

## **Guillermo Ortiz: The state of the Mexican economy**

Speech by Dr Guillermo Ortiz, Governor of the Bank of Mexico, at the LXVI Banking Convention, Mérida, Yucatán, 4 April 2003.

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It is an honor to participate, once more, in the National Banking Convention. This meeting takes place in a context of uncertainty about the recovery of the global economy. The recession of the Mexican economy is mainly a consequence of the links we have with the rest of the world. However, the relative performance by the Mexican economy during the recent slowdown is based on two key elements: first, reinforcement of the macroeconomic fundamentals, and second, development of the institutions the country has fostered in recent decades.

I will talk about these two crucial factors during my remarks and the challenges we face in order to foster a stronger and more competitive economy allowing for sustained and broad development for all Mexicans. With this purpose in mind, I will stress the hurdles that the current international environment poses for us and the pending tasks we have to accomplish in order to forge a better future for the years to come.

### **External environment**

The recovery of economic activity in the United States after the 2001 recession has been weak. The slowdown was the consequence of the necessity businesses faced to assimilate investment volumes that had been realized during the nineties, mainly in the areas of technology and telecommunications. The main difference between this recession and others in the past is that this one will end only through the gradual recovery of investment.

The vulnerability of the American economy along with corporate scandals, political tensions derived from the Iraq conflict, and the loss of the economy's dynamism, have weakened consumer confidence. In sum, we can highlight a series of issues that are contributing to making the recovery of the world economy much more uncertain:

- The deepening of the pessimism of economic agents motivated mainly by the Iraq war;
- The possibility of new terrorist attacks;
- Uncertainty about the oil price level and volatility;
- An increase of risk aversion in the international financial markets.

And over the medium term:

- The current account deficit and the low domestic savings rate of the United States together with the absence of structural reforms in Europe and Japan that would allow for a rebound in their economies and an orderly adjustment of the world economy.

### **Resistance to the world recession**

The Mexican economy has not been able to isolate itself from the global recession that has materialized in three ways: a lower growth rate, a drop in employment and a virtual standstill of Mexican exports.

Notwithstanding the above, the Mexican economy's performance in 2001 and 2002 presents some positive aspects. We can highlight the fact that Mexico has experienced a "normal" recession since 2001, if such a word is allowed. Throughout decades, Mexico knew the dark side of recessions, the one that we used to call "crisis." However, the experience that we have had with the recession that started in 2001 and the incipient recovery of 2002 has been quite different:

- The public deficit has been close to its target in the last two years;
- In 2002, the current account deficit was below 3% of GDP and was financed almost entirely by FDI;

- The exchange rate was relatively stable in 2001 and 2002, and actually, current peso depreciation has not affected the price level because exchange-rate pass-through has been virtually nonexistent;
- Inflation has been under control;
- The main peso-denominated nominal interest rates have fallen to single-digit levels, and the government and some private enterprises are issuing bonds in pesos at longer terms (up to ten years);
- Foreign direct investment reached a record high in 2001 and maintained a high level in 2002.

The vulnerability of the Mexican economy to recent external disturbances has been limited because of three factors: a) We have been able to advance in the strengthening of the macroeconomic fundamentals; b) The economic links with the United States have been reinforced, and c) In recent years, Mexico has consolidated its institutions, politically and economically.

### **Institutional improvements**

Two types of factors have contributed to the strengthening of the Mexican economy. It is important to highlight the economic policies that have been implemented, including the floating exchange-rate regime and the inflation-targeting framework that has been adopted for the conduct of monetary policy. In addition, progress achieved through the consolidation of the institutional framework has reinforced the effects of economic policy.

In the wake of the 1995 crisis, the public has developed a growing consciousness about the importance of prudent economic policies, and a consensus has slowly gathered in favor of reaching a lower inflation rate and keeping a lower fiscal deficit. Although a lot of progress has been made on the institutional framework in many areas, I will focus on the elements I believe are the most important:

- Fiscal discipline;
- Inflation abatement;
- Consolidation and capitalization of the financial sector;
- Reinforcement of electoral institutions and increased democratic credibility;
- Independence of the Supreme Court of Justice;
- NAFTA benefits.

With the objective of reinforcing the foundation for economic development, the current administration has continued efforts to maintain the health of the public finances. Fiscal prudence is reflected by the fact that public debt presents a sustainable level and a very comfortable maturity profile. Also, the public sector deficit has not increased when the oil price has fallen and the pace of economic activity has slowed. To this end, it is important to mention that the fact that the Mexican Congress is not dominated by a single political party has not weakened fiscal discipline (although public finances have not been modified structurally, an issue I will discuss later).

