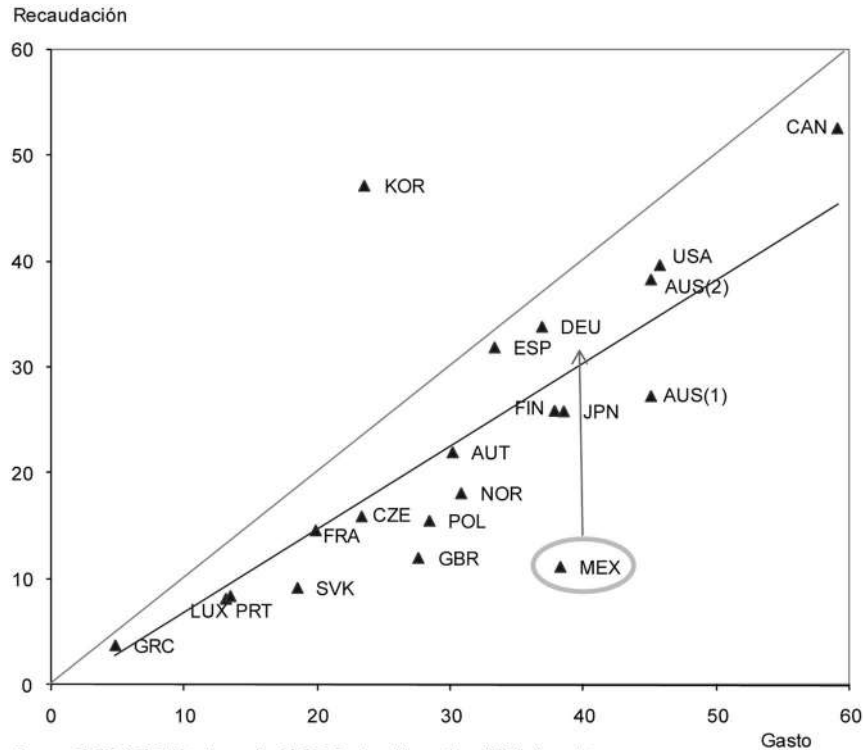


Source: International Monetary Fund (2005), Government Finance Statistics Yearbook; US Bureau of Economic Analysis; OECD (2005), OECD Economic Surveys: Mexico; Australian national authorities.

Summing up

Over the long run, Mexico needs to transit to a scheme of fiscal federalism in which states and municipalities acquire higher tax responsibilities. This transition will not only strengthen the Mexican federal system, but also if accompanied by a gradual

Figure 8
Percentages of sub-national revenue and expenditure
As a percentage of total central government, 2003 or 2004



Source: OECD (2009) Studies on the OECD Regional Innovation: 15 Mexican states.

effort to increase the capabilities of local governments, Mexico would allow governments to have more proactive role in the competitiveness of their regions and greater accountability to its citizens. Presumably, this would also have an impact on economic growth and competitiveness of the country as a whole. The path to follow is clearly indicated in the last chart (No. 8) which shows that Mexico could and should be at par with local revenue raising in other countries with the same level of decentralization of expenditure, namely, Spain, Germany, Finland or Japan.

I emphasize the long term, as for most economic actors and politicians, this is not a task that can be done overnight. Of course not, but today the foundations of such transition could and should be laid. Mexico, with the economic actors and politicians set the critical route in a horizon of 10 to 15 years to increase, the local rate of tax collection, from current levels, below 10% of the national

total to 30%, which is the level of federations grow as Germany or Spain, and it is consistent with the percentage of spending by local governments, which as in the case of Mexico, lies between 30% and 40% in these two countries.

An alternative that could be considered in the transition to this new scheme, is the asymmetric devolution differential of taxation powers between states and municipalities, *i.e.*, while the target to 15 years could be that all states have stronger revenue systems, the transition could start by granting more tax power to same and then to others. Spain, with its asymmetric system of decentralization of powers to its autonomous communities is an interesting example, which could be replicated in the case of Mexico.

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Resúmenes

OCDE, *“Respuesta estratégica a la crisis financiera y económica. Contribuciones al esfuerzo global”*.

