Policies for Success Under Globalization: The Case of Mexico

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Fifth International Meeting of Economists
On Globalization and Development Problems
La Habana, Cuba, February10-14, 2003

It is a pleasure and an honor to be here today. Although this is not the first time that the IMF is represented at this meeting, it is the first time that I have the pleasure to visit Cuba. I am particularly eager to learn from Cuba's experience, and I look forward to an enriching discussion comparing it with that of other economies in Latin America.

In this presentation I will focus on the policy options that can help the Latin American economies better benefit from their integration with the global economy. I will draw heavily from the experience of Mexico, a country that I have followed closely over the past few years. Mexico's policy choices in the past decade have included mistakes, for which the country has paid dearly, but also a great number of positive achievements. In particular, Mexico's policies following the 1994-95 debt crisis are enabling a path of faster growth and higher welfare enhanced by globalization. I think that Mexico's experience with trade and financial integration contains valuable lessons, both positive and negative, for other emerging economies, particularly in Latin America, and I will attempt to highlight these lessons and their implications in terms of macroeconomic policy design.

- I will start by discussing why Latin America has not reaped the same benefits as other regions from globalization.
- I will continue with a review of the region's policy approach over the past decade, and show how this approach has failed to take full advantage of the opportunities offered by global markets.
- I will then discuss the case of Mexico, and show how initial policy mistakes have been corrected to enhance the possibility of gains from trade and financial integration.

I. THE UNEVEN BENEFITS OF GLOBALIZATION

In theory globalization, by allowing a better allocation of the world's resources, should foster higher productivity and growth in all countries.

- Technological improvements are exchanged across countries, for example, facilitating the spread of medical and scientific discoveries. This has resulted in **a vast improvement in living standards** across the world over the past century, as illustrated by the general reduction in infant mortality and increase in life expectancy.
- Higher agriculture productivity allows a higher proportion of human needs to be covered, and **the number of people living in poverty has declined**.
- **In the second half of the century, world output grew at a rate that was four times faster** than that registered in the first half, and ten times faster than that registered during the previous three centuries.

However, these numbers mask considerable differences across countries and regions.

- Income growth was **much more rapid for the wealthiest countries**. For instance, the ratio between the average income in the poorest country, and that in the richest surged from 1 to 10 in 1900 to 1 to 30 in 2000.

- **As a region, Latin America did not fare well in the overall world ranking**. Over the past 50 years, it has lost ground not only with respect to the richer economies but also with respect to Asia. Latin America's average income declined from 26 percent of that of the richest countries in 1950, to 20 percent in 2000. Over the same period, the developing economies of Asia improved their relative position from an income of 8 percent of that of the richest countries in 1950, to 16 percent in 2000.

Most of Latin America's decline occurred in the 1980s, when regional output stagnated in the context of the debt crisis. However, even in the decades previous to the crisis, the region's relative growth performance had been weak, preventing it from narrowing the gap with the richest countries. Drawing from these outcomes, **many countries introduced starting in the late 1980s extensive and ambitious policy reforms aimed at taking advantage of the opportunities offered globally.**

The initial results of policy reforms in the late 1980s and early 1990s were promising: inflation was controlled while real economic growth increased. However, the countries were left vulnerable to financial shocks which culminated in the crises of 1988 and 2001-02. Per capita GDP in the region will be lower this year than in 1997.

There were significant differences in outcomes across countries in the region. Some countries, like Chile and Mexico, have improved their relative position, while others, like Venezuela and Argentina, have fallen back. The main factor behind these differences is the quality of macroeconomic policy management. I will now discuss the policy framework implemented in the region over the past decade and how it has helped, or hindered, the region's performance.

II. LESSONS FROM LATIN AMERICA'S RECENT POLICY EXPERIENCE

I will argue that the disappointing results of policy reforms in most of Latin America reflect several inter-related factors. A common feature underlying the poor results was the evident very high discount of long-term results by policy makers. Actions that yielded short-term gains were favored over policy choices that would yield more sustainable results, but where the benefits would largely be seen over a longer period of time. I will highlight five areas:

- **Inflexible exchange regimes,** that helped reduce inflation quickly, but undermined competitiveness and placed heavy demands on supporting policies.

