Mexico in a Globalized World

The University of Chicago
May 2007
Globalization has changed the international landscape. Since 1995 world trade has increased 45% and capital flows have tripled as a percentage of GDP.

**World Trade**
(Exports + Imports as % of GDP)

**World Capital Flows**
(Gross Flows as % of GDP)

Source: World Bank and IMF

Source: IMF
Mexico started opening earlier, entering the GATT in November 1986 and beginning a process of rapid trade liberalization. Being a labor intensive economy, this translated into rapid growth in manufacturing exports.

Non Oil Exports
(Billion 2006 dollars)

Non Oil Exports, 1987-2006
(real average annual change, %)

Source: INEGI
In recent years, Mexico has faced increasing competition from the incorporation of China to the world economy. Mexico’s share in US imports has decreased, though by a smaller amount than that observed in imports from other countries.

Share in US Non-Energy Imports (%)

- China
- Mexico
- Canada
- Japan

China enters the WTO in December 2001

* Data for January through March.
Source: US Department of Commerce
In contrast, the demand for commodities has increased due to Asian demand, benefiting countries who are large commodity exporters.

**Commodity Prices**
(Index, 1980=100)

**Share of Commodities and Manufacturing in Total Exports, 1994-2005**
(Average share, %)

<table>
<thead>
<tr>
<th>Country</th>
<th>Commodities</th>
<th>Manufacturing</th>
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<tbody>
<tr>
<td>Chile</td>
<td>84.5</td>
<td>15.5</td>
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<td>Australia</td>
<td>65.1</td>
<td>34.9</td>
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<tr>
<td>Argentina</td>
<td>62.8</td>
<td>37.2</td>
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<tr>
<td>Brazil</td>
<td>44.0</td>
<td>56.0</td>
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<tr>
<td>Russia</td>
<td>43.5</td>
<td>56.5</td>
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<td>Venezuela</td>
<td>34.5</td>
<td>65.5</td>
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<td>South Africa</td>
<td>24.8</td>
<td>75.2</td>
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<tr>
<td>Mexico</td>
<td>3.9</td>
<td>96.1</td>
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<tr>
<td>China</td>
<td>9.0</td>
<td>91.0</td>
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</table>

1/ The sample period for this country is 1995-2005
2/ The sample period for this country is 1997-2005
3/ Mexican data corresponds to 2006

Source: IMF

Source: WTO
Given the large surge in the global labor force, Mexico needs to adopt a strategy based on increasing its investment rates and competitiveness.

![Investment (% of GDP)](chart.png)

<table>
<thead>
<tr>
<th>Competitiveness Index</th>
<th>2006</th>
<th>2007</th>
<th>Change</th>
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<tbody>
<tr>
<td>United States</td>
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<tr>
<td>Singapore</td>
<td>3</td>
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<td>Switzerland</td>
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<td>14</td>
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<td>+</td>
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<td>Canada</td>
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<tr>
<td>China</td>
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<td>15</td>
<td>+</td>
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<tr>
<td>New Zealand</td>
<td>21</td>
<td>19</td>
<td>+</td>
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<tr>
<td>Chile</td>
<td>26</td>
<td>23</td>
<td>+</td>
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<tr>
<td>India</td>
<td>27</td>
<td>27</td>
<td>=</td>
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<tr>
<td>South Korea</td>
<td>32</td>
<td>29</td>
<td>+</td>
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<tr>
<td>Mexico</td>
<td>45</td>
<td>47</td>
<td>-</td>
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</tbody>
</table>

Source: International Institute for Management Development

Source: World Economic Outlook, IMF and INEGI
Important global imbalances have developed in the last six years. The US current account deficit continues to widen while developing Asia, and oil producing countries have increasing surpluses. These global imbalances will have to be corrected at some point.

Current Account Balance (% of GDP)

Source: IMF
Because of the close relationship between the Mexican and US economies, Mexico faces the challenge of adjusting in an orderly way to the correction in the United States.

**Mexican Exports by Country in 2006 (% of total exports)**

- US: 84%
- Canada: 2%
- Europe: 5%
- Latin America: 6%
- Others: 3%

**Industrial Production: Mexico and the US**

*Index, 2000=100*

Source: Banco de Mexico

Source: IMF
It is worth mentioning that although goods and capital markets have been liberalized worldwide, labor markets remain mostly closed. This has not prevented high migration flows, which the United Nations expects will continue.