En una economía mundial con gran interdependencia global y en recesión, las proyecciones apuntan hacia una desaceleración larga en la OCDE, con probabilidades de descenso de a lo menos 1/3 de punto del PIB. La crisis financiera se filtró a la economía real incrementando el desempleo en muchos países. La Respuesta Estratégica de la OCDE tiene como propósito tratar la crisis y aprovechar la oportunidad de construir una economía mundial más fuerte. Este documento presenta las aportaciones y propuestas de la OCDE, como una estrategia integral y aborda las interacciones entre los ámbitos financieros y de gobierno a fin de alcanzar el crecimiento sostenible, por medio de la acción y la cooperación. Ofrece materiales entregables que serán de tres tipos: acciones por parte de miembros y no miembros (como compromisos e instrumentos), recomendaciones de política, y seguimiento.

Francisco Suárez Dávila, *“La política económica mexicana ante la crisis mundial: Deficiencias y oportunidades”*.

Se analizan el carácter global, profundidad y larga duración de la crisis mundial, el estado actual de la economía mexicana y la respuesta del gobierno mexicano ante la crisis, con programas e instrumentos, a los cuales considera insuficientes y deficientes, además de revelar los rezagos de nuestro desarrollo económico por políticas equivocadas de muchos años. El autor afirma que “la crisis nos obliga a atacar eficazmente la emergencia económica, pero nos da la oportunidad de rediseñar nuestra estrategia económica y social de largo plazo”. Señala las tareas necesarias para

reorientar el proceso de desarrollo y reconstruir las instituciones, complementada por una política social que corrija desigualdades. Para ello es necesario el impulso de un Estado desarrollista, que combine competitividad externa y mercado interno fortalecido.

Guillermo Ortiz Martínez, *“Los retos de la economía mexicana para lograr un alto crecimiento sostenido en el mediano plazo”*.

El autor señala que el bajo crecimiento potencial de la economía mexicana responde, en último término, a un marco institucional que provoca que los agentes económicos enfrenten incentivos adversos. En particular, el marco institucional ha tendido a premiar relativamente más la extracción de rentas que la búsqueda de nuevas y mejores formas de producción, y ha propiciado bajas tasas de inversión tanto en capital físico, como humano. Esto conduce a un bajo dinamismo de la economía, a una mayor desigualdad en el ingreso y a una mayor pobreza.

Jorge A. Chávez Presa, *“La reparación del sistema financiero internacional. Un trabajo en ciernes”*.

Se advierte que las reformas del sistema financiero internacional representan tareas titánicas y que no se lograrán de forma inmediata ya que depende en gran medida de los tiempos en que los principales países definan que es lo que quieren, de un gran esfuerzo político; de la planeación y la ejecución, del desarrollo de nuevos esquemas y de la normalización internacional. Considera que la crisis representa la oportunidad para actualizar rezagos normativos y de supervisión en las entidades financieras.

Raúl Martínez Almazán, *“La crisis mundial en México: Una mirada hacia adelante”*.

Se plantea un cambio en la política económica para que el país pueda crecer a un mínimo de 5.0% del PIB y generar los empleos que demanda la población, mientras tanto señala la necesidad de un plan nacional *“anti-crisis”* bien estructurado y programado que permita la acción coordinada de los tres órdenes de gobierno y de la sociedad.

José Antonio Ardavín, *“Hacia un nuevo modelo de federalismo fiscal para México en el largo plazo: Lecciones de otras federaciones al interior de la OCDE”*.

En el largo plazo, es necesario que México transite hacia un esquema de federalismo fiscal en el que los estados y los municipios adquieran mayores responsabilidades fiscales. Esta transición no sólo fortalecería el sistema federal mexicano, sino que, de ser acompañado de un esfuerzo paulatino que incremente las capacidades de los gobiernos locales, permitiría a México contar con gobiernos más proactivos e involucrados en la competitividad de sus regiones y con mayor rendimiento de cuentas a sus ciudadanos más cercanos.

España, con su sistema de descentralización heterogénea de las distintas competencias de sus comunidades autónomas es un ejemplo interesante, que podría replicarse en el caso de México.

Abstracts

OECD, *“Strategic Response to the Financial and Economic Crisis. Contributions to the Global Effort”*.