In the fight against inflation, we continue to make progress. After three consecutive years in which the inflation target was met, in 2002 the annual rate was 120 basis points above target. However, this deviation was a consequence of the evolution of the agricultural sub index, whose prices are extremely volatile, and of the goods subject to government-administered prices, which are not determined by the market. This year it is to be expected that the inflation rate will converge to our 3 percent target.

We have been able to manage the external shocks we faced in recent years thanks to the floating exchange-rate regime. Likewise, stability has allowed an important increase in our international reserves. No doubt, our reserves have been one of the factors that explain the isolation of the Mexican economy from contamination by the events in Argentina, Brazil and Venezuela. They were also a determining factor during the process by which Mexico was given investment-grade status and hence has obtained better credit conditions in the international capital markets.

Given the current level of international assets that Banco de México has, the marginal advantages of accruing them at such a high pace have diminished. That is why the Exchange Commission recently

agreed on a mechanism that will reduce the rate of accumulation of international reserves. This mechanism is transparent, its operation does not imply a discretionary intervention in the market by the authorities, and it is also neutral with respect to the exchange rate.

In the last few years, the financial system has seen important advances. Now, the banking system presents sound capitalization ratios, satisfactory results and a better regulatory framework. It is important to mention that the legal framework in which the banking system operates has formed the groundwork for its expansion. Stability will be an important issue that will permit the renewal of credit. To this end, it is quite significant that some banks have already started to renew credit. However, the behavior is not yet widespread and amounts of new credit to date are insufficient to contribute properly to economic development.

In the political arena we have witnessed important institutional progress. For example, the creation almost a decade ago of the autonomous Federal Electoral Institute was a great success. Election transparency has contributed in a very important way to the economy through the so-called democratic bonus. No doubt the electoral legitimacy of the public authority is an essential factor for the political stability of the country.

With the consolidation of the democratic system, judicial power is more independent from the other powers. The Supreme Court is well respected, and its responsibility has been gradually transmitted to the federal courts to stimulate their improvement. Also, the local courts have been influenced by the Supreme Court's performance, although to a smaller extent.

As is known, an efficient judicial system constitutes an element of great value for economic development because, at the end of the day, it guarantees property rights and gives certainty to the decisions of economic agents. Recent studies point out that an adequate legal framework and an efficient law enforcement system are key to the development of nations. Therefore, this is a crucial element in the classification of debtors risk and in the determination of credit costs.

The North American Free Trade Agreement (NAFTA) has had not only a remarkable impact on Mexico's external trade, but has also been the engine of the institutional change that Mexico has experienced. In this respect, NAFTA has given certainty to trade relations between Mexico and other countries and has opened widespread investment opportunities. NAFTA has also contributed to Mexico's industrial modernization, to fostering innovation and competition and to creating a more predictable legal environment for all economic agents.

To a great extent, developed countries are developed because of the strength of their institutions. Economic development calls for clear and predictable rules, and institutions that assure they will be enforced.

### **The challenges: pending reforms**

It is not foreseeable that in the immediate future the world economy will present a favorable expansion pattern. The principal hurdles are the enormous current account deficit of the United States and an imminent fiscal deficit, to which we have to add the lack of structural reforms in Japan and Europe. It is evident that a situation in which the U.S. economy is absorbing two thirds of the world's savings is not sustainable. In other words, there should be an adjustment in the world economy in the future that, amongst other things, should imply a dollar depreciation. If such adjustment is not accompanied by a rebound of the European and Japanese economies, it is not foreseeable that it will take place in an accelerated-growth context.

Even under the most optimistic scenario it is not possible to expect, in the medium term, global growth comparable to that of the nineties. Hence, the premises on which the development of the Mexican economy has been based in recent years should be modified. It will be necessary to consolidate internal sources of growth. The key to success rests in the capacity of the Mexican economy to become more productive and more competitive in the international arena. Macroeconomic success by itself will not be sufficient to face actual and future challenges.

The continuation of progress that Mexico has made in the area of competitiveness will depend on the simultaneous success of two factors: reinforcement of the institutional and macroeconomic framework, and implementation of pending structural reforms.

There are concerns about the competitiveness of the Mexican economy against the rest of the world. As you may know, Mexico has fallen in the ranking of some indices that are elaborated by international

organizations in order to evaluate competitiveness. However, Mexico's competitiveness has deteriorated not because the country has not progressed but because other countries have done so at a faster pace. The most recent case is China, whose exports are gaining share of U.S. external trade at a faster pace than exports from Mexico. In order to promote a more favorable scenario, some countries are immersed in legal, economic and institutional reforms. In some instances, these processes have been called "second-generation reforms." But beyond denominations, what is clear is that it is not enough to do things right, nor to do them better than before, but you should do them at least as well as your key competitors. To that extent, it is necessary to find new ways to continuously increase Mexico's productive efficiency.

