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How Can Reforms Help Deliver Growth in Mexico?

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In the early 1980s, Mexico's inward-looking development strategy collapsed. By then macroeconomic instability—high inflation rates, large fiscal deficits, balance of payments crises, and a huge external debt—had become pervasive, not just in Mexico but also in many other Latin American countries. In mid-1982 Mexico announced that it would default on its external debt, precipitating what came to be known as the Latin American debt crisis and the "lost decade."

The crisis made clear that the country had to modify its development strategy, from one based largely on trade protection and a heavily interventionist state toward a more market-oriented, modern, deregulated economy. Since then Mexico, like many other Latin American countries, has been trying to return to sustainable economic growth by implementing a series of structural economic reforms and by moving toward a full-fledged market economy. During the second half of the 1980s and the early 1990s, the Mexican government managed to approve and implement a series of important economic reforms, including an

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ambitious privatization program, a partial pension reform, and wide-ranging trade liberalization and deregulation.

It is evident today, however, that Mexico's economic reforms have had relatively disappointing results: income per capita since 1981 has grown at a dismal average rate of close to 0.5 percent a year. Such a low growth rate, together with the generalized perception that economic growth has not been broadly shared, has generated ample popular discontent with economic reforms in Mexico. For that reason, any future reform proposals are likely to face much greater debate and opposition than in the past. In fact, disappointment with previous reforms, in an already difficult political context, has deterred recent administrations from pursuing further economic reform. As a consequence, Mexico has entered onto the path of reform inaction that currently characterizes most of Latin America.

At least two competing explanations have been advanced to explain the relative failure of economic reform in Mexico.[1] The first is that the reforms thus far have been insufficient and incomplete (Gil-Díaz, 2003), and that deeper and broader reforms are needed to achieve positive results. The second argues that, to the contrary, the economic reform process has gone too far and that it has been unable to break the stranglehold of existing economic interest groups, and may even have made them more powerful. This line of analysis concludes that the reform process should not continue and that some reforms may even need to be reversed. Although this point of view is not predominant in academic discussions, it is deeply entrenched in a large segment of the Mexican population.

We follow yet a third line of analysis. We claim that structural reform in Mexico has failed to contribute to more rapid growth because in some cases, such as the initial pension reform of 1992, the reforms were driven by a sense of urgency, and therefore were not actually designed to promote economic growth, whereas in other cases the reforms could have had positive effects but either were badly implemented (for example, privatization) or remain incomplete (for example, financial reform). Some other important economic reforms have not even been attempted, and, most important, in many other cases the sequencing of reform was inappropriate. All of these factors could explain why structural reform in Mexico has had such a limited—sometimes even a negative—impact on the foundations for growth.

In some cases, moreover, powerful interest groups have played an important role in preventing implementation of what might otherwise have been a successful reform. The opponents of further reform were in some cases the winners from the initial wave of reforms and may perceive that further reform could deprive them of those benefits (as described by Hellman, 1998). More recently, however, political and ideological confrontation among the three major political parties in

1. See Zettelmeyer (2006) for a recent summary of the evidence and debate on the relationship between reform and economic growth in Latin America.

Mexico has also become an obstacle to further structural reform (Lehoucq and others, 2005). The result has been a political situation in which each major party has veto power over the others, leading to reform inaction as an equilibrium outcome. These considerations, together with reform fatigue, are the main local constraints on further reform in Mexico.

Nevertheless, we believe that reforms can still be implemented in Mexico on a wide array of issues, and that these reforms can and should be designed so as to maximize their impact on the foundations for growth. The reforms that we see as needed in Mexico can be divided into two groups. The first consists of reforms that involve substantial ideological differences and political trade-offs, and therefore will require a much deeper level of discussion. In this group we include issues such as fiscal, energy, and labor reform. Achievement of any of these reforms will ultimately depend upon some agreement being reached among the major political forces, or at least between two of the three leading political parties, so as to guarantee a simple majority in Congress.

We argue here that this set of reforms—especially the fiscal and energy reforms—needs first an underlying institutional framework in order to work; this means, in particular, judicial and competition reform. For example, if Pemex, the state-owned oil company, were fully privatized under a weak competition framework, privatization might not yield the desired results. By the same token, as we argue later, without a judicial reform that includes the modification of the fiscal *amparo,* fiscal reform will not deliver the intended outcomes. For these reasons we focus on these two reforms and emphasize that the sequencing of reforms is important.

This second group of reforms includes those on which there are no major political or ideological differences among the political parties; here we anticipate that a congressional majority could be achieved in the short run. Some of these reforms have not been attempted either because they were considered already completed or because politicians are unsure about their implications for economic growth. This chapter will concentrate on this second set of reforms, since they are the ones that seem to be attainable in the short run and whose implementation depends mostly on political will rather than on ideological compromise.

The main objective of this chapter is to identify why previous reforms failed to generate a higher rate of sustainable economic growth in Mexico, and what can be done to reactivate the process of economic reform in a way that leads to faster growth. We devote particular attention to the specific characteristics and idiosyncratic aspects of the Mexican situation, as well as to the sequencing of the reforms proposed.

We begin in the next section by reviewing recent trends in the Mexican economy. Here we also develop a first approach to the recent evolution of some of the foundations for growth as defined by the CGD framework (see chapter 2). The next section explores the reasons for reform fatigue in Mexico and how this fatigue, in the current domestic political context, has become an obstacle to further economic reform. In this section we also briefly describe some of the economic reforms that have already been implemented, either fully or in part, including trade liberalization, privatization, and pension reform. The next section discusses some areas where the reform agenda might successfully be advanced. In particular, we propose and discuss three areas of reform for which there is some probability of consensus: legal and judicial reform, competition policy, and financial sector reform. Again, the first two sets of reforms are necessary for the other reforms to work. The financial sector is included for illustrative purposes, that is, to show that for this reform to work, a competitive environment and an efficient and adequate rule of law are both needed. The final section concludes.

Economic Growth and Its Foundations

Economic Growth in the Recent Past

The performance of the domestic economy during the past twenty-five years has been quite disappointing, not just for the Mexican population but for all who saw great potential in the economic reforms of the 1980s and 1990s.[2] The slow rate of growth in Mexico's real income per capita from 1981 to 2006 stands in sharp contrast with the country's own economic performance between 1950 and 1981, when real income per capita grew at a pace of 3.4 percent a year. This record of growth is depicted in figure 1, which also shows the structural break in 1981 that was detected statistically by Berg, Ostry, and Zettelmeyer (2006). However, starting in 1995 Mexico seems to have resumed a positive growth trend, with a slump between 2000 and 2003, which can be partly attributed to the U.S. recession of 2001. In any event, average annual growth in real income per capita between 1995 and 2006, at 2.2 percent, was not only slower than in the previous period, but slower than what many had expected given the amplitude and variety of reforms undertaken.

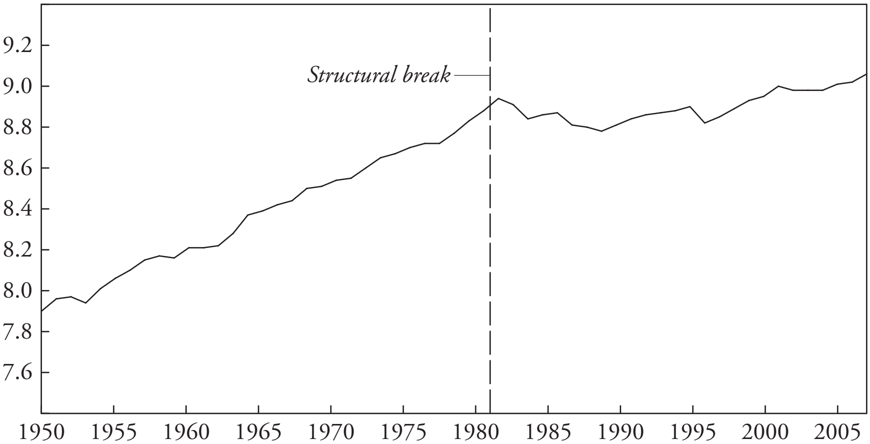
What accounts for Mexico's economic growth slowdown since 1981? Answering this question requires a deeper analysis of the underlying factors. One way to do this is by performing a standard growth accounting decomposition, to investigate whether the problem has been one of factor accumulation or of slow growth in total factor productivity (TFP). Several recent studies have attempted to disentangle the contributions of these different factors to growth in Mexico's GDP.[3] In general, all reach the same basic conclusion: Mexico's economy has grown slowly since the 1980s as a result of a sharp decline in TFP.

2. A large number of papers have explored Mexico's recent economic growth performance, including Tornell, Westermann, and Martínez-Trigueros (2004) and Garcia-Verdú (2007). The Mexican case has also been analyzed in the broader Latin American context in Loayza, Fajnzylber, and Calderón (2005) and Zettelmeyer (2006).

3. See, for example, Loayza et al. (2005) and García-Verdú (2007).

Figure 1. *Mexico: Real Income per Capita, 1950–2006*

Log units[a]



Source: Penn World Tables version 6.2 (Heston, Summers, and Aten, 2006) and author's estimates.
a. In constant dollars.

Table 1 reports the results of a growth decomposition exercise for Mexico during the period 1950–2006, based on a recent study by Garcia-Verdú (2007). The table shows the results for three subperiods: 1950–70, a period of very rapid economic growth with relative macroeconomic stability; 1971–82, a period of continued rapid growth, but accompanied by macroeconomic instability; and 1982–2006, a period of relatively slow growth.

The results are unambiguous: most of the slowdown in economic growth since 1982 has been due to a reduction in the rate of TFP growth, which even turned negative in the last subperiod.[4] A second contributing factor has been a reduction in the rate of capital accumulation, which clearly depends on the foundations for growth being sound. The fact that these two components, capital accumulation and TFP, are contributing far less to Mexico's economic growth than they used to suggests that the foundations for growth are not developing in a positive way. We look next at the recent trends in some of these foundations in more detail.

The Foundations for Growth

In what follows we make use of the analytical framework described in chapter 2 of this volume. This framework identifies five foundations for growth for the

4. These results are in line with those of Loayza et al. (2005), who found negative contributions from three alternative measures of TFP during the 1980s and an almost zero contribution during the 1990s.

Table 1. *Mexico: Accounting for Growth, 1950–2006*
Percent a year (annual averages)

Period	*Change in GDP*	*Change in capital stock*	*Change in composition of human capital*	*Change in total factor productivity*
1950–70	6.10	1.67	0.63	3.80
1971–82	5.97	2.54	1.94	1.49
1982–2006	2.42	1.22	2.07	−0.87

Source: Authors' calculations based on Garcia-Verdú (2007).

Latin American economies: property rights, equal opportunities, competition, macroeconomic stability, and a broader sharing of the benefits of growth. Unfortunately, there are no obvious ways of measuring some of these concepts or of capturing them through proxy variables. However, we do have suitable proxies for three of these concepts, and in this section we briefly review and discuss their track record in Mexico. In each case we use only those variables for which we have data before and after 1982, the year when Mexico's structural reforms got under way.

