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**Statement by Mr. Schwartz on Mexico  
Executive Board Meeting  
October 18, 2004**

During the last few years the Mexican economy has been characterized by macroeconomic stability, efficient debt management, financial sector soundness and compliance with international standards and codes in a number of areas. The recovery of the economy is well underway. GDP is expected to post a growth of 4.0 percent in 2004 and 3.8 percent in 2005. The upturn of the economy is linked to the strength of the global economy, particularly to that of the US. Recent manufacturing and maquila exports reflect the strengthening of world recovery and imports of intermediate goods anticipate growth of industrial activity. Consumption and investment have also shown increased dynamism. The recovery has been widespread among the different sectors and has resulted in improved employment indicators. The current account deficit, which accounted for more than 7 percent of GDP in the run-up to the 1994-95 crisis, is down to a sustainable 1.5 -2.0 percent of GDP. International reserves have increased ten-fold over the past ten years to close to US\$60 billion and a decade of a successful floating-exchange-rate regime has almost been completed. The current floating scheme and prudent macroeconomic policies have placed the country in a much better position to deal with capital market disturbances and prevented the build up of external disequilibria.

***Inflation and Monetary Policy***

During the last eight years inflation has declined significantly, reaching levels that had not been experienced for over three decades. Single digit inflation has become the norm and inflation reached a figure under 4 percent at the end of 2003. Notwithstanding, recent inflation has been boosted by supply shocks, including a temporary suspension of some meat imports from the US, climate effects on agricultural prices and the impact of higher international prices for oil and other commodities. In particular, it should be noted that the increases in administered prices have resulted from the non-discretionary use of formulas that link domestic prices to international references. Moreover, one should bear in mind that the cyclical recovery currently experienced by the economy feeds up the pass-through of supply shocks to consumer prices and thus has an effect on inflationary expectations.

Within the framework of an inflation-targeting scheme, the Bank of Mexico carries out a cautious analysis of the origins of inflationary pressures and their impact on inflation expectations. Monetary authorities have focused policy implementation on limiting the effects on inflation expectations that result from higher commodities' prices, remaining vigilant to address cyclical pressures on inflation that could emerge from the strength of

aggregate demand and promoting an orderly transition to an environment of higher interest rates. Reiterating its commitment to achieve the inflation target, the central bank has tightened monetary policy on six occasions this year.

Staff suggests that monetary policy implementation should consider the publication of an official inflation forecast in order to solve “*problems in communicating policies*” when inflation is above target. However, the fact that headline inflation has surpassed the target does not entail “communications problems”. Inflation has recently peaked up as a result of imported inflation, specifically, increases in commodity prices related to an upturn in world economic activity as well as a result of geopolitical uncertainty. Inflation expectations produced by market participants for the medium and long term place inflation within the variability interval announced by the central bank, and communication problems are not present. The Bank of Mexico has repeatedly tightened policy in order to bring inflation back to its variability range.

Moreover, the fact that the central bank has not incorporated inflation forecasts in its inflation-targeting scheme does not mean that its design has not been improved. During recent years, the Mexican inflation-targeting framework has incorporated additional elements that facilitate communication. For example, monetary policy announcements now take place according to a predetermined calendar, policy statements place more emphasis on underlying inflation and on explaining the nature of price shocks, and monetary policy implementation is fully understandable by market participants. Furthermore, a thorough analysis of a wide range of indicators, data and models has given the central bank a good grasp of the transmission process of monetary policy. The publication of an official inflation forecast as well as other refinements to Mexico’s inflation-targeting scheme are constantly evaluated by the central bank board.

However, it is believed that at a stage when the inflation forecast might be different from the target, an official forecast would not add much to the analysis, could even create confusion and needlessly affect the credibility of the central bank. Let us assume, for example, that an official inflation forecast is above the inflation target or variability interval announced by the central bank. Once the forecast is released, and assuming that the central bank enjoys some credibility, market participants would expect the monetary authority to implement policy in such a way as to achieve its original target. If the central bank is able to attain the original inflation target, the forecast loses relevance and next time a forecast is announced, market participants will not find it useful. However, if the original target is not met, the central bank would be regarded as a “good predictor” but as incompetent in reaching its target. In this case, the official forecast would simply serve to “validate” higher inflation expectation and thus affect inflation dynamics. In this case, the inflation forecast would unnecessarily delay the disinflationary process and make the fight against inflation more difficult.

Staff should note that for those successful inflation-target countries that do provide an inflation forecast, their forecast is almost always within their confidence or variability interval around the point target. In this case, the inflation forecast helps guiding expectations within the interval and, as such, it does not contradict the target. But in a situation where current inflation is running above the target, we do not see how an official forecast could

help. On the contrary, as it has been the case, if the central bank clearly specifies that its original target is maintained, even though current inflation exceeds such a target, and monetary policy is clearly identified as committed to bring inflation down from the current level to its medium term objective, then the central bank is in a stronger position to affect inflation expectations and thus speeds up the disinflationary process. This is the alternative that the Bank of Mexico has opted for and it has given good results. Furthermore, inflation forecasts produced by market participants are constantly updated and contrasted with the central bank's target, so no communication problems or lack of transparency have been present.