**International Migration**

(Thousand people)

![Graph showing international migration from 1950-2050 with two categories: Europe and Northern America.](image)

Migration has benefited both host and origin countries. In the Mexican case, this has been reflected in a sharp increase in remittances. Given the mutual benefits it is in everyone’s interest to guarantee a smoother migration process.

**International Remittances**
(billion 2007 USD)

Source: Banco de México.
Regarding domestic policies, in recent years, public finances have been consolidated, public debt has decreased as a percent of GDP and the average maturity of the internal public debt has increased.
Prudent fiscal and monetary policies together with the independence of the Central Bank have been reflected in inflation levels similar to developed economies and to historical minimums on interest rates.

The more solid policy environment has allowed the Mexican economy to avoid the BOP crises it had suffered in the past. More recently it has experienced normal business cycles.
Mexico’s regained stability has led to an increase in financial savings and a recovery in credit to the private sector.

**Financial Savings (% of GDP)**

- Non-Resident Domestic Financial Assets
- Non-Banking Sector Public and Private Securities
- SIEFORES and other Retirement funds
- Banking Sector (Includes Development Banks)

**Credit to the Private Sector (% of GDP)**

- Exchange Certificates
- Non-banking financial institutions
- Banking

Source: Banco de México.

Source: Banco de México and CNBV.
The banking system is adequately capitalized, the delinquency index has decreased and profits have increased.

Capitalization Index\(^1/\) and Delinquency Index\(^2/\)

Banking Sector Returns:
ROE\(^1/\) y ROA\(^2/\)

1/ Net capital/ Total risky assets.
2/ Overdue loans/ Total credit.
* 2006 data corresponds to November.
Source: CNBV.

1/ Annual net profits/ Average capital.
2/ Annual net profits/ Average total assets.
* 2006 data corresponds to November.
Source: CNBV.
In addition, several internal medium-term trends will condition Mexico’s future development:

- The demographic transition.
- The migration pattern from rural to urban areas.
- The inclusion of women in the labor force.

These changes provide both challenges and opportunities.
Population dynamics point towards an increase in the average age of the population and in the proportion of the working age population.

Source: CONAPO.
This implies that the expected labor force will increase by 6.4 million people from 2006 to 2012.

Expected Labor Force (Million people)

- The labor force will increase 9.4% in six years.

Source: CONAPO.
In addition to the demographic transition, Mexicans will continue migrating to urban areas for an increase of 5.5 million people in the urban population from 2006 to 2012. Together these factors will boost the demand for housing and public services.

**Percentage of Population Living in Urban Areas (%)**

- 2006: 75.8%
- 2012: 76.7%
- 2030: 78.9%

Source: CONAPO

**Total and Urban Population Growth Rate (%)**

- Total: 1.20 (2006), 1.03 (2012), 0.85 (2016), 0.54 (2028), 0.40 (2030)
- Urban: 1.20 (2006), 1.03 (2012), 0.85 (2016), 0.54 (2028), 0.40 (2030)

Source: CONAPO.
Women’s participation in the formal economy has increased considerably but is still much lower than men’s, and the income gap has remained relatively constant.

Source: INEGI.
Female school enrollment has increased considerably and drop out rates have diminished. This should contribute to greater participation and to a reduction in the wage gap.

**Middle School Enrollment**
(% of female population between 13 and 15 years of age)

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<thead>
<tr>
<th>Year</th>
<th>Male</th>
<th>Female</th>
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<tr>
<td>1970</td>
<td>57.7</td>
<td>47.5</td>
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<td>2005</td>
<td>82.4</td>
<td>82.5</td>
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**Female Drop Out Rate**
(% of total female student population)

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<th>Level</th>
<th>1996</th>
<th>2004</th>
<th>2017</th>
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<tr>
<td>Primary School</td>
<td>2.7</td>
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<td>Middle School</td>
<td>7.7</td>
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<td>High School</td>
<td>15.8</td>
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Source: SEP.
If women’s participation in Mexico by 2012 were to reach the rates currently seen in Spain and Argentina, the labor force should incorporate 6 million women.

Expected Women in the Labor Force in 2012

Million women in the labor force in 2012

* Refers to women’s participation in the labor force in Spain in 2007 and in Argentina in 2006.

Source: CONAPO Mexico, INE Spain and MECON Argentina.
Although poverty has decreased in recent years, marginalization and regional inequality are still very substantial.