Property Rights

As a proxy measure for property rights, we use the Legal Structure and Security of Property Rights Index developed by the Cato Institute, which is one of the components of the World Economic Freedom Index computed annually by that organization. Since 1995 the Cato property rights index has been based on five indicators: judicial independence, impartiality of the courts, protection of intellectual property, military interference in the political regime, and integrity of the legal system. Values of all the indicators range from zero to 10, with zero indicating maximum weakness.

Table 2 traces the Cato property rights index for Mexico since 1970. The pattern is erratic, with a slight improvement between 1975 and 1990 followed by a sharp reversal between 1990 and 2000 and then a slight recovery after 2000. The index in 2004 was well below its value in 1980, which means that there was no net progress at all over those twenty-five years; the index actually shows a slight decline since the beginning of the structural reform process. This pattern, as discussed later, could be associated with the negative performance of some of the previous economic reforms.

Macroeconomic Stability

Mexico, like many other Latin American countries, has gone through several macroeconomic crises and has suffered from macroeconomic instability and high vulnerability to external shocks. Mexico has also experienced several devaluations of the peso and has signed several letters of intent with the International Mone-

Table 2. *Mexico: Strength of Property Rights, 1970–2004*
Index, 10 = maximum

	1970	*1975*	*1980*	*1985*	*1990*	*1995*	*2000*	*2004*
Cato Legal Structure and Security of Property Rights Index	4.7	4.1	6.3	5.4	6.8	5.3	4.2	4.5

Source: Gwartney and Lawson (2007).

tary Fund in an effort to restore macroeconomic stability.[5] Any of a number of variables could be used as a proxy for this foundation for growth. We focus on only two that were at the heart of the regionwide macroeconomic instability of the 1970s and 1980s: inflation and public sector debt.

Inflation in Mexico began to increase in the early 1970s and then accelerated in the 1980s, reaching almost 150 percent at its peak in 1987. Since then inflation has mostly followed a declining trend, with a brief spurt upward in the mid-1990s, when it approached 50 percent as a result of the tequila crisis of 1994–95. After that episode, however, inflation steadily declined, and since 2000 it has been in the single digits; it is close to 4 percent currently.

The ratio of Mexico's total (external and internal) public sector debt to GDP increased substantially in the early 1980s, reaching a peak of 104 percent in 1987; the ratio of external debt to GDP reached a peak of 73 percent that same year. Since then, however, both ratios have steadily declined (again with a small increase during the 1994–95 crisis) and today are at moderate levels.

Together these two indicators allow us to conclude that Mexico's economy has become much more stable in recent years compared with the 1980s and 1990s. This suggests that Mexico's macroeconomic stability foundation has shown significant improvement and could have contributed to increasing the economy's growth potential.

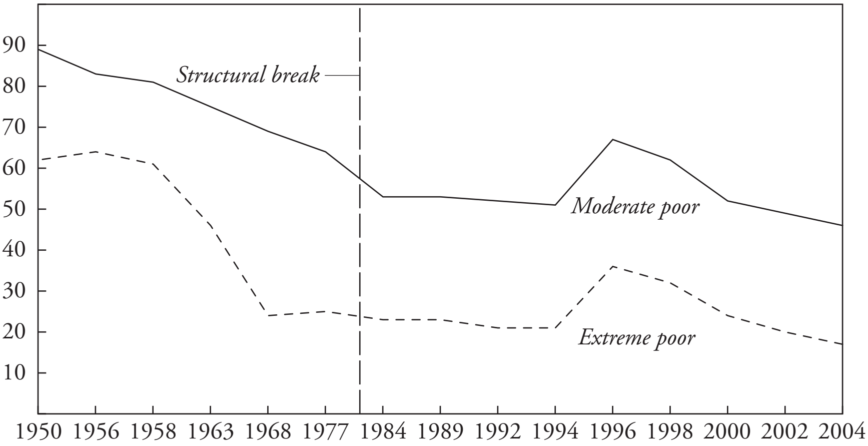
Broad Sharing of the Benefits of Growth

We view Mexico's failure to share the benefits of economic growth more broadly as critical to understanding some of the disappointment with structural reform. We focus on two variables as proxies for this concept: poverty rates and income inequality.

Poverty. There are three officially defined measures of poverty in Mexico: food poverty (also called extreme poverty), capabilities poverty, and assets-based poverty (also called moderate poverty); all of these are defined in terms of income

5. See Lustig (1998) for more details on the episodes of macroeconomic instability in Mexico.

Figure 2. *Mexico: Moderate and Extreme Poverty, 1950–2004*
Percent of total population



Source: Székely (2005).

thresholds. The longest poverty rate series for Mexico using consistent data and estimation methods was recently published by Székely (2005); this series is available from 1950 to 2004.

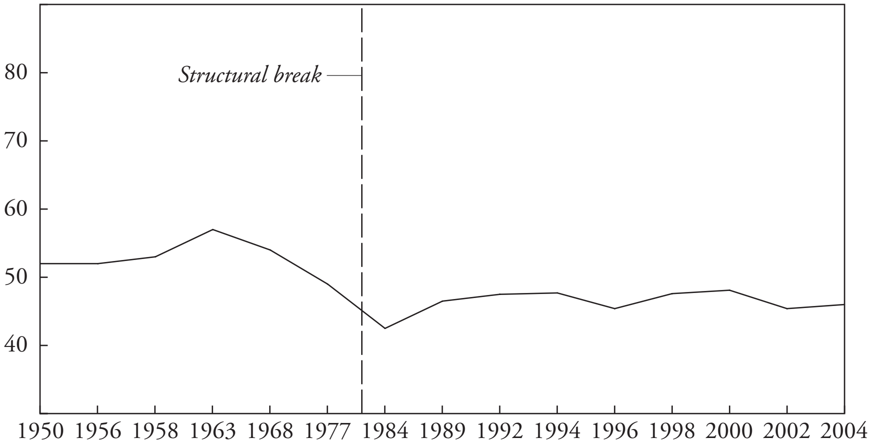
Figure 2 shows these series for two of the three measures of poverty: moderate and extreme. Both have declined substantially since 1950, but most of this reduction took place well before the launch of structural reforms in 1981. Indeed, except for the period around the tequila crisis, Mexico's moderate and extreme poverty rates have shown remarkable stability and a certain degree of downward rigidity since the early 1980s and the late 1960s, respectively: the extreme poverty rate in 2000 was the same as it had been in 1968. On the other hand, the number of people in extreme poverty has remained almost constant at around 20 million since 1950, while the number of moderately poor has doubled, from 24 million people in 1950 to around 50 million in 2004.

Inequality. Latin America is well known for having the highest levels of economic inequality among world regions, and Mexico is no exception. Székely (2005) also provides a long time series for income inequality in Mexico, with data available for selected years between 1950 and 2004. The story told by these data, shown in figure 3, is similar to that for poverty: income inequality has been relatively stable in Mexico, with little net change from 1984 to 2004, despite a slight increase from 1984 to 1994 and a reversal thereafter. As with poverty, all the reduction in this indicator occurred before the period of structural reform; no significant long-run improvement is evident since then.[6]

6. There has been, however, an important reduction in income inequality since 1994. Esquivel (2008) analyzes the observed reduction in Mexico's income inequality since 1994.

Figure 3. *Mexico: Income Inequality, 1950–2004*

Gini index (100 = most unequal)



Source: Székely (2005).

To summarize, Mexico's economic reforms have had little substantive effect on the foundations for growth. The only foundation for which there is some evidence of improvement in recent years is macroeconomic stability. Neither the property rights environment nor the broad sharing of economic growth has shown substantial improvement in the recent period. On the contrary, in terms of the Cato property rights index, Mexico is now below its own 1980 level, and poverty and inequality have shown no substantial improvement since the early 1980s. It is therefore not surprising that Mexico's economic growth performance has been disappointing.

Has Growth Been Inclusive?

To analyze whether economic growth in Mexico has been inclusive, we report the results of Munguía (2008), who performed an analysis similar to that of Dollar and Kraay (2002). The latter used a cross-country panel data regression model to estimate the effect of overall growth in income per capita on growth in income per capita among the poorest quintile. They found that the incomes of the poor grew at the same rate as average income per capita: that is, the elasticity of the bottom-quintile growth rate with respect to the overall growth rate was not statistically different from one. Dollar and Kraay concluded from this evidence that "growth is good for the poor."

Munguía (2008) used information from Mexico's income-expenditure household surveys from 1992 to 2006. These surveys are conducted every other year, so that data were available for eight cross sections. The author then computed

Table 3. *Mexico: Elasticity of Income Growth of the Poor with Respect to Average Income Growth*[a]

Sample period	*States included in sample*	*Estimated elasticity* *With time dummies*	*Estimated elasticity* *Without time dummies*
1992–2006	All	1.053	1.054
		(0.050)	(0.041)
1992–1998	All	0.907	0.999
		(0.216)	(0.102)
2000–2006	All	1.052	1.048
		(0.074)	(0.063)
1992–2006	Poor states only	0.864	0.900
		(0.090)	(0.087)
1992–2006	Rich states only	1.001	0.973
		(0.069)	(0.054)

Source: Munguía (2008).

a. Results of a regression of the log of growth in income per capita of the poor on the log of growth in average income per capita, using the system-GMM (generalized method of moments) method. All regressions include two lags of the dependent variable as instruments. Numbers in parentheses are standard errors.

both average income per capita and that of the poorest quintile using state-level data from all thirty-two of Mexico's states, 256 observations in all. The author regressed the log of income per capita of the poor on the log of overall average income per capita, controlling for such variables as education, foreign direct investment, and the share of the maquiladora sector in the state. To reduce the bias associated with the model's specification, following Dollar and Kraay's (2002) methodology, Munguía estimated the model in both levels and first-differences using the system-GMM (generalized method of moments) approach.

Table 3, which summarizes his results, shows that the income growth elasticity of the poor is again very close to one in all specifications. In fact, none of the estimated coefficients is statistically different from one, suggesting that average income per capita at the state level grew at the same rate as income per capita among the poorest quintile. Thus, although economic growth in Mexico was not pro-poor, in the sense that the poorest did not benefit more than proportionally from economic growth than the middle of the distribution, at least growth was not biased against them.

Using a different approach, Esquivel (2008) has shown that, at least since 1994, the income of the bottom part of the distribution has grown faster than that of the rest of the population. This fact explains the reduction in inequality that has been observed since that year. This result, together with our previous discussion, suggests that the problem with the recent trend in income growth in Mexico is mainly its low level rather than its distribution.

