



Reforms in Mexico

April 13, 2007

Structural changes in many areas require attending to all policy dimensions and therefore creating reform “packages”. In the Mexican case, three recent examples are:

- **Fiscal Strengthening and Reform (ongoing since 2001)**
- **Financial Sector Reform (ongoing since 2001)**
- **Public Sector Worker’s Pension System Reform (2007)**

In 2000, one of the pillars of a stable economic environment, healthy public finances, still had to be consolidated.

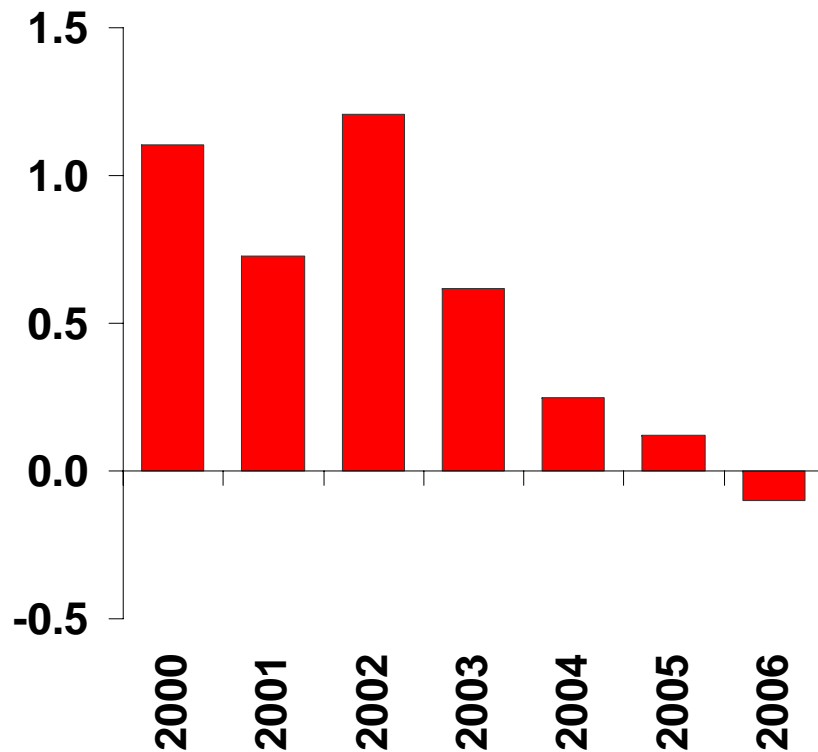
- **The public deficit was above 1.0% of GDP and Public Sector Borrowing Requirements (PSBR) exceeded 3.0% of GDP.**
- **The Historical Balance of the PSBR remained at 40% of GDP, while net public debt represented 22.9% of GDP, and they were on an increasing path.**
- **Domestic government debt had a short maturity and more than half of the public debt was external.**
- **Responsibility in public finances had not been institutionalized depending on the current policymakers and not on a long-term stability objective.**

Important changes to public finances were made mainly in three aspects:

- **Public Finances were managed responsibly.**
- **A proactive debt management helped develop local markets and changed the composition and maturity of public debt.**
- **Clear rules for responsible public finance management were made into law through the new Federal Budget and Fiscal Responsibility Law approved in 2006.**