### ***Fiscal Policy and Debt Management***

On the fiscal front, a deficit of 0.3 percent of GDP is expected for 2004, with the aim to reduce it to 0.1 percent in 2005. Public Sector Borrowing Requirements are expected to amount to 2.6 percent of GDP at the end of this year and 2.1 percent in 2005. Public finances have benefited from the oil windfall and the recovery, hence the authorities expect to accomplish the fiscal targets without problems. Fiscal spending has become more efficient and more transparent and the debt structure has also been strengthened.

We agree with staff that the process of fiscal consolidation that has taken place in Mexico should have relied less on oil related revenues. Nevertheless, the following must be emphasized. During the current Administration fiscal targets have been met (both the traditional definition of deficit and Public Sector Borrowing Requirements) every year even during the low growth episode that the Mexican and the world economy went through. In this context, several countries used fiscal policy to foster the recovery, a temptation that was avoided in Mexico. In addition, the political economy process has prioritized fiscal consolidation over undertaking counter-cyclical policies. My authorities believe that, given the current conditions facing the Mexican economy, this is the correct approach. Furthermore, in the last two years and for 2005 the Income Law incorporated conservative assumptions for the oil price, therefore permanent expenditure pressures are not being generated by the high prices observed in the oil market. This strategy has led to excess revenues that have been allocated to savings and investment. Certainly, it would be desirable to increase savings as staff recommends, but it would be imprecise to consider that the extraordinary revenue has been used to boost public-sector consumption. In sum, the consistent achievement of the fiscal goals in recent years should not be belittled as a minor achievement.

Notwithstanding that in recent years the achievement of fiscal goals has been favored by high oil revenues, it must be highlighted that the composition of public spending has improved, favoring productive investment. Therefore, once the fiscal accounts are adjusted to consider productive investment in order to assess the sustainability of the fiscal position, we find that public finances are better and that fiscal consolidation efforts have been greater than what an ordinary analysis reveals.

Throughout the report one finds several instances where staff suggests that *“the spending of windfall oil revenues has made the fiscal position more vulnerable to a decline in oil prices”*,

and “*on the need to save a significant portion of future windfalls to avoid increasing dependence of the budget on oil revenues*”. We find these comments misleading since they do not clearly depict what has taken place in Mexico and consider that this kind of comments seem to confuse the economic concept of savings with that of financial savings.

We all agree that long-run fiscal sustainability would generally imply saving a portion of the current non-renewable resource revenue. Such an approach would both stabilize usable revenue and provide for the accumulation of financial resources that compensate for the depletion of the natural resource, thus allowing to implement fiscal policies that are set within a longer-term framework. That is, financial savings are designed to smooth expenditure.

As opposed to the above definition of financial savings, the economic concept of saving refers to the excess of current revenue over current expenditure with the objective of preserving net government wealth. Savings in this case can be allocated both to public investment or held as financial assets. Moreover, economic theory does not favor any of the two possible destinies. However, it is common sense that if a government allocates all of its economic savings to public investment during “good” times and fails to build up financial assets, it might find it difficult to finance expenditures during “rainy days”.

As a result of the above considerations, Mexican authorities have tried to strike the right balance between the allocation of excess revenues and it must be stressed that its largest share has been devoted to investment and savings rather than current expenditures (a fact that staff fails to recognize). According to the current Budget Decree, after deducting the expected increase on non-programmable expenditures and the decrease in other revenue sources, excess revenues are allocated according to a formula that distributes 74.2 percent to savings vehicles (PEMEX trust fund, Oil Stabilization Fund and improvement of the public balance) and 25.8 percent to infrastructure investment in the states. The fact that it is expected that PEMEX will eventually allocate its share to investment in the development of the Mexican oil sector (exploration, production, etc.) should not be seen as “current expenditures” but as a measure that preserves wealth and allows the oil company to become more efficient. We have to keep in mind that the rate of return from investing in the development of the Mexican oil sector is substantially larger than the yield that can be obtained from financial assets as T-bills, thus Mexico finds it more profitable to invest in the oil sector than in financial assets.

Therefore, the assumption that in 2004 savings have been small is incorrect. Moreover, it should also be recognized that no permanent expenditure pressures are being generated as a result of the spending expansion associated with excess revenues. These revenues are allocated mostly to investment and savings and are non-recurrent in nature and consequently can not become a pressure for public finances.

As a result of the external public debt management strategy, the government faces a comfortable debt-service payments schedule as debt has been rolled over on more favorable terms. An example is the recent placement of US\$1.5 billion at a fixed rate with a 30 year maturity. This issuance allows the Mexican government to pre-finance most of its 2005

obligations and is in accordance with the external net debt-reduction target of US\$500 million approved by Congress for this year.