Reform Fatigue, the Political Constraint, and Previous Reforms

How did Mexico go from being one of the region's leading reformers in the early 1990s to the "reform paralysis" of recent years? Part of the answer lies in the dismal performance of the Mexican economy, discussed above, after the initial set of reforms. However, this is not a convincing explanation for everyone, since some have argued that the Mexican economy would have done better if further reforms had been implemented. Why, then, are further economic reforms not being as vigorously pursued in Mexico as they were in the 1980s and 1990s? Why have recent administrations been unable to pass a single important economic reform? We see three reasons behind this outcome: first, a generalized perception that the reform agenda had failed to generate faster economic growth; second, a change in political conditions that have made it much harder to implement any further economic reform; and third, the actual failure of some of the first group of reforms. We address each of these issues in turn.

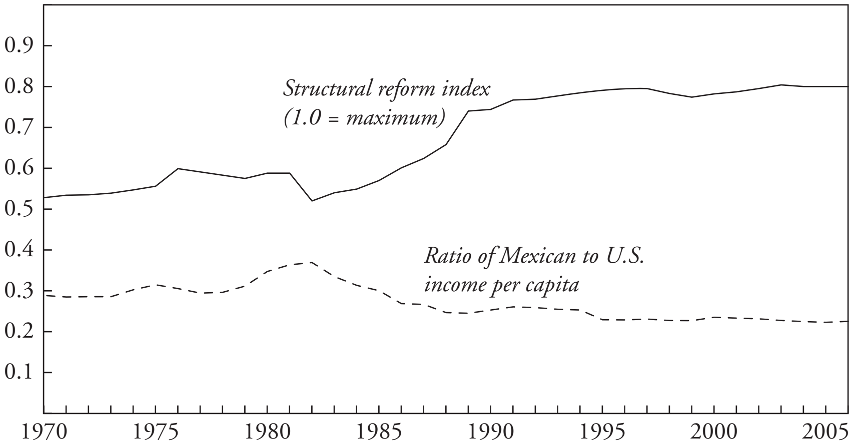
Economic Growth and Reform

The relationship between reform and economic growth is not an obvious one. Often reforms affect growth only indirectly. In any event, Mexico's reforms were expected to have a positive effect on growth, and indeed it was precisely on those grounds that the government justified them. Yet, as we have seen, Mexico's economic performance does not seem to have improved in the wake of the reforms. Indeed, an important segment of the population perceives their overall effect to have been negative, and not without reason. Figure 4 compares an index of structural reform with the ratio of Mexico's GDP per capita to that of the United States for the period since 1970.[7] The figure shows a surprising mirror image between these two variables: when the reform index started to increase in 1982, GDP per capita relative to the United States started to decline, and when the rise in the reform index began to slow around 1989, the GDP per capita ratio started to stabilize as well. Since 1997 both indices have been basically constant.

Although this pattern obviously does not imply causation, that may not matter to the general public, who perceives only the negative association between reform and economic performance. Given these results, it is not surprising that important groups of the Mexican population are less than eager to support a continued pro-reform agenda.

7. This index was originally calculated by Morley, Machado, and Pettinato (1999) and was recently updated and revised by Escaith and Paunovic (2004). We are assuming no changes in the index between 2004 and 2006.

Figure 4. *Mexico: Structural Reform and GDP per Capita Relative to United States, 1970–2006*



Source: Penn World Tables version 6.2 (Heston, Summers, and Aten, 2006); Escaith and Paunovic (2004); authors' estimates.

The Political Context and the Policymaking Process

Also helping to explain the lack of further reform is the change in the political context and in the policymaking process in Mexico. In the late 1980s and early 1990s, Congress approved some important and technically complex economic reforms without major difficulties, in part because until 1994 Mexican politics was dominated by a single party, the Revolutionary Institutional Party (Partido Revolucionario Institucional, or PRI).

The PRI, which ruled Mexico for several decades beginning in the late 1920s, lacks a clear ideological stance and therefore has been capable of some flexibility in the policies it embraced. It was under the PRI that Mexico adopted, in the 1940s and 1950s, an inward-looking economic development strategy. Later, as this strategy began to show some fragility, successive PRI administrations, beginning with that of President Miguel de la Madrid (1982–88), started to adjust the economic model and proposed several economic reforms to confront some of the emerging problems. These reforms, which included a massive program of privatization, tariff reduction, deregulation, and the initial stage of a financial reform, were deemed urgent and necessary in light of the fiscal, monetary, and balance of payments problems that Mexico faced during the 1980s.

De la Madrid's successor, Carlos Salinas de Gortari (1988–94), continued with these policies and indeed went much further in some areas (Aspe, 1993). It was under his administration that Mexico proposed a free trade agreement with the

United States and Canada, which was implemented as the North American Free Trade Agreement (NAFTA) in 1994. One can appreciate the magnitude of this change of perspective for Mexico by noting that as recently as 1980, the Mexican government had rejected, on purely nationalistic grounds, membership in the General Agreement on Tariffs and Trade (GATT).

The lackluster economic results of the 1980s and the failure (perceived or real) of some of the economic reforms of that period, together with a more open political environment, took their toll on the PRI's popular support. Thus, although PRI candidates won the presidential elections of 1988 and 1994, they faced much stronger competition and barely obtained an absolute majority of the popular vote (figure 5). In those two elections and in the mid-term elections of 1991, the PRI continued to win absolute majorities in both houses of Congress. This facilitated policymaking, and some important economic reforms were implemented without strong opposition in Congress during this period.[8]

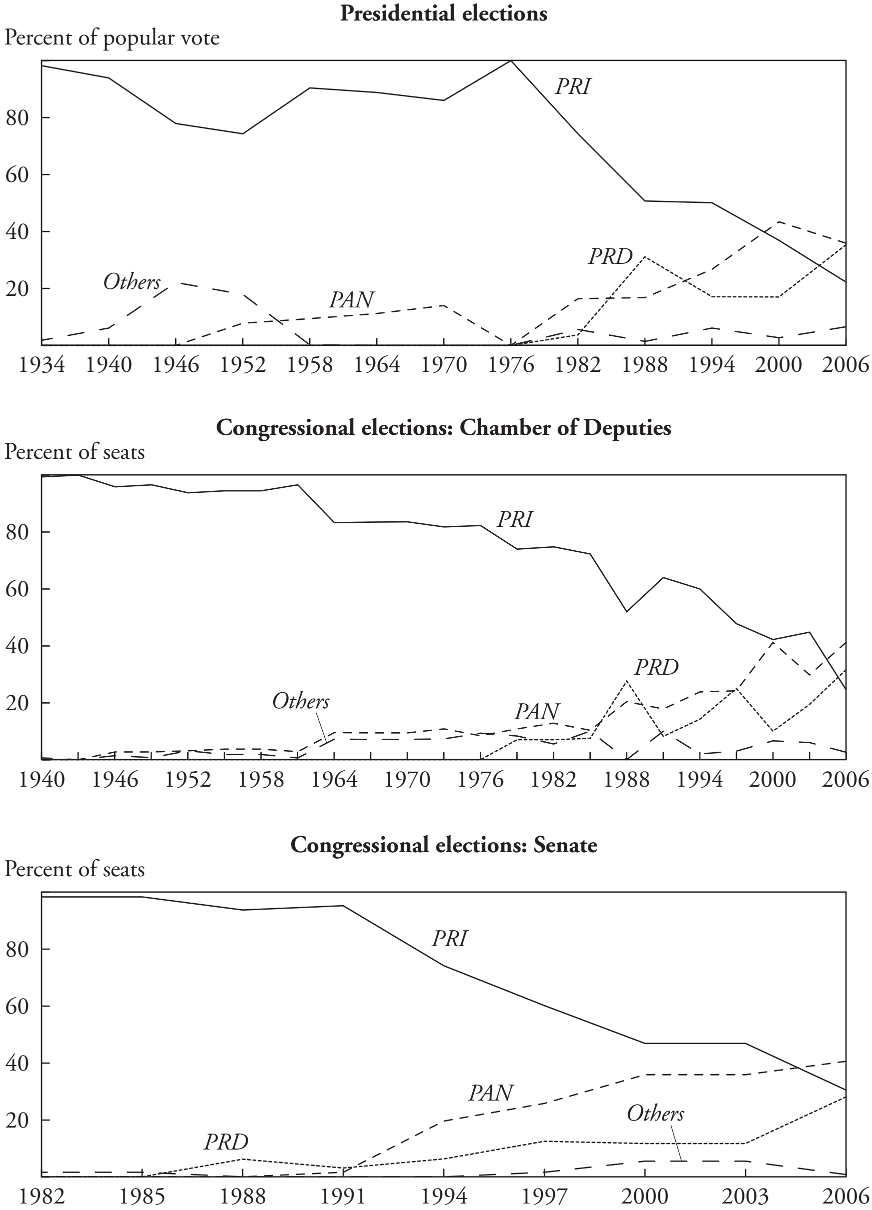
However, during President Salinas's administration the PRI had already lost enough seats in Congress that it could no longer make constitutional changes without the support of other parties. (These changes require a qualified majority of two-thirds of the votes in both houses.) Therefore, in order to advance the reform agenda when constitutional reforms were needed, Salinas and the PRI formed a voting coalition with the right-of-center National Action Party (Partido Acción Nacional, or PAN). The PRI could still pass other reforms without having to resort to compromise with other political forces. During this period the leftist-oriented political parties (which in figure 5 are generically labeled as PRD) opposed most of the reforms but were unable to prevent their passage.

In 1997, during President Ernesto Zedillo's administration (1994–2000), the political context underwent a dramatic and important change. For the first time in Mexico's recent history, the governing party failed to achieve a simple majority in Congress, and the country entered an era of divided government. Not surprisingly, this change coincided with the beginning of the period of reform inaction shown in figure 4.

In 2000, for the first time after more than seven decades in power, the PRI lost the presidential election to Vicente Fox, the PAN's charismatic candidate. However, the PAN failed to win either house of Congress, and thus President Fox faced an even more complex situation than had his predecessor. Not only was the PAN unable to approve any reform proposal without support from other parties, but it lacked the PRI's political expertise as well. Not surprisingly, then, the new administration proved incapable of building a majority coalition with other political forces. The result of the mid-term elections in 2003 left the governing

8. This is not to say that economic reform was not debated. In fact, some reform proposals generated a heated debate in the media, and others provoked public demonstrations of opposition.

Figure 5. *Mexico: Results of Presidential and Congressional Elections, 1934–2006*



Source: Nohlen (2005) and 2006 official results from Instituto Federal Electoral (http://www.ife.org.mx) party in an even worse situation, with only 30 percent of the seats in the Chamber of Deputies.

Following a very close presidential election in 2006, Mexico again has a divided government, with the new president, Felipe Calderón of the PAN, facing the same problems that his predecessor, President Fox, did. Nevertheless, as of 2008 two reforms had passed, a public pension reform and a fiscal reform, with the support of both the PRI and the PAN. The fiscal reform, however, is a very weak one, and short of what had been anticipated. An energy reform has been proposed and as of this writing is being heatedly debated in Congress. This reform will probably be either rejected or so diluted as to make it almost irrelevant.