In Mexico there are some structural reforms that are needed in order to increase competitiveness. Due to the importance they have, I will concentrate on three of them:

- fiscal;
- energy, and
- labor.

The fiscal system in Mexico suffers structural and managerial problems that result in a dearth of resources. Three of them stand out:

- high tax evasion;
- excessive dependence on oil revenue; and
- a narrow tax base.

For a long time, fiscal policy has faced the challenge of abating fiscal deficits by reducing expenditures. The lack of public resources, added to the need for containing the fiscal deficit, has resulted in a public investment level that can be classified as narrow and that in recent times has fluctuated around 2 percent of GDP. This magnitude is lower or much lower than the one you observe in countries with the same development level of Mexico.

The scarcity of resources to finance public investment is hindering the growth capacity of the Mexican economy and preventing the possibility of elevating competitiveness. In other words, the fiscal problem has materialized in sub-par investment levels entailing high social costs. Numerous needed physical and human investments, I repeat, are not materializing because of the lack of resources and because resources are focused on areas that do not result in large benefits.

With higher fiscal revenues, comparable to those obtained by countries of the same economic development, it would be possible to improve the development of our human capital at this historic moment. If we are not able to do so, it is possible that the opportunity to use the demographic bonus, derived from the fact that Mexico will have a large proportion of young people, will vanish.

There are many concrete cases in which budgetary constraint is postponing the realization of investments of great potential benefit. One example is natural gas. Despite the fact that we have huge natural gas fields, in recent years Mexico has been importing natural gas because of the lack of funds to finance the investments that would allow for exploration and transportation. Also, we need a proper legal framework that allows private-sector participation in natural gas development and exploitation.

It is urgent that Mexico modernize the electricity industry in order to reduce the costs associated with the generation of electricity and to improve operational quality, with the aim of increasing Mexico's development capacity and at the same time extending investment in the sector in order to satisfy future electricity demand.

Last but not least, labor reform would allow Mexico to have a much more flexible economy, with higher productivity. We should not forget that our main trading partners, Canada and the United States, have very flexible economies. The Canadian case stands out because the Canadians were capable of making their public finances sound and making the labor framework more flexible. In Canada, market flexibility allowed for a drop in unemployment and more efficient participation of the labor force in the production process. In fact, Canada, an economy closely linked to that of the United States, has avoided recession, maintaining a well-balanced and strong growth pattern.

Although the structural reforms I have mentioned are crucial, there are other important complementary tasks that have to be completed at all government levels and by society itself to make it possible to elevate competitiveness. These do not need congressional approval, and we can mention such tasks

as deregulating, promoting and fomenting business activity and improving security. For example, in accordance with recent studies, it is well known that in Mexico the average time needed to open a new business is 90 days, while in Canada it takes only two.

The implementation of structural reforms requires previous political agreements. That happened in Canada and in other countries that have successfully completed such reforms. So let me conclude by highlighting the importance of building such consensus in Mexico.

Ladies and Gentlemen:

In 2002, Latin America experienced its worst year in terms of economic growth since 1983, and the region has started to show what some are calling the reform fatigue syndrome. The argument that adjustment policies and structural reforms are counterproductive has also been given, wrongly citing the Argentine case. However, this argument can be refuted with evidence from the Chilean case.

However, it seems to me more useful to concentrate on the Mexican case. As I have tried to explain, our economy is stronger and more resistant to external shocks than before. The reason is simple but of great importance: We have implemented deep transformations in many of our institutions, modernizing them and making them more competitive and efficient.

In particular, I would like to highlight in this important forum progress that has been achieved in maintaining a better capitalized, more efficient and viable banking system that operates under a modern regulatory framework. Nonetheless, it is necessary for this progress to translate to in a balanced renewal of credit, to the end that the people worthy of receiving credit have that possibility.

In what concerns the rest of the structural framework of the Mexican economy, the road ahead should be traced with a clear understanding of these achievements. We have to take advantage of the opportunities that the openness of the Mexican economy with the rest of the world offers. We should not be afraid of international competition; instead, we should do our best to make Mexico a more competitive country. The pending issues on the national agenda make up an ambitious program of economic modernization, tough but promising. We must promote that program without delay and with decision, moving away from regressive claims that only delay our strategic insertion in the XXI century.