In a global economy with a large degree of global interdependence and in recession, all projections point to a significant slowdown for the OECD, with a potential loss of 1/3 of a point of GDP. The financial crisis has seeped into the real economy, increasing unemployment in many countries. OECD's strategic response is intended to deal with the crisis and take advantage of the opportunity to build a new, stronger World Economy. This document presents the contributions and proposals of the OECD as an integrated strategy, covering the interactions between financial and government areas, and geared towards attaining sustainable growth through action and cooperation. Deliverables offered are divided into three types: actions from members and non-members (such as undertakings and instruments), political recommendations and follow-up.

Francisco Suárez Dávila, *“Mexican Economic Policy facing the Global Crisis: Deficiencies and Opportunities”*.

Analysis of the global character, breadth and duration of the global crisis, the current state of the Mexican economy, and the response of the Mexican government to the crisis, with programs and instruments deemed insufficient or deficient; reveals the backlogs of Mexican economic development due to long-standing policies. The author holds that “the crisis forces us to efficiently deal with the economic emergency, but also gives us the opportunity to redesign our economic and social strategies in the long term”. This paper points out the necessary steps in order to reorient the development process and rebuild the institutions, complemented by a social policy to correct inequality. This requires the thrust of a development-minded State capable of combining external competitiveness and a strong internal market.

Guillermo Ortiz Martínez, *“The Challenges of the Mexican Economy for Achieving a High Sustained Growth in the Medium Term”*.

The author indicates that the low potential growth of the Mexican economy is the end-result of an institutional framework that confronts economic agents with adverse incentives. Particularly, said framework tends to reward extraction of rents than the search for new and better means of production, and propitiates low investment rates, both in physical and human capital. This results in an economy with reduced dynamism, greater income inequality and greater poverty.

Jorge A. Chávez Presa, *“Repairing the International Financing System: A Budding Work”*.

This article acknowledges that the reform of the international financial system represents a titanic undertaking that will not be accomplished overnight, since it depends to a large degree of the times in which the main countries define their goals as well as a huge political effort; planning and execution, development of new schemes and normalization at the international level. It considers the crisis to be an opportunity to bring backlogs up to date, in connection to regulation and supervision of financial institutions.

Raúl Martínez Almazán, *“World crisis in Mexico: a glance forward”*.

This article presents a change in the economic policy for Mexico to grow a minimum 5% of GDP and generate jobs demanded by the population, while articulating the need for a well-structured and scheduled national anti-crisis plan that allows coordinated action of all three orders of government and society.

José Antonio Ardavín, *“Towards a new model of fiscal federalism in Mexico for the long run: Lessons from other federations within the OECD”*.

In the long term, it is necessary for Mexico to move towards a model of fiscal federalism where states and municipalities acquire a greater degree of fiscal responsibility. This transition will not only strengthen the Mexican federal system but, if accompanied by a gradual effort to increase the capabilities of the local governments, will also allow Mexico to create a more proactive and involved approach from government towards regional competitiveness and a greater degree of accountability to its citizens.

Spain, with its system of heterogeneous decentralization of the different competences of its autonomous communities, is an interesting example that could be repeated in the Mexican case.

Instrucciones para el Colaborador

1. Exclusividad.

Los artículos enviados a la REVISTA DE ADMINISTRACIÓN PÚBLICA (RAP) deben ser inéditos y no haber sido sometidos simultáneamente para publicación en otro medio.

2. Naturaleza y temática de los trabajos.

Deben ser de carácter eminentemente académico o relacionarse con uno o varios temas considerados de interés para las administraciones públicas de México y otros países.

3. Características de los trabajos.

- Podrán entregarse, para su dictamen y publicación, en idioma español o en idioma inglés.
- Deberán entregarse totalmente concluidos, ya que iniciado el proceso de dictaminación no se admitirán cambios.
- Deberán ser escritos usando letras mayúsculas y minúsculas y sin errores mecanográficos.
- Deberán tener una extensión máxima de 25 cuartillas, sin considerar cuadros, gráficas y lista de referencias bibliográficas utilizadas. En casos excepcionales, y a juicio de la RAP, se aceptarán trabajos con una extensión diferente.
- Deberán entregarse impresas en papel tamaño carta por una sola cara y en formato electrónico en Word para Windows, en letra tipo Arial tamaño 12 a un espaciado o interlineado de 1.5.
- Deberán contar con una estructura mínima de título, introducción, desarrollo y conclusiones, cumpliendo con las siguientes especificaciones mínimas:

- a) El título del trabajo debe tener una clara relación con el contenido, debe ser breve. Se podrán aceptar subtítulos si el tema lo amerita.
- b) Las siglas empleadas deben tener su equivalencia completa al usarse por primera vez en el texto.
- c) Las notas deben aparecer numeradas y agrupadas al final del texto, usando el orden que sigue para las referencias al pie:
- Para libro: nombre, apellido, título, lugar de edición, editorial, año (si no es primera edición, indicar el número de edición).
 - Para capítulo de libro: nombre, apellido, "título del capítulo", título de libro, lugar de edición, editorial, año, pp.
 - Para artículo: nombre, apellido, "título del artículo", nombre de la revista, volumen, número, periodo y año, pp.
- d) La bibliografía final se ordenará alfabéticamente, siguiendo al formato anterior, pero invirtiendo el orden del nombre y apellido del autor (apellido, nombre). Es obligatorio que todas las referencias y citas contengan todos los datos.
- Si la fuente original no menciona alguno(s), los autores del trabajo deberá hacerse explícito usando las expresiones "sin pie de imprenta", "sin fecha", etc.
- e) Los cuadros, gráficas, figuras y diagramas deben contener obligatoriamente la fuente completa correspondiente y ser lo más claros y precisos posible; es decir evitar las abreviaturas, a menos que el espacio no lo permita, e indicar las unidades cuando sea el caso.
- Los cuadros serán numerados con el sistema arábigo (cuadro 1, 2, 3, etc.) y romano para mapas planos, figuras, láminas y fotografías (figura I, II, III, etc.). Debe indicarse el formato electrónico de los archivos gráficos que incluya la colaboración (ppt, jpeg, pdf, bmp, etc.).
- f) Cada gráfica, cuadro, diagrama o figura deberá incluirse en un archivo diferente en formato Excel o Word para Windows, indicándose en el texto el lugar que le corresponde a cada uno.

4. Dictaminación.

Las colaboraciones se sujetarán a un proceso de dictamen con carácter anónimo, llevado a cabo por un comité de árbitros, cuya decisión es inapelable. Se comunicará al autor el fallo en un lapso no mayor a 6 semanas posteriores a la fecha de recepción.

5. Resumen y abstract.

En una hoja por separado se entregará un resumen del artículo, tanto en español como en inglés, con una extensión de 60 a 120 palabras.

6. Corrección y edición.

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7. Difusión.

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- Los autores deberán enviar sus trabajos al correo electrónico rap@inap.org.mx o en disco compacto debidamente identificado con el título del artículo y el nombre del autor o autores.

9. Identificación.

- En la carátula del trabajo se indicarán el título y la fecha de elaboración. Se deberá omitir el nombre del autor para guardar su anonimato durante el proceso de dictaminación.
- En una hoja por separado serán incluidos los siguientes datos:

- a. Título del trabajo, el cual debe ser breve y claro.
- b. Nombre completo del autor o autores; indicando para cada uno el máximo nivel de estudios alcanzado y, de ser el caso, los que haya en curso (incluyendo la disciplina e institución);
- c. Enviar breve currículum académico de cada autor (mencionando líneas actuales de investigación y la bibliografía completa de las últimas 3 ó 4 publicaciones) y profesional (incluyendo la actividad y centro de trabajo donde se encuentra al momento de someter a dictamen el artículo);
- d. Datos de contacto: domicilio, teléfono, fax y correo electrónico, a fin de poder establecer comunicación directa con el autor o autores.

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Las colaboraciones deberán enviarse a:
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Revista de Administración Pública



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The articles sent to the Revista de Administración Pública (RAP) shall be unpublished and not undergone simultaneously to publication in another media.

2. Nature and subject matter of the works.

They shall be of an eminently academic character or relating to one or several topics considered interesting for the public administrations of Mexico and other countries.

3. Characteristics of the works.

- They shall be able to be given, for their auditing and publication, in Spanish or English.
- They shall be given totally concluded since once the auditing process is initiated, changes shall not be admitted.
- They shall be written using capital and lower case letters and typing errors.
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 - For article: name, last name, "title of the article", and name of the review, volume, number, period and year, pp.
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Desafíos y Oportunidades**

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