Risks associated with a reduction of flows to emerging markets have considerably been reduced by changing the composition of public debt and relying more heavily on domestic financing. Moreover, the reduction in the cost of financing in the domestic market has contributed to an improvement of the private sector's balance-sheet position and in the development of domestic markets. The maturity of the yield curve has been extended up to 20 years. Institutional investors are now interested in domestic issuances with long-term fixed rates due to further progress in the development of the financial system and reforms to the pension system. In order to further reduce interest rate risk, the government will continue to substitute debt with floating rates for new instruments with fixed rates. Currently, almost 50 percent of domestic debt instruments with a maturity of one year or more are linked to fixed rates, compared to nearly 15 percent at the end of 2000. It is expected that domestic debt will represent 65 percent of public debt in 2005, compared to 53 percent in 2000.

In the staff's treatment of the evolution of the debt to GDP ratio one should realize that, in recent years, the path of this ratio has been more influenced by the behavior of the exchange rate of the Mexican peso with respect to the dollar as well as by the exchange rate of the dollar with respect to other currencies in which public debt is subscribed. This is an important clarification since usually an increase of the debt to GDP ratio can erroneously be interpreted as lack of fiscal discipline. Exchange rate movements are temporary in nature and therefore the authorities expect debt as a share of GDP to return to a decreasing path.

The international comparison sections of the Selected Issues paper on the "*Structure and Cost of Public Debt in Mexico*" show that the current broad public debt level in Mexico is lower than the median value of emerging market economies as a percentage of GDP, support the conception that Mexico's public debt level is not high and claim that the size of the Mexican public debt does not itself prevent future rating upgrades. As such, the referred analysis refutes the Staff Report's characterization of Mexican debt in paragraph 25 as "*uncomfortably high*".

### ***Output Gap, Productivity and Structural Reform***

Staff's growth assumptions for 2005-2009 deserve further analysis. The rate of growth of potential output at the baseline scenario (2.9 percent) seems low, as it is based on a total-factor-productivity (TFP) growth rate assumption heavily influenced by the large negative swings observed in the periods of crisis of the 80s and 90s. Therefore, it is not consistent with estimates of potential growth for the periods 1996-2001/2002, carried out by previous studies and by the background paper itself. Along with the TFP growth estimation problems, the output gap (below 2 percent) to infer the behavior of GDP growth is small since it overlooks the macroeconomic conditions and is affected by end-of-sample problems. These factors may be leading to a substantial underestimation of growth for the next years. Taking into account that: (a) trend TFP growth should be higher, (b) the output gap is larger than estimated in the paper, (c) the process of getting back to the potential output should take 3-4 years at most, and (d) the fact that the Mexican economy is still to benefit from the recent

financial sector reforms and from a sounder banking system, the average growth rate for 2005-2009 should be revised upwards by at least 0.5 percent. This is important since growth forecasts have an effect on all the medium-term fiscal projections produced by staff.

We agree with staff that medium-term growth prospects are contingent on making progress in the reform agenda. Analytical work has emphasized that lack of further economic reforms accounts for the failure to deliver growth and development. Significant challenges remain in Mexico's structural reform process. The absence of progress in implementing structural reforms has affected competitiveness. Authorities have been engaged in a constructive dialogue with all sectors in order to reach consensus on a whole set of reforms that would boost productivity. Approval by the Legislative branch is in the best interest of the country as it would contribute to raise potential growth.

### *Statistical Coverage of Fiscal Accounts*

Mexico is a strong believer in the usefulness of Fund's surveillance. In the last ten years, the availability and transparency of Mexican economic and financial indicators have increased considerably and, as noted on the staff report and on the ROSC on data dissemination, the overall quality of statistics is good and timely. Mexico observes the SDSS and its metadata are posted on the DSBB. We understand the importance of fiscal indicators, including those of the non-financial public sector, and publish our fiscal targets. Since 2001 Mexico publishes a comprehensive measure of the fiscal balance--the Public Sector Borrowing Requirement--which includes the financing needs of public entities and of private and social entities that act on the government's behalf.

However, we are concerned by the fact that the coverage of fiscal statistics in Fund documents and programs varies across regions. The evenhandedness of surveillance is questioned when we note that, according to a FAD internal report, more than 80 percent of Latin American countries provide information on the non-financial public enterprise sector. In contrast, the operations of public enterprises in Middle-Eastern countries are not covered in the fiscal accounts, and only 12 percent of the OECD countries provide this information. Similarly, the coverage of fiscal targets in Fund programs in Latin America includes, in over 70 percent of the cases, non-financial public sector figures. This contrasts markedly with an average of nearly 20 percent in the universe of country programs, and with the absence of non-financial public sector coverage in Middle Eastern countries. If we are all to be measured by the same yardstick, it would be required to develop indicators for all members including all type of fiscal contingencies. We call on management and staff to design a plan that would guarantee that all membership is subject to the same scrutiny.