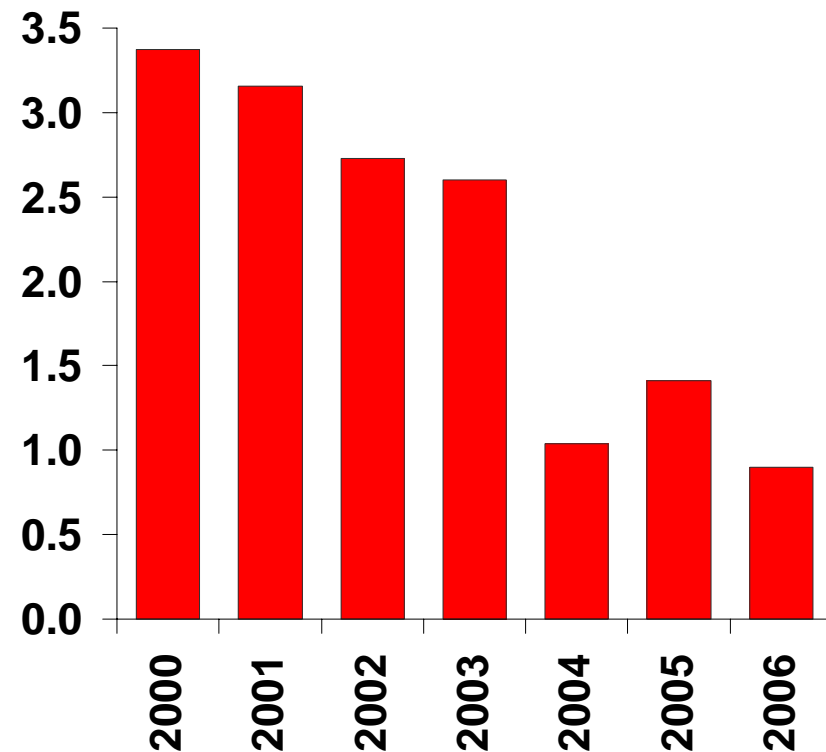
The public deficit was decreased gradually and posted a surplus of 0.23% of GDP in 2006. Accordingly public sector borrowing requirements have decreased considerably.

Traditional Deficit *
(% of GDP)



Source: SHCP

Public Sector Borrowing Requirements
(% of GDP)



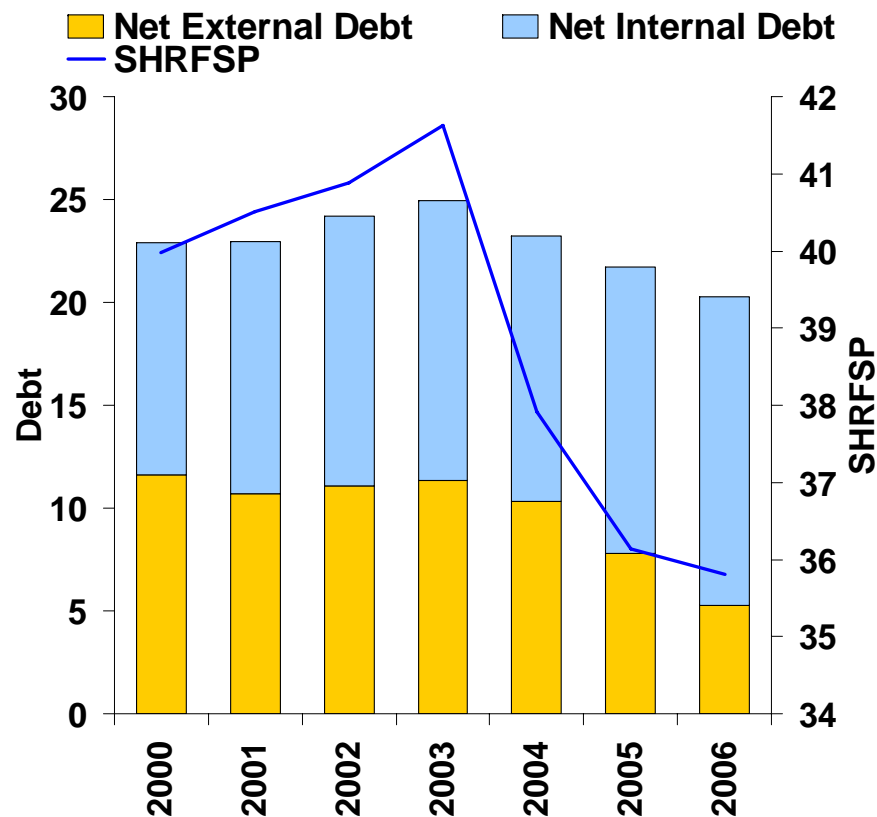
Source: SHCP

In recent years, Mexican public debt management has focused on developing the local market and reducing external exposure.