As mentioned above, the new political situation seems to have prevented approval of some important economic reforms that could have contributed to enhancing Mexico's opportunities for economic growth. The next section reviews the performance of some of the reforms that were approved in the 1980s.

Results of Some Previous Reforms

Mexico's recent reform inaction can partly be explained by the apparent lack of effectiveness of the previous reforms in delivering growth. What went wrong? Why did Mexico's economic reforms fail to translate into stronger economic growth? Were they ineffective in terms of influencing the foundations for growth, or were they simply not aimed at influencing them? To answer these questions, we briefly review three of the most important previous reforms in Mexico: trade liberalization, pension reform, and privatization.

Trade Liberalization

In 1985, in the midst of a macroeconomic crisis, the Mexican government announced a unilateral reduction in tariffs on foreign goods as well as the elimination of many trade barriers and import quotas. This surprising move represented a substantial change from Mexico's traditional protectionist policy and marked the beginning of a new trade policy. During the early 1990s, to consolidate this new approach to international trade, the Mexican government signed a free trade agreement, NAFTA, with the United States and Canada. Since then Mexico has established free trade agreements with many other Latin American nations and with the European Union, Israel, and Japan.

The objectives of this reform were the following:

- to improve efficiency and resource allocation in the economy
- to attract more foreign direct investment (FDI) and contribute to generating employment
- to contribute to macroeconomic stability by imposing price discipline through lower import prices, and
- to improve the broad sharing of the benefits of growth by reducing prices of imported goods for everyone.

The reform succeeded in achieving many of its original objectives and, together with the achievement of macroeconomic stability, can be considered as one of the most important reform successes in Mexico. Both trade flows and FDI increased considerably after the launch of NAFTA; prices of imported goods helped keep Mexico's inflation in line; efficiency, resource allocation, and productivity in Mexico's industry improved (see López-Córdova, 2003, and Lederman, Maloney, and Servén, 2005).

However, it is also clear that the high expectations about the impact of trade liberalization in general, and NAFTA in particular, have not fully materialized. The following are some problems with the design and implementation of this reform:

• According to Easterly, Fiess, and Lederman (2003), the main factor contributing to the lack of convergence in income per capita between Mexico and the United States is the weaker quality of Mexico's institutions: the rule of law, government integrity and effectiveness, and regulatory quality. Improvement in these areas could help increase the beneficial effects of trade liberalization.

• Despite passage of several other free trade agreements, Mexico's trade is still highly concentrated in the U.S. market. More than 80 percent of Mexico's exports go to the United States, and close to 70 percent of Mexico's imports come from that country. Inadequate infrastructure, together with high fees and lack of investment in Mexico's ports, undoubtedly played a role in this outcome.

• An unintended consequence of trade liberalization has been increased regional inequality. The northern states, already relatively rich, have tended to benefit the most from greater FDI flows, job creation, and lower income inequality, whereas the relatively poor southern states have benefited little (Esquivel et al., 2002; Borraz and López-Córdova, 2007). Lack of adequate infrastructure and human capital in the southern states largely explain these results (see Esquivel et al., 2002).

To deal with these obstacles, we propose the following steps:

• Implement a general reform of many of the institutional aspects of the Mexican economy, including enforcement of the rule of law and regulatory quality.

• Invest in education and infrastructure in Mexico's southern region to help that region catch up and to generate a better business environment there.

• Improve and reform the operations of Mexico's ports and invest in infrastructure throughout the country. Stronger regulation and application of the antitrust laws in the ports' operation may be needed.

• More generally, an adequate and consistent regional development policy needs to be designed and implemented.

Pension Reform

In 1996 Congress approved a new social security law and a new law governing the retirement savings system. This legislation brought about a radical change in the retirement conditions of formal private sector workers (around 10 million workers at the time the law was passed). Mexico had previously had a pay-as-you-go pension system, where current workers' contributions were used to finance current pensions. However, demographic changes (especially a substantial increase in life expectancy) and problems with the administration of pension funds in the past made it clear that this system would eventually collapse.

The new laws implemented a change toward a scheme based on individual savings accounts. They mandated the creation of specialized pension fund management firms (*administradoras de fondos para el retiro,* or *afores*), which would administer the workers' savings accounts and invest the accumulated resources.

The main objectives of the pension reform were the following:[9]

- to solve the fiscal crisis associated with the previous system
- to provide an opportunity for workers to increase their retirement income through participation in financial markets
- to increase the national saving rate by giving workers a sense of ownership of their retirement savings, and
- to contribute to the deepening of the domestic financial system.

By helping to prevent a fiscal crisis, pension reform played a fundamental role in ensuring macroeconomic stability and was thus indispensable. However, the reform cannot be considered completely successful, since it has not achieved many of its other objectives, and indeed it is not obvious that most workers will benefit from the reform. Many workers will not save enough to pay for the minimum guaranteed pension. Many others perceive that their retirement savings are being eroded by the high fees and commissions charged by the *afores.* The domestic financial system has not improved as a result of the reform, nor has financial intermediation increased. All this seems to be due to a number of problems of design and implementation, including the following:

- The high administrative costs of individual accounts reduce workers' future retirement income. These high costs will eventually lead to a large number of workers being unable to accumulate enough resources to pay for the minimum guaranteed pension, and this will increase the fiscal burden in the future (Sinha and Rentería, 2005).
- The *afores* industry is highly concentrated, and the government antitrust agency claims that these firms seem to be acting in a noncompetitive manner (Comisión Federal de Competencia, 2006). For example, real net returns on accounts managed by the largest firms over the 1997–2005 period averaged a minuscule 0.8 percent a year. Yet the *afores* themselves have been extremely profitable, with returns on equity much higher than those of most Mexican banks (which are quite high by international standards).
- From the perspective of two of the foundations for growth—the broad sharing of the benefits of reform and equality of opportunities—the reform was only

9. See Grandolini and Cerda (1998).

partial: it included only nongovernment workers in the formal sector, leaving out the bureaucracy as well as the 60 percent of the population not covered by any pension scheme.

- The financial system faces inadequate incentives to increase its role in financial intermediation and needs a reform of its own (see below).

We propose the following steps to allow pension reform to better address the growth foundations:

- Promote competition in the *afores* sector. Remove obstacles to entry into this market. Enforce anticompetition laws in the sector.
- Increase transparency concerning the real costs incurred by workers, by requiring *afores* to reveal complete and comparable information about the accounts they manage and about their own risk position.
- Modify the pricing structure in order to better align incentives. Fees should only be charged for account administration and returns to investment. There is no reason to charge fees on either the stocks or the flows of retirement accounts.
- Pursue a reform of the financial sector to increase its role in financial intermediation.

Privatization

In 1982 Mexico began a wide-ranging and ambitious privatization program: by 1988 the government had sold 155 public sector firms, and another 261 by 1995.[10] The first stage of the program focused on relatively small firms, and the second on bigger and more complex operations. Around 98 percent of the total proceeds from privatization were obtained during the second stage. Privatization was part of a more general divestiture program that also included the dissolution, liquidation, merger, and transfer to state governments of many other public entities. The number of public sector entities fell from 1,155 in 1982 to 219 in 1994. The largest privatized firms were Teléfonos de México (Telmex), three banks (Banamex, Bancomer, and Banca Serfín), and two airlines (Aeroméxico and Mexicana). An important infrastructure concession program proceeded in parallel.

The main objectives of the privatization program were the following:

- redefinition of the government's role in the economy
- improvements in efficiency and resource allocation
- a temporary increase in government revenue, and
- a new relationship with the private sector.

Some authors (e.g., Chong and López-de-Silanes, 2005) view the Mexican privatization program as highly successful and beneficial. Although perhaps true in many cases, there were also several cases of mismanagement leading to very poor economic outcomes. The main problem, however, was that the least successful

10. For more details on the privatization reform see Rogozinski (1998).

cases were those related to the largest firms or to key sectors of the economy: examples include telecommunications, banks, ports, and highways. Problems of design or implementation included the following:

- The selection of bidders was often plagued by irregularities and was highly discretionary and opaque. In the case of bank privatization this was documented in a report commissioned by Congress (the Mackey Report).
- Inadequate sequencing was also a problem. In some key cases, privatization took place with insufficient or even no regulation for the post-privatization stage. Again the privatized banks are a prominent example. The absence of appropriate prudential regulation and supervision led to extreme cases of "related lending" (Laporta, López-de-Silanes, and Zamarripa, 2003) and to an uncontrollable credit boom during the early 1990s (Sachs, Tornell, and Velasco, 1996). Both factors played a key role in the 1994–95 tequila crisis.
- In other cases, such as telecommunications and the ports, a public monopoly was transferred to the private sector without an appropriate regulatory and institutional framework. (As discussed later, the federal agency regulating competition was established only at the end of 1993.) In the Telmex case, the results have been relatively high tariffs, predatory behavior, and the abuse of monopoly power (Del Villar, 2007). In the case of the ports, lack of regulation has led to high tariffs, underinvestment, and inefficient operation (Paredes, 2007).
- The National Highways Concession Program was a complete disaster. According to Rogozinski (1998), director in chief of the Office for Privatization, the program "was not a success. Owing to design flaws, costs were higher both during construction of the original design and during the post-construction phase. Fares and traffic volume were merely rough estimates and or were determined at discretion."
- These problems eventually led to the renegotiation of the concessions' original conditions, and the terms of half of the concessions (twenty-six out of fifty-two) were extended to the maximum length allowed. Later, with the onset of the crisis, the government launched an extremely costly road recovery program.[11]
- After the tequila crisis, a large segment of the newly privatized banking sector had to be bailed out. The cost of the bailouts is very difficult to estimate, but some authors put it at nearly 15 percent of GDP. The bailouts were the natural outcome of a grossly mismanaged privatization process and contained important irregularities of their own, according to the Mackey Report. Not surprisingly, the whole process has been questioned for its opacity and abuse of discretion (Haber, 2005).

This brief review indicates that in some key sectors of the economy, privatization was far from successful, and in some cases it was a complete failure, with

11. Guasch (2004) has analyzed the determinants of renegotiation in concession contracts in Latin America. He finds that macroeconomic shocks, the quality of the regulatory framework, corruption, and the timing of elections, among other variables, help explain the probability that a contract would be renegotiated.

negative implications for the whole economy. However, some steps can be taken to reduce these negative effects:

• Improve supervision and regulation in the privatized sectors. In particular, strengthen the supervisory and regulatory capabilities of the National Banking and Securities Commission and the Federal Telecommunications Commission.

• Avoid the renegotiation of infrastructure concessions in the future. Any renegotiation represents a violation of the original terms and conditions, affecting perceptions of the strength of the rule of law.

• Promote greater competition in the privatized sectors and improve antitrust law and its enforcement.