- **A lack of fiscal discipline,** that allowed politically popular policy choices at the expense of gradual public debt accumulation with unsound financing.
- **Financial regulatory frameworks** that did not encourage a deepening of domestic capital markets and accommodated an excessive level of risk.
- **Inadequate trade integration,** especially in a context of broad financial integration.
- **Insufficient institutional and structural reforms,** with too little attention paid to needed prioritization and quality of implementation.

Together, these factors created a macroeconomic and financial structure that was highly exposed to external and internal shocks, and vulnerable to shifts in market confidence.

1. Exchange rate regimes were largely inflexible

The majority of countries in the region adopted exchange-rate based stabilization programs in the early 1990s. The imperative was generally the control of inflation, that had reached unmanageable levels in many countries. **Thus, by the early 1990's, only a handful of countries had exchange regimes that could be considered flexible.**

Stabilization programs experienced initial success: inflation fell quickly, while economic activity increased. However, these **inflexible exchange rate systems harbored a number of problems that gradually came to sight.**

- They constrained responses to internal and external shocks.
- They encouraged capital inflows and balance-sheet mismatches via informal dollarization. Capital inflows reduced fiscal discipline, promoted unsound financing of deficits, and fueled lending booms that led to banking crises.
- They masked growing imbalances in the economy and undermined competitiveness through real exchange rate appreciation.

Strong macroeconomic policies and institutional reforms would have been needed to make fixed exchange rate regimes sustainable, but the supporting framework was not in place.

2. A lack of fiscal discipline contributed to rising public debt levels

Many countries in the region shared a common vulnerability leading up to recent crises — **rising levels of public indebtedness and shallow domestic capital markets**. While pre-crisis debt/GDP ratios in the range of 50 percent were particularly high by international standards, they concealed important weaknesses:

- The bulk of public debt was denominated in U.S dollars, reflecting low policy credibility and increasing vulnerability to short-term shocks.
- Almost all domestic debt was short-term and linked to either the exchange rate or short-term interest rates, because of shallow domestic capital markets.
- With overvalued real exchange rates, the debt-to-GDP ratios were understated.

- Debt ratios drifted up in the 1990s due to a lack of budget discipline. Fiscal deficits increased even when economic growth was strong, leaving little room for counter-cyclical policies during times of economic weakness.

The lack of fiscal discipline reflected **a number of weaknesses in fiscal systems:**

- Political support for corrective measures was limited, and weak fiscal institutions impeded implementation.
- Revenue bases were narrow, and collection mechanisms weak, while current spending was subject to rigidities, in part due to earmarking.
- Arrangements with sub-national levels of government were generally inflexible.

3. Financial regulation was overly permissive.

Financial liberalization was a mainstay of policy reform in Latin America in the 1990s, mainly focusing on deregulation and privatization. However, **supporting regulatory frameworks remained inadequate:** they generally aimed at narrow definitions of balance-sheet matching and capital adequacy, without sufficient attention to exchange risk.

Also, with depositors preferring dollar-based instruments, **informal dollarization of banking systems rose during the 1990s**. Banks offset the immediate balance-sheet risk by lending in dollars. But borrowers generally lacked dollar income streams, meaning that shifts in exchange rates led to insolvency in the corporate sector and consequent loan defaults. Domestic banks became vulnerable to sudden stops in capital inflows and deposit runs, with central banks lacking adequate foreign exchange reserves relative to dollarized deposits.

4. Trade integration lagged behind capital market opening.

Latin America’s trade sector is relatively small in terms of GDP, and exports are often concentrated in a few commodities. This has increased the region’s vulnerabilities and constrained the scope for policy management due to:

- High ratios of foreign debt to exports despite lower ratios of foreign debt to GDP.
- With exports representing a small share of GDP, large real exchange rate movements are needed to improve external imbalances increased structurally by the access to foreign capital.