- **The annual debt management strategy has followed three main guidelines:**
 - **Finance the public deficit in the domestic market.**
 - **Focus domestic financing on long-term fixed-rate securities. By October 2006 Mexico successfully auctioned a 30 year Peso denominated nominal fixed rate bond, being one of three middle-income countries that have established a 30 year fixed rate reference.**
 - **Improve external financing conditions through a series of coordinated operations.**
- **In addition, the development of local markets has strengthened the financial system.**

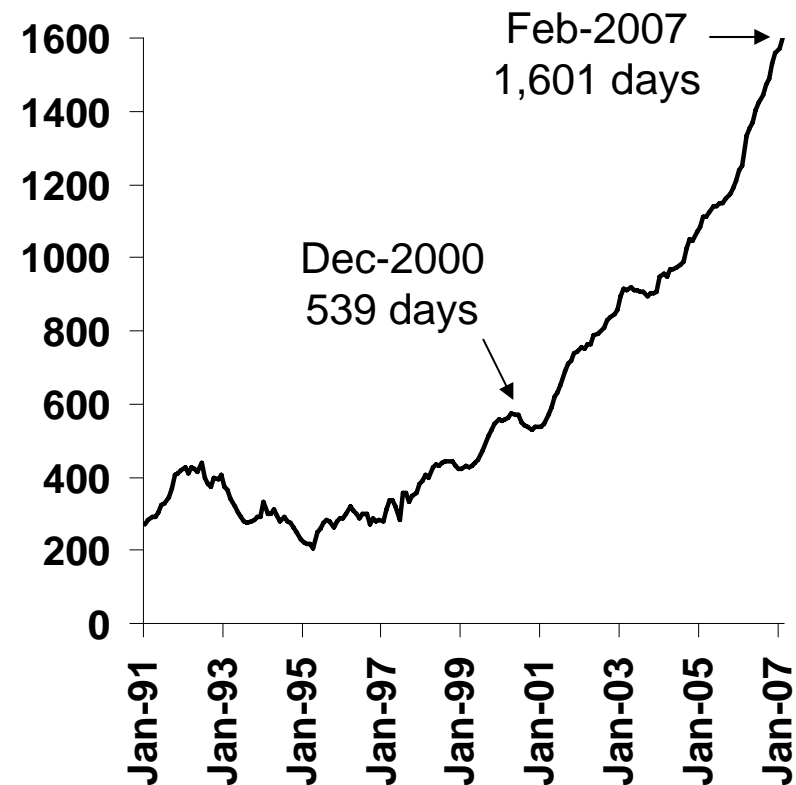
As a result of the government's efforts and the changes in public finance management, public sector liabilities have declined, their composition has improved and the average maturity of domestic debt has increased.

**Net Public Debt and Historical Balance of the PSBR
(% of GDP)**



Source : SHCP.

**Average Maturity of Domestic Debt
(days)**



Source : SHCP.

The new Federal Budget and Fiscal Responsibility Law was necessary to institutionalize prudent fiscal policies and to substitute the obsolete 31 year old “Budget, Accounting and Federal Public Expenditure Law”:

- **The approval of the budget had become increasingly complicated, generating economic, judicial and political uncertainty.**
- **A series of elements, such as the price of oil for budget purposes, were negotiated annually with a short-term perspective.**
- **The previous law did not include basic principles of fiscal responsibility and transparency.**

The new Federal Budget and Fiscal Responsibility Law was approved on March 2006 by a wide majority of both the Chamber of Deputies and the Senate (more than the 2/3 majority required for reforming the Constitution).

The new Federal Budget and Fiscal Responsibility Law fosters:

- ✓ **Responsibility in Public Finances**
- ✓ **Transparency and accountability**
- ✓ **Order and certainty in the annual approval of the economic package**
- ✓ **More modern budgetary procedures**

Nevertheless, further fiscal reform is needed. The fiscal reform we would like to implement is based on four pillars:

- **Expenditure:** Greater efficiency, transparency and accountability in the use of resources.
- **Revenues:** A diversification of the revenue structure that helps reduce the vulnerability to oil price volatility and to possible future reductions in the oil production platform.
- **Fiscal Federalism:** The relation between the Federal Government and Federal entities should be set on a more solid base.
- **Fiscal Administration:** Attending the claim that not everybody pays taxes, promoting a fair tax burden and reducing fiscal evasion.