Previous Reforms and the Foundations for Growth

Our review of some of the reforms implemented in Mexico during the 1980s and 1990s has shed some light on why they failed to generate sustained economic growth. Many of the reforms suffered from serious problems of sequencing or implementation, or both. Some failed to have any positive effect on the foundations, and some even had a negative effect.

A prime example is privatization, whose impact on every one of the foundations was negative. Privatization effectively harmed competition in many sectors, because without adequate regulation, private firms with monopoly power could exercise this power without restrictions. The property rights foundation was weakened by the constant renegotiation of contracts in infrastructure concessions and by the opacity and abuse of discretion in many official decisions. The equal opportunities foundation was affected in that privatization did not seek to level the playing field for participants in some of the privatized markets; instead winners were hand picked, resulting in the consolidation of new privatized and export-oriented elites in place of the old statist and import-competing groups (Tornell and Esquivel, 1997). Also, inadequate regulation and supervision of the privatized banks contributed to the 1994–95 crisis and to its worsening, thus affecting the macroeconomic stability foundation. Finally, since the large losses associated with the bank and highway bailouts were socialized, privatization also had a negative effect on the broad sharing of the benefits of growth.

Pension reform also had a negative effect on economic competition and on the broad sharing of growth benefits. The reform gave rise to a highly concentrated market of pension fund management firms (the *afores*), which seem to be extracting enormous economic rents from the fees and commissions paid by millions of workers. Pension reform also seems to have adversely affected the equal opportunities foundation, since workers with similar wages but different degrees of financial sophistication may end up receiving very different benefits in retirement. This outcome is due in part to the complexity of administering this type of resource, but also to the heterogeneity and magnitude of fees and commissions charged by the *afores.*

Table 4. *Mexico: Intended and Actual Impact of Reforms on the Growth Foundations*

Reform	*Property rights*	*Equal opportunities*	*Competition*	*Broad sharing of growth benefits*	*Macroeconomic stability*
Trade liberalization					
Intended		+	+ +	?	?
Actual		~	+	+	+
Pension reform					
Intended	+	+ +		?	+ +
Actual	~	–	–	–	+
Privatization					
Intended	+	+		+	+
Actual	–	–	–	–	–

Key: +, positive; + +, strongly positive; –, negative; ~, mixed; ?, unclear.

Finally, trade liberalization is the only reform that has had positive effects both on the macroeconomic stability foundation and on competition and the broad sharing of growth benefits. However, this reform, too, had some negative effects—both unintended and unexpected—on the equal opportunities foundation, since it increased the already large regional disparities in Mexico.

Table 4 summarizes the effects of each reform on the foundations for growth in Mexico. For each reform, the first row shows the potential effect according to the CGD framework, and the second row the actual effect as described above.

How to Advance the Reform Agenda?

Some additional reforms, if correctly implemented, could have important positive effects, not just by themselves but also by helping the previous reforms have a real and positive impact on the foundations for growth. A careful reading of the implementation and design problems of previous reforms suggests three areas that need to be addressed: the rule of law, competition, and the financial sector. Each of these issues has already been mentioned in the discussion of at least two of the reforms above. For that reason, but also because they may strengthen some of the foundations for growth that have been the most weakened, in the next section we discuss three reforms that could, in our opinion, contribute to generating sustained economic growth.

What Reforms Should Be Pursued?

Three reforms that we consider both important and viable in the short run in Mexico are legal reform, reform of competition policy, and financial reform. Again we stress that the appropriate sequencing of these reforms is important.

Legal and Judicial Reform

The Mexican legal system is well known for its complexity and inefficiency.[12] Its complexity derives from the interaction of the three branches of government (legislative, executive, and judiciary) and the three levels of government (federal, state, and municipal). Its inefficiency is evident in the fact that a large number of cases go unresolved or are subject to extremely long delays before a final decision is reached. In general, complexity in itself should not necessarily be regarded as dysfunctional, since the existence of a diversity of actors, conflicting interests, and institutions is typical of any democracy. In Mexico, however, this complexity reinforces the inefficiency of the legal system. As mentioned above, Mexico's property rights index, which encompasses several aspects of the legal system, has not shown any significant improvement since 1980.

Legal enforcement in Mexico is also weak. This may be due to several factors, including an inefficient judicial structure, lack of resources, lack of independence from the executive branch (at both the federal and the state level), ineptitude, and corruption. Even the Mexican Supreme Court, where eleven judges are responsible for solving the most important disputes in the nation, usually lacks the necessary support of professionals specialized in certain areas. Furthermore, unlike many other countries, Mexico lacks an adequate system of specialized tribunals in economic and regulatory matters, such as competition and regulation. This often leads tribunals to base their decisions on procedural aspects rather than on the substance of the case.

As a federal republic, Mexico has courts at two levels of government: state and federal. Here a recurring problem is the lack of independence of some state courts with respect to the state's executive power. In many cases the court's appointments overlap with gubernatorial terms of office, thus facilitating political intervention. In fact, such overlapping of appointments (the so-called *sexenio judicial*) is prevalent in about half of Mexican states. This situation leads to excessive use of one of the key features of the Mexican legal system: the *amparo.*

The *amparo* is a multifaceted concept in Mexican law that summarizes several procedures designed to protect citizens from the authorities' inappropriate application of the law. Some of these are the following:

- habeas corpus
- the administrative *amparo,* which applies to the first- and second-level judicial review of federal administrative cases, and
- the judicial *amparo,* which serves as the third-level federal appeal for local cases.

Hence the lack of independence of the state courts accounts for the existence of a third-level federal appeals procedure, which leads some cases to drag on for years.

12. See López Ayllón and Fix-Fierro (2003) and Magaloni and Negrete (2000).

Members of the federal judiciary have no incentive to eliminate this appeal procedure, since it allows them to oversee the state courts.

There is also a strong tendency toward excessive use of the administrative *amparos.* These are used mainly in fiscal cases, where individuals dispute tax charges, usually on the grounds that some tax law or regulation violates the definition of equity and proportionality established in the constitution. The overuse of these *amparos* results in severe losses of tax revenue and high administrative costs for the government.

There are two main explanations for the excessive use of this type of *amparo.* First, the Mexican Supreme Court, unlike its counterparts in other countries, has accepted the principle that it should rule on issues of equity and proportionality and has adopted very shallow interpretations of these concepts; in other countries, such as the United States and Spain, the high court may decide on such a basis but only in extreme situations (Elizondo and Pérez, 2006). Second, as a result of an established legal principle called the "formula Otero," *amparos* in Mexico do not establish a general precedent but apply only to the individual filing the case. This leads to the awkward situation where a fiscal regulation may be declared unconstitutional for one or more individuals, but others in the same circumstances still have to pay the tax.

As a result of the growing demand for *amparos* in Mexico, they have become increasingly complex and technical, and thus relatively expensive. As a consequence, they have tended to disproportionately benefit high-income people and large firms (Enrigue, 2006).

Objectives

A comprehensive legal reform in Mexico should aim at the following objectives, among others:

- improved efficiency of the judicial system
- increased predictability of the legal process
- enhanced access of the population to the judicial system
- increased independence of the judicial branch with respect to both the local and the federal executive powers, and
- increased transparency and accountability of the judicial system.

Expected Effects on the Foundations for Growth

Legal reform could have important effects on several of the foundations for growth.

Property Rights. Legal reform could improve the definition and protection of property rights, including greater protection against expropriation without fair compensation, a stronger guarantee of the efficient enforcement of contracts, and better protection for individuals against biased decisions by politically controlled judiciaries. Improving the efficiency and predictability of the legal process could have a significant impact on property rights in Mexico. Mexico has a long tradition of expropriation (the whole banking system was expropriated in 1982, for example), and individuals and firms have usually had limited rights to challenge government decisions.

Equal Opportunities. In principle, all legal systems are designed to protect everyone in society. However, participation in and access to the legal system in Mexico are relatively costly, and therefore access to the system is highly unequal, which in turn reinforces economic inequality. One survey found that 40 percent of Mexicans believe that the law is mainly used to "protect the interest of powerful people." A legal reform that includes a reduction in the cost of access could increase participation, reduce inequality, and increase trust in the legal system.

Competition. The legal system should promote competition by preventing capture of regulatory authorities. It can also increase competition directly by improving efficiency in the enforcement of regulatory rulings, such as those by the federal competition and telecommunications commissions. It may also help to improve the regulatory process and to avoid regulatory capture by dominant firms in specific markets. In fact, empirical evidence shows that the quality of the legal system affects firm size at the state level in Mexico (Laeven and Woodruff, 2007).

Macroeconomic Stability. Since the government loses tax revenue through the *amparos* and spends a fair amount of resources (both monetary and human) in legal proceedings responding to them, a legal reform that would regulate and diminish the incentives for excessive use of *amparos* could improve the fiscal balance, by discouraging tax evasion and reducing the legal and administrative costs of enforcing the tax laws.

Obstacles to Successful Reform

Several obstacles may impede the successful implementation of legal reform and should be taken into account when designing any new reform:[13]

- the poor quality of public property registries: in 2003 the total value of unregistered properties in Mexico was about $245 billion
- extremely long resolution periods in local judicial procedures, and an absence of alternative dispute resolution mechanisms
- strong incentives for excessive use of the administrative *amparo,* as discussed above
- a lack of specialized tribunals with jurisdiction over economic and regulatory issues
- lack of independence of the state courts from the state executive
- absence of an incentive for the federal judiciary to eliminate the federal appeals procedure, and

13. Parts of this section draw on Hernández Ochoa (2006).

• lack of appropriate incentives for local judges to reform the existing dispute resolution mechanisms.

Overcoming the Obstacles

Successful implementation of legal reform will likely require the following steps:

• Reform of the *amparo* law is needed to reduce incentives for the excessive use of both administrative and judicial *amparos.* Stricter criteria for granting *amparos* and stronger sanctions for frivolous lawsuits are also needed.

• *Amparos* could be allowed to set general precedents, eliminating the "formula Otero." This could have important consequences for the Ministry of Finance. All three leading candidates in the most recent presidential election supported this proposal, suggesting that a consensus on this issue can be built.

• The Supreme Court should avoid intervening in matters of equity and proportionality with respect to tax laws and regulations. This authority properly belongs to the legislative power.

• Specialized tribunals in areas such as competition and economic regulation should be created.

• State judicial branches should be granted independence from both the federal judiciary and state executive authorities. The simultaneous appointments of court members and state executive authorities should be eliminated.

• Public property registries should be modernized and updated with the latest technology. This is critical for adequate property rights protection and may provide greater certainty in some economic transactions.

• The civil and commercial procedure codes should be reformed to allow different tracks for simple and complex cases.

• Alternative dispute resolution mechanisms should be introduced, to reduce the cost of access to the legal system and shorten judicial delays. For example, commercial arbitration mechanisms and conciliation procedures could be used in the initial stages of disputes.