The region’s growth potential likely was also adversely affected. Numerous empirical studies—including recent studies by David Dollar and Aart Kraay at the World Bank—indicate that countries with open trade regimes have grown more quickly than those that have not integrated their trade regimes internationally.

- **In East Asia**, the share of exports in GDP is about double that of Latin America, and their growth rates have been higher.

- **In Latin America**, Chile is one of the most open economies in the region and is a clear beneficiary of recent globalization. Mexico also has gained from trade and financial integration in recent years.

5. Structural and institutional reforms were uneven and insufficient

To boost political support, measures were often adopted that front-loaded the benefits, while postponing the costs. For instance, privatization generated one-off revenues that allowed more painful fiscal adjustments to be postponed. Deeper structural reforms that would have yielded long-term payoffs — such as liberalization of labor and trade markets and reform of tax systems — were not pursued aggressively.

Institutional reforms often focused on legal/constitutional frameworks, but neglected policy implementation. Insufficient attention was given to developing the institutions needed for effective market functioning in a deregulated environment. Privatization proceeded in many cases without a fully supporting regulatory system.

Corruption was not successfully addressed in several countries, reducing the real and perceived benefits of market-based reforms. Little attention was paid to the need for increased and more efficient **social spending**, leading to insufficient social safety nets. These factors, in turn, undermined support for further reforms. By the end of the 1990s, growing political divisions and civil conflicts in many countries strained the consensus for continuing reform efforts, with so-called reform fatigue setting in.

III. A Safer Macroeconomic Framework—The Case of Mexico

Some countries in the region — notably Chile, and more recently Mexico — have pursued a policy framework that led them to improved performance in the 1990s. I will now discuss in some detail the case of Mexico. I think this offers interesting insights on the type of policy approach that can take advantage of globalization while minimizing costs.

Mexico faced in late 1994 a devastating financial crisis that wiped out most of the economic and social achievements of the previous decade. More generally, the Mexican economy had been subject for more than two decades to a string of severe economic and financial crises every six years, following electoral cycles. After the Tequila crisis, the Mexican authorities opted for a comprehensive policy approach aimed at shielding the economy from both domestic and external shocks, while still taking full advantage of the continuing process of globalization. I will discuss five pillars of this strategy.

- The first three—fiscal, monetary and financial policies—aimed at restoring macroeconomic stability and increasing resiliency to shocks;
- The other two—trade integration and institutional reforms—sought to expand integration in the global economy as a way to boost the economy's growth potential.

1. Fiscal consolidation and debt management

A major requirement to restore macroeconomic stability after the Tequila crisis was the **reduction in the fiscal deficit and deeper capital markets**. Costly bank restructuring operations had pushed up the consolidated public sector deficit to 6 percent of GDP in 1996. By 2002, it had come down to 3 ½ percent of GDP.

Important lessons can be drawn from this adjustment effort:

- **Prudent borrowing and innovative debt management practices are a cornerstone of fiscal consolidation.** Debt levels were reduced and the composition changed to reduce vulnerability to short-term shocks; public sector debt declined by 7 percentage points of GDP between 1995 and 2001.
  - The share of external debt in total public sector liabilities declined from 75 percent to just over 30 percent. In addition, the average maturity of external debt was extended significantly.
  - Domestic debt management also improved. With policies to deepen domestic capital markets, the authorities were able to introduce long-term fixed rate bonds that extended the average maturity of government debt instruments.
  - These policies, coupled with greater market confidence, cut the interest burden on the budget by more than half.

- **Fiscal adjustment can accommodate essential spending, especially on poverty.** Although social spending declined slightly in the first years of adjustment, it recovered quickly, reaching over 10 percent of GDP in 2002.

- **Fiscal adjustment must include institutional changes that promote fiscal responsibility and transparency.**
  - Since 1998, the annual budget has included automatic adjustors of expenditure to offset revenue shortfalls.
  - Also, fiscal policy is now set within a medium-term fiscal plan that aims at achieving a deficit of around 2 percent of GDP by 2006 and further reductions in the level of public debt.
  - In addition, important strides have been made to enhance the transparency of public sector activities and the integrity of the budget process. The Finance Ministry has strong control over budget execution, and the most important public enterprises are included in the budget.