In 2000, five years after the 1994-1995 crisis, the financial sector continued facing a series of problems that severely hampered its growth potential:

- **By 2000 financial savings had only grown 2 percentage points (pp) of GDP since their lowest post crisis level and were still 1pp lower than in 1994.**
- **After reaching 27% of GDP in 1995, credit to the private sector represented only 9.5% of GDP in 2000.**
- **Overdue loans represented 5.8% of total credit.**
- **Profits in the banking sector were low in relation to both capital and assets.**

In order to stimulate higher growth in the Mexican economy and a recovery in the financial system, a series of reforms were necessary. These reforms focused on:

- **Fostering credit to all sectors of the economy.**
- **Increasing the rate of savings, particularly of long-term nature.**
- **Improving the regulation and supervision of the financial sector.**

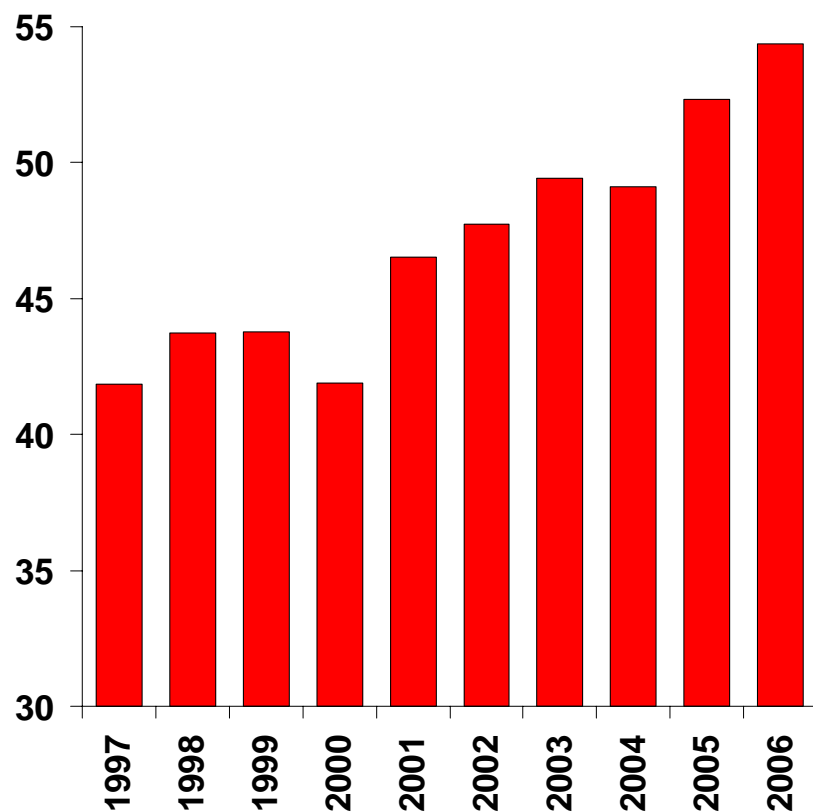
These objectives required substantial modifications to the legal, operational and regulatory framework of the system.

More than 40 laws and regulations were reformed. In addition, new development banks were created.

- **Legal and Regulatory Changes:** Private sector pension reform; greater competition in financial services; rules for the use of collateral; strengthen the framework of deposit insurance; improve the operation of the payments system and of credit bureaus; protect minority shareholders and foster access to the stock market.
- **Development Banks:** Providing savings and credit services to the population with the least access to the financial system; developing the primary and secondary mortgage markets; destining resources and technical assistance to the rural sector.