Competition Policy Reform

In December 1992 Congress promulgated the Federal Law of Economic Competition (Ley Federal de Competencia Económica, or LFCE).[14] This law mandated the creation of the Federal Competition Commission (Comisión Federal de Competencia, or CFC), which began operating in 1993. The CFC is the Mexican federal agency in charge of competition policy, including the investigation of anticompetitive practices, the supervision of vertical and horizontal mergers, and the defense and promotion of competition in the economy.

From the outset, the appropriate level of autonomy of the CFC has been subject to debate. One option was to create an administrative entity within what is

14. Parts of this section draw on a background paper prepared by Marcos Avalos.

now the Ministry of Economy. This ministry, however, had a reputation for being protectionist, and some feared that it might tend to protect strong local monopolies as part of an industrial policy program. Another option was to create a completely autonomous competition authority, but no consensus could be reached. As a compromise, the CFC has been since its creation an administrative entity associated with the Ministry of Economy, but enjoys technical and operating autonomy.

Objectives

The main objective of the LFCE is to increase the overall efficiency of the economy. To that end, the law seeks to generate the appropriate conditions for effective competition. It tries to protect and promote competition through the prevention and elimination of monopolies, monopolistic practices, and other restrictions that may hinder the efficient operation of markets. In some aspects the LFCE acts as a regulatory law, for example when evaluating whether vertical or horizontal mergers should be allowed. In other instances the LFCE is not strictly speaking a regulatory law, in that it can only be applied ex post, after a company or industry has violated some aspect of the competition law.

In applying the LFCE, the CFC interacts with other government agencies and regulatory bodies and must take into account many other Mexican laws and regulations with important implications for economic competition. These laws and regulations must be applied along with the LFCE.

In 2004 the Organization for Economic Cooperation and Development reviewed the performance of Mexico's competition policy during its first decade of operation. The study (OECD, 2004) found that the CFC had been relatively successful: "The accomplishments of the Commission have been noteworthy . . . taking into consideration the harsh conditions under which the Commission operates." In recent years, however, the juridical and organizational framework governing competition policy in Mexico started to show some weaknesses. Implementation of the LFCE also began to encounter problems when a series of judicial rulings revealed deficiencies in the law, in terms not only of its procedures but also of its constitutionality. This situation led to a proposal to modify the legislation, and a new LFCE was approved by Congress in mid-2006. This reform had three main objectives:

- to make the CFC's recommendations (in terms of regulations, norms, and policies) binding on public sector institutions
- to strengthen the CFC's authority to sanction anticompetitive market behavior
- to solve certain procedural deficiencies.

The reform solved many of the problems identified under the old LFCE, but the law remained far from perfect. In the next section we discuss how this reform may affect the foundations for economic growth, and we identify some problems of design and some local factors that may undermine its success. Finally, we discuss some proposals that could improve the economic impact of this reform.

Expected Effects on the Foundations for Growth

As previous studies have shown, competition policy can enhance the intensity of competition in an economy and thus have a positive effect on economic growth. For example, Krakowski (2005) showed that competition policy strengthened economic competition in a sample of more than 100 countries; Dutz and Hayri (2000) showed that the intensity of competition is positively associated with an economy's rate of growth. Other studies have shown similar effects of competition policy on economic growth, employment rates, the level of FDI, and income distribution (OECD, 2006).

In terms of the CGD framework, competition policy reform could have a direct effect on three of the five foundations: economic competition, equal opportunities, and property rights. It could also have an indirect effect on the broad sharing of growth benefits.

This reform, if successful, will have a positive effect on economic competition in Mexico, by guaranteeing the existence of competitive markets and adequate rules for a competitive economic environment. Today, the absence of effective antimonopoly legislation allows firms with monopoly power to exercise it in ways that reduce both social welfare and economic efficiency. By strengthening the CFC and adjusting the LFCE to make it more effective, competition policy reform could increase competition, thereby having a positive impact on one of the main foundations for growth.

Competition reform would also benefit the equal opportunities foundation. The LFCE is designed to protect producers in cases where the behavior of one or more competitors puts competition at risk. In other words, it does not protect producers if they lose market share because of lack of efficiency or innovation, but only when they are being affected by anticompetitive behavior. A successful reform would level the playing field for all competitors in markets where the absence of an effective competition policy allows dominant firms to engage in anticompetitive behavior.

If successfully implemented, this reform could also have a positive effect on the competition, equal opportunities, and property rights foundations in several key regulated sectors. This is a major issue since many of the CFC's opinions on the regulations, procedures, legislation, and norms established by some regulatory authorities have been highly controversial. More important, the regulatory authorities were not obliged to abide by the opinions or recommendations of the CFC.

Under the new law that was approved in 2006, the CFC's opinions regarding the effects on competition of government programs, proposed legislation, or policies became binding for these public sector institutions. Also, the regulatory framework of various sectors of the economy now requires a favorable opinion from the CFC as a prerequisite for the authorization of concessions, permits, or transfer of rights. Since the implementation of the LFCE, laws in key sectors such as telecommunications, commercial aviation, airports, toll roads and bridges, transportation vehicles, and natural gas have been modified, so that any deregulation or privatization initiative in these sectors now requires the approval of the CFC.

In addition, the relevant federal regulatory agency will control rates if the CFC rules that the effective level of competition is insufficient. Finally, some laws now require that potential bidders for public services franchises obtain the approval of the CFC. For all these regulated sectors, an efficient CFC and an effective implementation of the LFCE are key to promoting competition, leveling the playing field for participants, and protecting the rights of those already involved in (or wishing to enter) these markets.

Finally, the effectiveness of competition policy could also have had a positive effect on the broad sharing of growth benefits, since it is expected that enhancing competition in key sectors of the economy will have a disciplinary effect on prices and on product quality, thus making it likely that larger segments of the population will participate in some of these markets.

Obstacles to Successful Reform

Some possible obstacles to and constraints on successful reform are the following:

• *An institutionally weak competition agency.* The CFC's ability to promote and protect competition is deeply constrained by several factors: a lack of full institutional autonomy, which could result in its capture by other government agencies; inadequate financial autonomy, which increases the risks of inefficient implementation of competition policy; and lack of clarity in the allocation of responsibilities between the CFC and some other regulatory agencies, such as the Federal Telecommunications Commission.

• *Lack of an appropriate design for collecting relevant market information.* As mentioned above, one of the main tasks of the CFC is to investigate possible monopolistic practices. There are two ways in which the CFC can begin a formal investigation of such practices. The first is by formal accusation (*denuncia*) by a firm operating in the relevant market that considers itself harmed by the practices of another market participant. The second is by the CFC initiating its own ex officio investigation if it considers that a firm is engaging in monopolistic practices.

Table 5 shows the number of monopolistic practices investigations, both those following accusations and those undertaken ex officio, since 1993. Between 1993 and 1997, the numbers of accusations and of ex officio investigations were almost equal (72 and 70, respectively). Since 1997, however, investigations stemming from accusations have far outnumbered ex officio investigations (380 versus 87).

Table 5. *Mexico: Results of Investigations into Anti-Competitive Behavior, by Type of Procedure, 1993–2006*

		By accusation			*Ex officio*		
			Investigations resulting in sanction or recommendation			*Investigations resulting in sanction or recommendation*	
Period	*Total investigations*	*No. of investigations*	*Number*	*Percent*	*No. of investigations*	*Number*	*Percent*
1993–94	30	19	4	21.1	11	6	54.5
1994–95	16	6	1	16.7	10	6	60.0
1995–96	27	14	5	35.7	13	10	76.9
1996, 2nd half	17	8	0	0.0	9	2	22.2
1997	52	25	2	8.0	27	13	48.1
1998	50	33	9	27.3	17	5	29.4
1999	41	26	3	11.5	15	6	40.0
2000	63	55	7	12.7	8	4	50.0
2001	64	46	6	13.0	18	7	38.9
2002	68	59	20	33.9	9	3	33.3
2003	38	33	6	18.2	5	0	0.0
2004	42	34	6	17.6	8	2	25.0
2005	62	58	9	15.5	4	2	50.0
2006	39	36	1	2.8	3	2	66.7
Total	609	452	79	17.5	157	68	43.3

Source: Comisión Federal de Competencia (2007a), statistical appendix.

The fact that a much smaller fraction of accusations (17.5 percent) than of ex officio investigations (43.3 percent) result in sanctions suggests that such an imbalance may be undesirable and inefficient. It also suggests that the CFC lacks adequate criteria to establish its own priorities.[15]

The main problem with ex officio investigations is that the ability to gather the necessary information then depends on the competition agency's own capacity, rather than on that of consumers or competitors. The CFC uses three sources of information to detect anticompetitive practices: indirect sources, such as newspapers, magazines, and Chamber of Commerce bulletins; suggestions by the Ministry of Economy; and information given in an accusation. The CFC gathers information for specific cases but does not have a permanent monitoring system for gathering information on monopolistic practices.

- *Lack of consideration of efficiency gains.* One crucial aspect of the application of competition policy to mergers is the potential for efficiency gains. This is not a minor point: many competition authorities around the world focus on efficiency gains when discussing merger activity. Therefore it is important to explicitly include efficiency criteria in the Mexican LFCE, because even if legislation does consider the possibility of efficiency gains, the law is not clear on this point and lacks specific evaluation criteria to prove the existence of these gains. In fact, empirical evidence suggests that Mexican merger policy involves the delicate balancing of anticompetitive effects against possible efficiency gains (Avalos and De Hoyos, 2008). In assessing this trade-off, the antitrust authority often relies on very limited and imperfect information, since not only is the evaluation of market power inherently imprecise, but the merging parties usually have better information on the potential efficiency gains than the regulator. Although the merger review process is designed to extract as much information as possible from the parties involved, it is reasonable to assume that some asymmetries remain.[16]
- *Lack of a specialized legal system.* Mexican courts lack experience in implementing competition policy. In general, judges lack economic training and, specifically, training in specialized areas such as competition and economic regulation.
- *Procedural deficiencies.* A crucial aspect of competition policy is how the competition law is implemented. In the United States, for example, the competition authorities evaluate the possible anticompetitive aspects of mergers and other practices and then take their case to the courts, which are the ultimate decision-makers. In contrast, in Mexico the CFC may issue a sanction or a fine in the first

15. Davies and Driffield (1998) report that in the case of the U.K. Monopoly and Merger Commission, ex officio investigations have priority over accusations.