2. Monetary and exchange rate policy

Another key element of the macroeconomic framework was the introduction of a **flexible exchange rate policy.** Exchange rate flexibility has limited speculative capital movements, and helped the Mexican economy absorb shocks, both positive and negative. This has given market participants confidence that major external imbalances would not develop.

Exchange rate flexibility is supported by the **maintenance of a tight, independent monetary policy**. A formal inflation-targeting framework was introduced in 2001 with the objective of lowering inflation to 3 percent from 2003 and over the long term.

The new monetary framework also included **institutional dimensions**:

- The BOM has a legal mandate to achieve price stability as well as instrument independence. It has been able to build credibility through its consistent track record of prudent and timely decision-making.
- To foster a high level of transparency, the BOM communicates its views to the markets through quarterly reports, press releases and frequent public speeches.

3. Strengthening the domestic financial sector.

After the traumatic banking crisis of 1994-95, restoring the soundness and competitiveness of the banking industry was critical. **Financial reform rested on three main pillars**:

- **Revamping the financial supervisory and regulatory system** on the basis of the Basel Core Principles for Effective Banking Supervision. For instance, limits have been set to the use of forbearance, disclosure requirements have been expanded, and higher requirements have been established for regulatory capital.
- **Improving the legal framework** governing the financial sector, with the aim of facilitating loan recovery procedures. The framework for corporate reorganization and bankruptcy was also revamped, with streamlined procedures including through tight time limits for the various stages of the process.
- **Defining a transparent framework** for dealing with the losses associated to the 1994–95 banking crisis, asset recovery, the disposal of distressed assets and the resolution of troubled banks.

Reforms have significantly improved the Mexican financial system's resilience to shocks. The Mexican authorities recently requested a comprehensive assessment of the Mexican financial sector by a joint IMF-World Bank team—a process known as FSAP. The report found that the Mexican banking sector has strengthened its capital base and the average quality of its assets considerably over recent years. It concluded that Mexico complied broadly with international standards and codes and had made significant progress regarding transparency.

4. Furthering trade integration.

Governments have often sought to foster growth through increased government spending. The results were short-lived growth spurts brought to a halt by balance-of-payments crises. Reaching a higher and more sustained growth path requires **increasing the role of the**

private sector in the economy, and opening the country to the dynamic forces of global markets.

The Mexican authorities had embarked in the 1980s upon a path of **market deregulation and trade opening** that culminated with the signature of the NAFTA in 1994. The determined adjustments in fiscal, exchange and financial policies that were undertaken after the Tequila crisis gave stronger support to these policies. They restored macroeconomic stability and bolstered private confidence, paving the way for renewed investment and growth. As a result, **private investment jumped** from 16 percent of GDP in 1995 to over 20 percent in 2000, and output growth rose to an average of over 5 percent.

Under the combined positive influence of NAFTA-related market liberalization and of the devaluation of the peso, **the export sector attracted growing flows of investment, both foreign and domestic**. Exports grew at an average rate of 16 percent per year, and their share in GDP rose from 15 percent in 1994 to 29 percent in 2000. Most importantly, exports diversified away from the traditional oil and natural resource sectors, and manufacturing accounts for a growing share of shipments. The expansion of manufacturing exports contributed to higher employment and technology transfer, boosting both output and income growth.

5. Strengthening institutions.

Persistent institutional reforms—beyond those to the fiscal and financial institutions mentioned earlier—have provided Mexico with a solid backdrop for effective policy design.

Reforms have been introduced to encourage greater political plurality and increase political openness and accountability. Important evidence of the increased maturity of Mexico’s political and economic institutions was the transition after the 2000 presidential election, which broke the one-party domination that had been in place for seventy years. The strengthened political institutions allowed the authorities to resist political pressures to alter the policy stance in the run up to the elections, leading to a smooth transition.