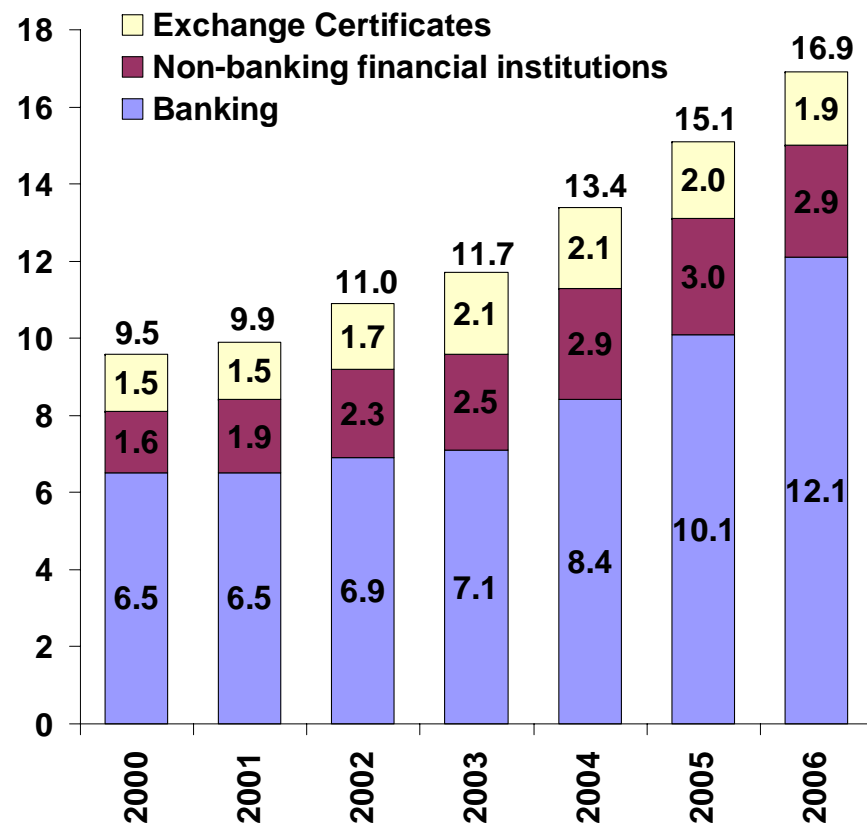
The reforms to the financial sector, together with macroeconomic stability, promoted higher financial savings and credit to the private sector. The first grew from 41.9% of GDP in 2000 to 54.4% in 2006; the second grew from 9.5% of GDP to 16.9% in the same period.

Financial Savings
(% of GDP)



Source: Banxico

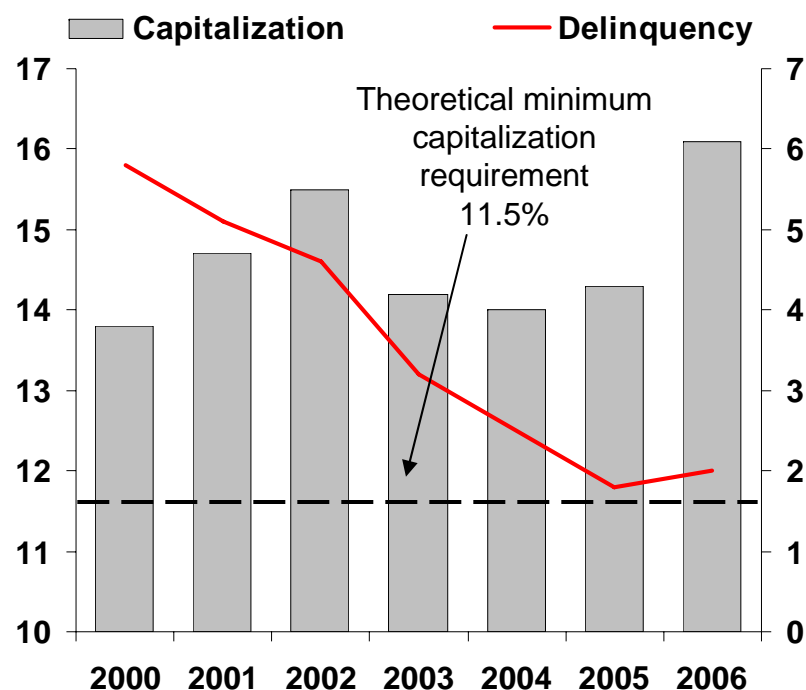
Credit to the Private Sector
(% of GDP)



Source: Banxico and CNBV.