16. In practice, most mergers claim to achieve some efficiency gains, or "synergies." Fisher (1987) argues in favor of establishing very high standards for proving such gains and cites examples where these gains were claimed but did not materialize.

instance, after which the CFC allows the sanctioned firms to appeal the decision. This device used in the appeal is an administrative, not a legal, procedure, under which the CFC must review its own decision and then decide whether to ratify, modify, or revoke it. If the CFC decides to ratify or modify the original resolution and the sanctioned firm remains unsatisfied, it can resort to a legal process called *juicio de amparo* (judicial review) through the local district court. However, this court may only challenge the legality or constitutionality of the commission's decision, not the merits. In any event, the court can give the firm an *amparo,* which suspends the application of the resolution. This process can take a long time (five to seven years),[17] during which the CFC may not apply its resolution until the court decides either to ratify it or to challenge its constitutionality. The whole procedure is very costly and slow and absorbs a substantial amount of the CFC's resources. Not surprisingly, this device has basically become a mechanism for delaying enforcement.

• *Further delays in the judicial process.* Besides seeking a *juicio de amparo,* firms can challenge a ratified resolution by presenting a formal appeal to the Federal Tribunal of Fiscal and Administrative Justice (Tribunal Federal de Justicia Fiscal y Administrativa, TFJFA). These two alternatives have been used more intensively in recent years as a way of avoiding the effective application of fines by the CFC. Not only can the sanctioned firm contest the fine in the administrative court, but the court can also evaluate the internal proceedings and the competition analysis that justified the fine. Thus, the TFJFA has become an additional step in the review of competition proceedings. This generates a vicious circle, where the revision by the TFJFA generates additional paperwork, unnecessarily drawing out the procedure and reducing the efficacy of the CFC's system of fines. The fact that judges lack specific training on competition issues gives firms even stronger incentives to appeal, using either of these two legal channels. This has slowed the implementation of competition policy in Mexico.

Overcoming the Obstacles

The following proposals may improve the effectiveness of competition policy reform:

• *Grant full autonomy to the CFC.* This should include financial autonomy, under which the CFC would request its own budget. Greater autonomy would make the CFC less vulnerable to capture by other government agencies.[18]

• *Create a specialized court.* A court specializing in economic issues, and competition and regulation in particular, is necessary for the proper implementation

17. Sometimes it can even take longer. For example, judicial review in the case of the CFC versus Telmex (the dominant firm in the telecommunications sector) took almost ten years.

18. There are several examples of autonomous competition authorities in less developed countries, including El Salvador and Honduras (Rivera and Schatan, 2008).

of competition policy. Such a court would offer many benefits in the implementation of competition policy, since it would eliminate long and costly administrative procedures and free up human, physical, and financial resources at the CFC. This court could be designed in a manner similar to Chile's Tribunal for the Defense of Free Competition.

• If the preceding recommendation is not possible or would take too long to implement, two others could be considered. The first would *internalize judicial risks in the design and implementation of competition policy.* In practical terms, the judicial system is the main obstacle to an effective competition policy. In the infamous Telmex case, the judicial process obstructed the proper implementation of competition policy through procedural delays and through judicial protection mechanisms (*amparos*). This case shows that there is always the risk that a case will become stalled in the judicial system, rendering the CFC ineffective. Legal problems have also limited the collection of fines: only 10 percent of fines due have been paid since the CFC's creation. This is disturbing, since fines are an important disincentive to monopolistic practices. The lesson is that judicial risks should be internalized in the design and implementation of competition policy. For example, if monopolistic predatory pricing is difficult to prove in a given case, the competition authority must opt for a different approach.

• *TFJFA proceedings should not constitute a review of LFCE procedures.* The TFJFA is not a specialized entity in anticompetitive policies and does not have any formal authority in those matters, according to Article 28 of the constitution. Therefore its use as a mechanism for reviewing LFCE procedures should not be allowed.

• *Improve the mechanism for conducting investigations of monopolistic practices.* A monitoring system for the generation and gathering of information on monopolistic practices should be created. Investigation of these practices should switch from the present reactive policy to a proactive one. At present the following are the main criteria used to determine whether to conduct an investigation: probability of success; the pursuit of certain anticompetitive practices that economic agents themselves have not reported; and the number of cases that the CFC can handle. This organizational scheme must be changed; the competition agency should be able to define priorities in order to carry out relevant ex officio investigations.

• *Define appropriate and specific methodologies.* Little is known about the evaluation criteria or the weight given to each variable in the decisions of the competition authority. Competition policy can hinder rather than foster economic activity if it increases transaction costs for both the government and economic agents. For instance, in trying to evaluate the potential efficiency gains of a merger, the CFC faces two limitations. The first is asymmetric information, in that the companies proposing the merger have an incentive to overestimate how much the merger will reduce marginal costs. The second is that the CFC lacks the instruments and the methodology to estimate marginal costs on its own and to accurately evaluate the likely efficiency gains of a merger. The commission should take a more assertive stance on this matter and not leave the corroboration of these possible gains to the companies. Since its creation, the CFC has taken steps to improve its methodology, but it has not yet developed the advanced quantitative techniques that would help it make better decisions.

Financial Sector Reform

Financial sector reform in Mexico is essential, because it has the potential to improve several of the weakest foundations for growth simultaneously, in particular the broad sharing of growth benefits, equal opportunities, and competition. The impact of this reform would be enhanced if it were preceded by legal and competition policy reform along the lines discussed above. These reforms are thus complementary; however, we believe that some measures can be taken independently.

Mexico has already been through several stages of financial reform. The previous reforms, however, were motivated by either macroeconomic stability or financial deregulation concerns. The first set of reforms sought the deregulation of the sector and included the privatization of banks, as discussed above. The second was launched in reaction to the tequila crisis and included the recapitalization of banks, improvements in prudential regulation, and new legislation oriented toward securing property rights and improving contract enforcement (in particular, the ability to foreclose on collateral).[19]

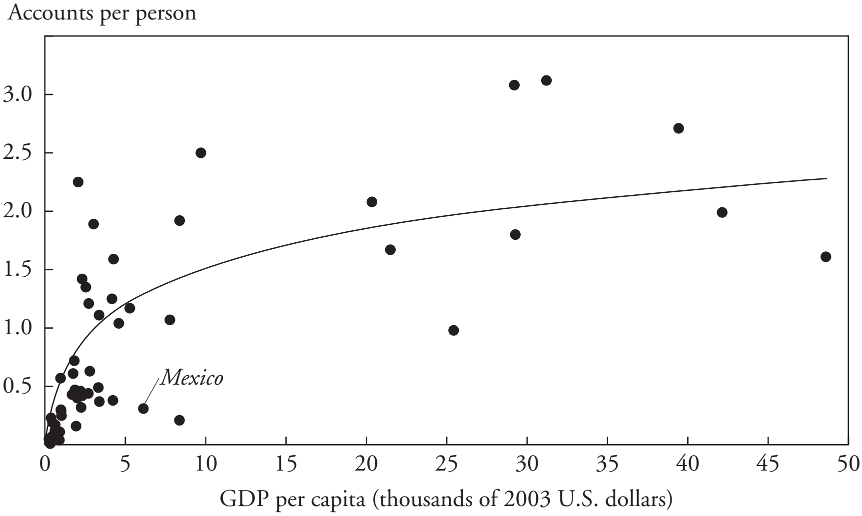
As already mentioned, the first set of reforms actually had negative effects on several important foundations for growth, such as macroeconomic stability, economic competition, and property rights. Neither set of reforms impinged in any significant way on the broad sharing of growth or on equal opportunities. Thus, financial reform to date cannot be considered successful, since it has not had a positive influence on the foundations for growth.

The financial sector in Mexico today is characterized by inadequate access and low financial deepening. In what follows we focus on the banking sector, which is still the most important source of financing and intermediation for the private sector (Stephanou and Salinas, 2007).

In terms of access, Mexico's financial sector ranks near the bottom worldwide. In a recent study (Beck, Demirgüç-Kunt, and Honohan, 2008) that measured financial access as the share of the adult population with access to an account with a financial intermediary, Mexico ranked 101st out of 157 countries, with just 25 percent of adults having access to an account. Among upper-middle-income countries (by the World Bank classification), Mexico has the lowest level of finan-

19. See Aspe (1993) and Murillo (2005) for a description of the first and second reform stages, respectively.

Figure 6. *Prevalence of Deposit Accounts and GDP per Capita, 2003–2004*



Source: Beck, Demirgüç-Kunt, and Honohan (2008), table A.2.

cial access of any country except Romania, and Mexico is well behind many other countries with lower income per capita.

A second measure of access to financial services is the number of deposit accounts per 1,000 people. According to Beck et al. (2008), Mexico's figure of 300 accounts per 1,000 is below that for many poorer countries, such as Guatemala, Ecuador, and El Salvador (around 400 per 1,000), about half that of Brazil and Colombia (600 per 1,000), and far below that of Chile, which has as many accounts as people. Figure 6 shows that Mexico has only about one-fourth the number of accounts that one would expect given its income per capita. Only Saudi Arabia performs worse on this measure.

Access to the banking sector in Mexico is not just a problem on the deposit side; there are also important problems both on the credit side and in the system of payments. Unfortunately, there are no comparable data available on the number of loans per capita. However, cross-country data on banking credit to the private sector show that although credit has started to increase in recent years, and is now around 22 percent of GDP, it is still only about half what one would expect given Mexico's income. In addition, 70 percent of localities in the country do not have a formal bank branch, which means that nearly 30 percent of the population lacks convenient access to any kind of financial service.

What explains this poor performance? The short and most popular answer in Mexico is that the banking sector is highly concentrated, not very competitive, and highly profitable, extracting economic rents from bank users. We present below some empirical evidence regarding these claims.

Table 6. *Mexico: Concentration in the Banking Sector, 2007*
Percent

	Share accounted for by		
Indicator	*Two largest banks*	*Four largest banks*	*Six largest banks*
Assets	43.7	68.9	82.2
Deposits	43.4	70.6	85.9
No. of branches	36.6	62.7	84.2
Income from fees[a]	54.7	81.8	93.8
Credit cards issued[a]	67.7	87.3	92.5
Consumer credit	52.0	77.2	87.7
Profits	55.4	80.0	92.1

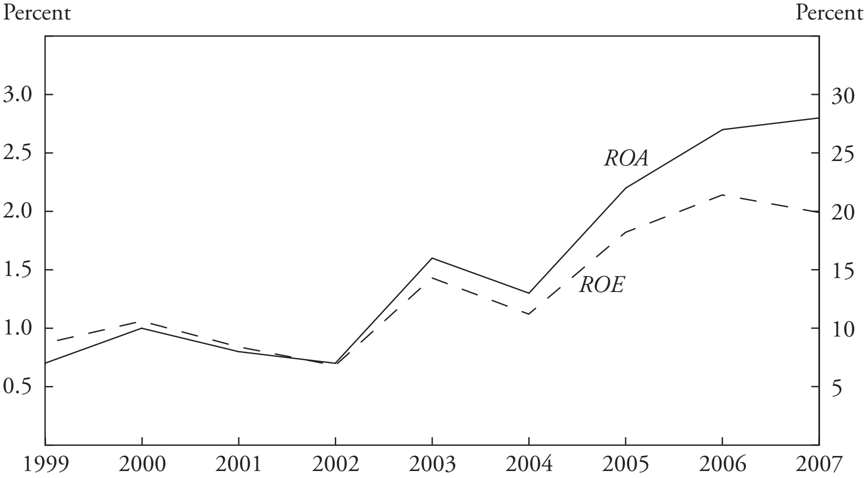
Sources: National Banking Commission and Banco de México.
a. Data are for 2006.