Source: SEDESOL

The above trends imply that Mexico has to:

- Regain competitiveness to compete in international markets.
- Take advantage of the higher savings and workforce associated to the demographic transition.
- Create conditions for a large increase in the demand for formal sector jobs.
- Facilitate an orderly increase in the proportion of urban dwellers as well as in women’s participation in the workforce.
In order to face these challenges, take advantage of the opportunities and attain higher growth and development, the State will use all the instruments under its control:

- A rational spending policy in health and education and in the fight against poverty.

- Fostering those sectors with highest job creation (housing, tourism and the agricultural sector, amongst others).

- Focusing on infrastructure projects that reduce regional inequality.

- Supporting productive activities through the financial intermediation of development banks.

- Fostering greater competition in the economy.

- Applying better regulation or deregulation, according to the specific case, of both public and private activities.
Important efforts are required to foster investment in infrastructure.

- Several studies find that investing in infrastructure, as well as maintaining and improving its quality, contributes to increasing the productivity of various sectors of the economy.

- Additionally, important synergies exist when infrastructure investment projects in different sectors are combined.

- Therefore, there is evidence that some countries owe part of their success to strong investment in infrastructure, which generates virtuous cycles of public investment-private investment-growth.

- However, infrastructure investment projects only become profitable in long time spans. Therefore, public investment is vital for the success of these projects.

- In the Mexican case, in spite of the Federal Government’s efforts, the countries' infrastructure lags behind.
In terms of paved roads, Mexico’s network lies between those of low and middle income countries. In general, infrastructure quality is low. Therefore Mexico needs an ambitious investment agenda in infrastructure.

Paved Roads
(% of total network)

Infrastructure Quality
(Index, 1=low and 7=high)


Public finances face important challenges: a low level of revenues to GDP and a high dependence on volatile oil revenues.

**Total Revenues (% of GDP)**

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</table>

*Source: Government Financial Statistics, FMI, (2004); Revenue Statistics OECD 2006 and SHCP.*

**Mexican Federal Government Revenue Structure (% of total revenues)**

- Oil Tax
- Non-oil Tax
- Non-tax Oil
- Non-oil Non-tax

*Source: SHCP.*
The recent reform to the public worker’s pension system was a first step to continue strengthening public finances in addition to guaranteeing the system’s financial viability. Additionally, benefits were lost if workers moved from the public to the private sector:

✓ Financial Insolvency
  • The increase in life expectancy, a lower average age of retirement and less active workers per pensioner resulted in the system’s insolvency.
  • The net present value of the ISSSTE’s deficit exceeded 50% of GDP.

✓ Lack of mobility
  • Accounts could not be transferred between public and private pension systems.
  • Workers that moved from the public to the private sector or vice versa subsidized the systems.

<table>
<thead>
<tr>
<th></th>
<th>1975</th>
<th>2005</th>
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<tbody>
<tr>
<td>Life expectancy at birth (years)</td>
<td>64.4</td>
<td>75.7</td>
</tr>
<tr>
<td>Average retirement age (years)</td>
<td>61.9</td>
<td>55.0</td>
</tr>
<tr>
<td>Average years receiving pension</td>
<td>2.5</td>
<td>20.7</td>
</tr>
<tr>
<td>Workers per pensioner</td>
<td>20</td>
<td>4</td>
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</tbody>
</table>
The 2007 reform to the ISSSTE public worker’s pension system considered:

- Maintaining the current defined benefit scheme was not an option.
  - Mobility can not be guaranteed without individual accounts.
  - Changing the system’s parameters did not solve long-term financial problems.

- The reform introduced an individual account scheme with the following characteristics:
  1. Pensions determined by individual accounts
  2. The mobility of individual accounts
  3. Defined contributions
  4. Minimum guaranteed pension
  5. Incentives for voluntary savings
Additionally, fiscal reform is still necessary to face the expenditure needs in terms of social and economic spending and to decrease the reliance on oil revenues. The reform that we would like to implement is based on the following pillars:

- **Expenditure:** More efficiency, transparency and accountability in the use of public resources.

- **Revenues:** A diversification of revenues that contributes to reduce the vulnerability to volatile oil prices and possible decreases in the oil production platform.

- **Fiscal Federalism:** The relation between the Federation and the 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.
An agenda on regulatory reform and greater competition needs to be based on:

- Open markets so that:
  - Existing investment opportunities are taken advantage of,
  - Greater economic competition is generated,
  - Prices of products decrease, and
  - There are higher incentives for improvements in productivity and more technological innovation.

- Reduce transaction costs in all fields including: opening a business, enforcing contracts and improving the rule of law. This is particularly important for the creation and operation of small and medium businesses.