Currently, the banking system is adequately capitalized, the delinquency index has decreased and profits have increased.

Capitalization Index^{1/} and Delinquency Index^{2/}



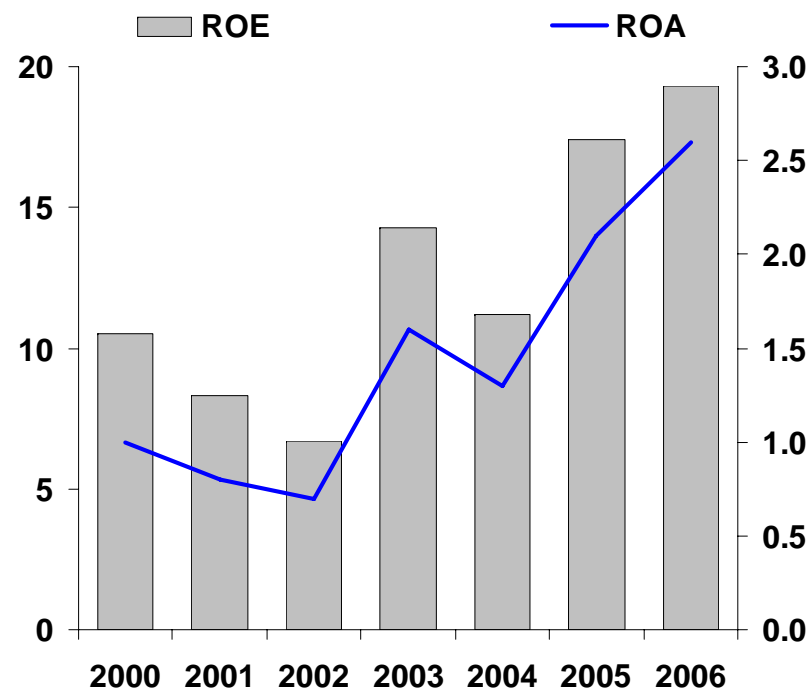
1/ Net capital/ Total risky assets.

2/ Overdue loans/ Total credit.

* 2006 data corresponds to November.

Source: CNBV.

Banking Sector Returns: ROE^{1/} y ROA^{2/}



1/ Annual net profits/ Average capital.

2/ Annual net profits/ Average total assets.

* 2006 data corresponds to November.

Source: CNBV.

In relation to capital markets, despite many adjustments to the 1974 Securities legislation, the Mexican Stock exchange and capital investments in general did not develop to their potential:

- Market capitalization was low in relation to the size of the economy,
- The market was highly concentrated and slightly more than 150 firms were listed, compared to 1,500 in Korea, a country whose economy was of similar size to Mexico,
- In spite of being the second largest economy in Latin America (roughly 30% of GDP), Mexico received only 10% of private equity flows to the region, contrasting with around 30% of foreign direct investment.

A new Securities Law approved in December 2005 attempts to increase the depth of the stock market by solving severe lags in regulation. In particular:

- It promotes the introduction of new companies into the stock market by making medium size firms more attractive for venture capital and private equity investments and easing the process of going public.
- It improves transparency, minority rights, and radically modernizes the corporate structure of listed companies in line with international practices.
- Other innovations include: modernization of the stock brokerage houses regime, clarification of the notification process and the redefinition of legal violations and penalties.

Partly as a result of the new Law, Mexico's rank in the Doing Business Investor Protection Index jumped from 121 to 33 in one year although 29 new countries were incorporated in the list.

A reform to Mexico's public sector pension system was necessary to further strengthen public finances. The pension system as a whole had the following structure:

✓ **IMSS-AFORE System (Since 1997)**

- Defined contribution system that covers formal workers of the private sector. Pensions are totally funded through individual accounts.