A second important institutional reform has been decentralization with a clear framework of the rules of the game. Since the early 1990s decision-making power has been gradually devolved to state and municipal governments, with decisions in key areas (education, health) becoming the prerogatives of sub nationals. To avoid potential destabilizing elements, the resource transfers from the federal to the sub national governments are rules based. Sub national governments indebtedness capabilities are clearly constrained. As a result, their outstanding debt was less than 2 percent of GDP at end-2001.

A system of targeted social programs has been institutionalized, such as the widely acclaimed *Progresa* program (recently renamed *Oportunidades*). About 4.2 million Mexicans receive benefits under this integrated program for education, health and nutrition. Households are carefully selected amongst the very poor in marginalized communities, receipt of benefits strictly conditioned upon performance objectives (such as school attendance or health visits). A number of studies have concluded that *Progresa* has been successful in raising school attendance, reducing child labor, increasing preventive health care visits, and improving the health of both children and adults.

IV. CONCLUSIONS AND LESSONS FOR LATIN AMERICA

To conclude: What is the balance of Mexico's experience with increased economic integration, and what are the policy lessons for the rest of the region?

The benefits of globalization.

Mexico has clearly benefited from increased integration with the global economy: it has grown faster, poverty has declined, and it is now more resilient to unexpected shocks.

- **Mexico is one of the fastest-growing economies in Latin America.** Importantly, the recent economic slowdown has been treated as it would in the industrial countries; not as portending an economic crisis, but as part of the natural business cycle that calls for careful economic attention.
- **Poverty has declined fast in recent years**:
    - The Tequila crisis had devastating effects on the poorer segments of Mexico's population, as did the crises that preceded it. Between 1994 and 1996, the poverty rate increased from 51 to 62 percent. But since 1996, there has been **an impressive turnaround**: the poverty rate declined to 46 percent by 2000, and extreme poverty to 18 percent (from 30 percent in 2000). Both in urban and rural areas, poverty is now below the 1994 pre-crisis levels.
    - **Growth was the main determinant of the decline in poverty**, not only because of the higher income associated with higher growth, but also because of its positive impact on non monetary welfare indicators such as infant mortality and life expectancy.
    - **Social spending also contributed.** The Mexican system of targeted social subsidies is widely regarded as a model for other countries.

Policies pursued have **increased both the level of integration with the global economy and its resilience to external shocks.** This is best illustrated by Mexico's performance in the context of recent episodes of international financial turbulence. While a succession of emerging economies stumbled in the 1990s, Mexico continued to grow. The policy framework allowed the government to react swiftly to these external shocks through timely adjustments in fiscal and monetary policies that minimized the impact of regional contagion.

Yet, for all the progress achieved, significant challenges still remain:

- 45 million Mexicans are still poor. Inequality remains massive, as well as disparities between ethnic groups and regions.
- Mexico's gross external financing needs remain high, leaving the country vulnerable to a sudden stop in capital inflows.

Further structural reforms are needed to enhance economic growth prospects. Tax reform, labor market reform, energy sector reform, telecommunications reform, and further advances in fighting corruption and improving the quality of public administration are needed for sustained increases in Mexico's productivity, and subsequent declines in poverty.

Lessons for Latin America

What general lessons can be drawn from the Mexican experience that can be of use to other Latin American economies as they try to improve the terms of their insertion into the global economy? I can think of **three important lessons**:

- **The benefits that countries derive from trade and financial integration depend in good part on their policy framework**. Policies that reduce vulnerabilities to short-term shocks will maximize gains from integration, because crises are very costly, particularly for the poor.
- **Policy choices must be couched in the context of long-term growth and inflation goals**. Institutional and structural reforms must be carefully prioritized. Emphasis must be placed on policies with a long-term pay off, including broad trade opening, and labor market and judicial reforms.
- **To be sustainable the policy framework must rest on a broad political consensus.** Political support can be mobilized by reducing corruption and protecting the most vulnerable segments from the short-term costs of adjustment through improved social safety nets.

Thanks you very much for your attention.

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