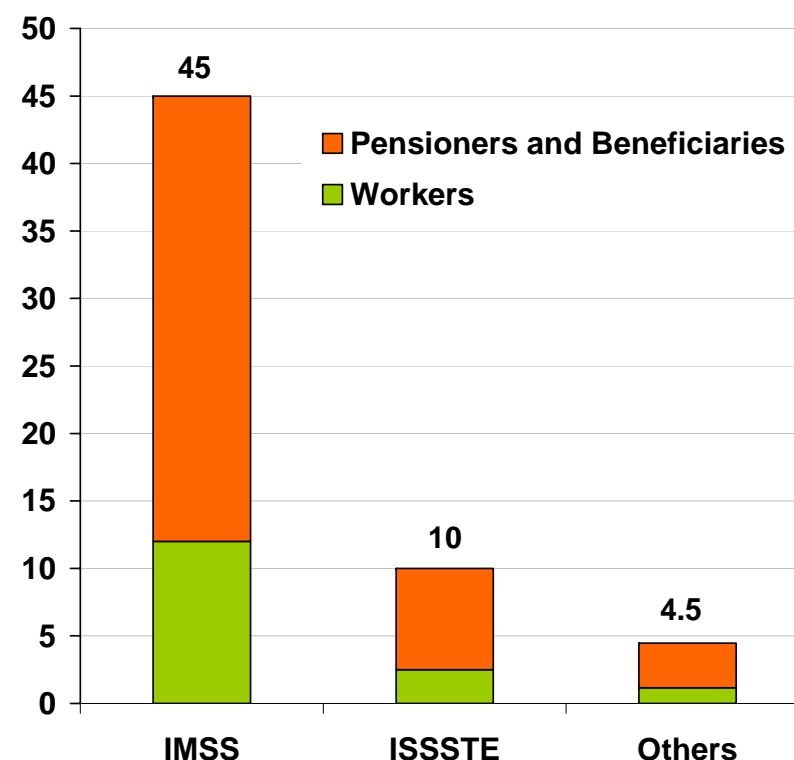
✓ **ISSSTE System (Before 2007 reform)**

- Defined benefit system that covers workers of the public sector.
- Insufficiently funded.

✓ **Other public systems**

- IMSS-RJP
- State and municipal systems
- Public firms and universities
- Development banks

*Population Covered
(Millions)*



The former ISSSTE system and other public systems had severe financial problems and benefits were lost if workers moved from the public to the private sector:

✓ **Financial Viability**

- Higher life expectancy, a lower retirement age and a smaller number of active contributors had implied that contributions were insufficient for paying the pensions of retired workers.
- The estimated net present value of ISSSTE's deficit was 57% of GDP.

	1975	2005
Life expectancy (years)	64.4	75.7
Retirement age (years)	61.9	55.0
Years as a pensioner	2.5	20.7
Contributors per pensioner	20	4

✓ **Mobility**

- There was no transferability between public systems nor with private sector pensions.
- Workers with mobility subsidize the pensions of other workers.

The 2007 ISSSTE Reform considered the following:

- ✓ **Maintaining the defined benefit scheme was not an option.**
 - **Portability cannot be assured without individual accounts.**
 - **Modifying the system's parameters would not solve the financial problem in the long run.**
- ✓ **The reform introduced an individual account scheme with the following characteristics:**
 - 1. Pensions determined by individual accounts**
 - 2. Portability of individual accounts**
 - 3. Defined contribution (gradually raised from 7% to 12.7%)**
 - 4. Minimum pension guarantee**
 - 5. Incentives to voluntary savings**
- ✓ **ISSSTE reform could generate net savings for the public sector of close to 40% of the estimated contingent liabilities of the former system.**

These examples of reform in Mexico allow us to draw the following lessons:

- Whether reforms can be completed in a gradual way or require a big-bang approach depends on the type of the reform.
- Fiscal and financial reforms were done gradually. Even if the reforms were not as complete as is desirable, there can be significant piece-meal progress.
- Pension reform was completed using a big-bang approach. Middle-of-the-road changes could end up making matters worse.
- Reforms were treated individually to increase their chances of approval. Each one required creating a consensus amongst the society and with lawmakers.