Concentration. The Mexican banking sector is indeed highly concentrated. Although thirty-nine banks now operate in the country, the two largest control around half of the sector (table 6). The four largest banks account for around three-quarters of the sector, and the six largest for almost 90 percent. Although some other countries have concentration measures as high as or even higher than Mexico's, few of these countries are of comparable size or level of development.[20]

Competition. Of course, high concentration does not necessarily imply lack of competition. The generalized perception in Mexico, however, is that the banking sector is insufficiently competitive. This is supported by a recent report (Banco de México, 2007) suggesting that at least some important segments of the banking sector do not behave in a manner consistent with competition.[21] The study analyzed the degree of competition in the bank credit market by type of loan (consumer, mortgages, and commercial) from 2000 to 2005 and found that the intensity of competition across these types of loans is not homogeneous. In particular, for at least one type (consumer credit), the researchers could not reject the hypothesis of perfectly collusive behavior, and for another (commercial credit) they could not reject the hypothesis of monopolistic competition. The only segment of the market that seemed to behave competitively was the mortgage credit market. Avalos and Hernández-Trillo (2008) have argued that this segment of the market has faced increasing competition from nonbank entities (the so-called SOFOLES). As these authors show, mortgage rates have declined substantially in recent years as competition between banks and other financial intermediaries has intensified.

20. See Caprio, Levine, and Barth (2007) and CFC (2007b).
21. See also Negrín et al. (2008) and Solís (2008).

Figure 7. *Mexico: Profitability of the Banking Sector, 1999–2007*



Source: Comisión Federal de Competencia (2007b); authors' estimates.

Profitability. The perception that Mexican banks are highly profitable is not without basis. Figure 7 shows two standard indicators of profitability for the banking system, return on assets (ROA) and return on equity (ROE), for 1999–2007. The figure shows good levels of profitability and, more important, a rising trend in the past few years. By way of comparison, Negrín et al. (2008) show that average ROA in 2000–03 and 2004–06 for a sample of emerging market economies was close to 1.0 and 1.8 percent, respectively, below the ROA for the Mexican banking system in those same periods (CFC, 2007b).

The high degree of concentration in Mexico's banking sector and the lack of competition in certain segments of the credit market certainly help explain the recent increase in the sector's profitability. To see how these aspects are related, however, we need to consider two additional pieces of information: interest rates by type of loan and the composition of banks' loan portfolios.

The implicit average interest rate on consumer credit is almost three times that on mortgage and commercial loans (28.4 percent versus 10.4 and 9.9 percent, respectively). The difference in total costs, which include bank fees, between consumer credit (on credit cards) and mortgage credit is even greater: 47 percent versus 13 percent.[22] Of course, part of this difference is due to the higher risks and operating costs associated with consumer credit; however, lack of competition in the consumer credit subsector could also be playing a role, as suggested by the CFC (2007b).

22. Data are for April 2007. For more details see CFC (2007b).

In terms of portfolio composition, it is interesting to see how the Mexican banking sector has switched substantial resources away from commercial and mortgage loans and toward consumption lending (the segment in which the sector seems to behave collusively). This segment, which used to represent about 5 percent of the banks' total loan portfolio, now accounts for about one-third.

To sum up, more resources are now devoted to consumer loans, where banks usually charge much higher fees and interest rates, resulting not only in a highly profitable banking sector, but also in one where commercial lending has lost relevance and where social exclusion is still quite important. In that sense the banking system does not seem to be contributing to the development of the economy; this alone could justify a new financial reform.

Objectives of the Reform and Their Impact on the Foundations for Growth

Financial reform should seek to achieve the following objectives:

- Enhance competition (which in turn could have positive effects on competition in many other sectors).
- Increase access to both sides of the industry (deposits and loans), without compromising financial stability.
- Improve conditions of access to financial services and, more important, level the playing field with respect to access to financial resources.

As already mentioned, financial reform along these lines could have a positive effect on the following foundations: broad sharing of the benefits of growth, equal opportunities, and greater competition. Appropriate prudential regulation and supervision are also important, so that achieving these objectives does not harm the macroeconomic stability foundation.

Achieving the above objectives will undoubtedly have positive effects that go well beyond the financial sector. Indeed, financial sector reform can be considered a prerequisite to faster economic growth.[23] For example, providing greater and better access to financial resources for small and medium-size firms may contribute to reducing the gap between these and larger firms, which can usually borrow on better terms or in foreign financial markets. In fact, many large nonexporting companies are also in need of domestic currency credit. Leveling the playing field for small and medium-size firms is therefore crucial so that these firms can not only survive, but also invest and grow and become more competitive in their own sectors (Beck and Demirgüç-Kunt, 2006).

For microenterprises, the fact of access to financial resources may be even more important than improving the terms of that access. Most microentrepreneurs (60.8 percent) seeking start-up capital resort to their own savings; other sources of credit include savings and loan institutions (15.7 percent), friends and relatives

23. See, for example, Aghion, Howitt, and Mayer-Foulkes (2005).

(13.7 percent), carryover business capital (5.1 percent), moneylenders (2.1 percent), and suppliers and clients (2.0 percent). Only 0.6 percent seek financing from commercial banks.[24]

Obstacles to Successful Reform

At least three main local constraints or obstacles stand in the way of successful reform: the judicial system, competition policy, and the potential for misguided diagnosis. We review each of these in turn.

The Judicial System. The inefficiency and corruption of the judicial system threaten to undermine the efficacy of financial reform. Reform is likely to have better results if it is accompanied by a properly functioning judicial system.

An appropriately designed financial system will have a strong influence on the protection of property rights. Making this happen will require not only sound law but also the ability to enforce it. For example, when extending a loan, a bank needs a strong legal and judicial system in order to be able to seize collateral in case of default. Most banking and financial transactions take the form of contracts, which the judicial system has to be efficient at enforcing. This is particularly important in situations of financial distress, when interest rates may become more volatile and financial risks increase. The protection of property rights and the efficiency of the judicial system are therefore essential conditions for financial reform to be effective.

The recent literature on financial reform emphasizes the relationship between financial and legal institutions. For example, Laeven and Majnoni (2005) found that an efficient judicial system helps reduce the costs of credit. Beck, Demirgüç-Kunt, and Maksimovic (2005, 2006) found that the interaction between legal and financial variables explains firm size in a sample of countries, and that weakness in these variables may act as a constraint on the growth of small and medium-size firms. The interaction between financial reform and judicial reform is important for leveling the playing field for smaller firms.

Competition Policy. A strong CFC would be very helpful in implementing financial reform in Mexico, since it may have to confront one of the most important, concentrated, and powerful sectors of the Mexican economy: the banks. A weak CFC could become an obstacle to successful implementation. It would therefore be highly desirable to proceed with financial reform only after competition policy has been reformed along the lines discussed above. This, however, should not become an impediment to proceeding with this reform.

Errors in Diagnosis. A wrong, incomplete, or misguided diagnosis of the situation could lead to a poorly designed reform. Enhancing competition in the consumer credit market is a necessary but not sufficient condition for this reform to be successful. Although improving the conditions of consumer credit is important

24. For more details see Hernandez-Trillo, Pagán, and Paxton (2005).

in and of itself, another fundamental issue should not be overlooked, namely, the need to promote, through appropriate market incentives and regulations, the channeling of additional resources toward productive and profitable projects of small and medium-size firms. This is probably one of the most important channels through which the financial sector can have an effect on economic growth, and it should not be underestimated.

Promoting competition in the financial sector actually has several dimensions that should be addressed simultaneously: promoting interbank competition, creating a more pro-competitive environment within the banking sector, and promoting competition between banks and nonbank institutions in certain areas. The last of these is critical, since there is evidence, both international and domestic, that when nonbank institutions are able to contest the monopoly power of banks, margins are reduced and banks behave more competitively. This was the case in the United States (Allen and Santomero, 2001), where pension and investment funds have been the main competitors with banks in recent decades. A similar situation occurred recently in Mexico, where the appearance in 1996 of the institutions known as SOFOLES led to a substantial reduction in mortgage interest rates (Avalos and Hernández-Trillo, 2008).

A multidimensional approach to the promotion of competition in the financial sector is justified not only by the evidence described above, but also because competition is necessary to reduce banks' incentives to use their resources in a manner that is relatively unproductive in terms of social welfare. Almost two-thirds of the profits of the Mexican banking system between 1999 and 2005 came from fees, commissions, and investments in securities (mainly government bonds), and only about one-third from interest on loans. Of the latter, almost 70 percent came from consumer credit, where credit cards are the most important instrument. This means that banks have restricted their activities to those that are either risk-free (securities) or risky but highly profitable (consumer credit). This behavior has undoubtedly taken a toll on commercial credit, which has largely disappeared from bank portfolios.

Of course, such behavior is absolutely rational and consistent with the incentives and regulation that banks face. For that reason, competition must be promoted on many fronts so that banks return to their original role as financial intermediaries between savers and firms willing to carry out productive and profitable projects.

Overcoming the Obstacles

What needs to be done to achieve the objectives of reform and to avoid the obstacles just identified? We offer the following specific suggestions:

• *Promote competition throughout the financial sector,* and specifically in commercial and consumer bank credit. In general, this competition should come from various sources: from a larger number of banks, from a more pro-competitive environment within the banking sector, and from nonbanking institutions. The following are specific proposals in this direction.

- *Reduce barriers to entry.* Even after a recent 11 percent reduction, Mexico's initial capital requirements for new banks remain among the highest in the world, at around $330 million. As the CFC (2007b) has noted, this is about nine times the amount required in Canada, five times that in Europe, four times that in Chile and Brazil, and more than twice that in Japan. Although the so-called niche banks now have separate requirements starting as low as $130 million, this is still a high figure and may act as an important barrier to entry.
- *Develop an appropriate framework of regulatory and prudential supervision for niche banks.* This new type of bank was approved with a modification to the Law of Credit Institutions in mid-2006. However, as of May 2008 the financial authorities had not yet developed an appropriate regulatory framework for these institutions. As a consequence, although many applications have been submitted, none has yet been approved. It is urgent that the appropriate regulatory framework for these banks be put in place.
- *Improve the competitive environment in the banking sector.* This could require a much more decisive intervention by the competition authorities on issues such as collusion in the consumer credit market, as well as in the determination of banking fees, which today appear quite high. If the competition authorities are unable to intervene directly and establish sanctions for noncompetitive behavior in this sector, because of the absence of further competition policy reform, then compelling testimony on this issue like that offered in CFC (2007b) could be very helpful in convincing the financial authorities to intervene.
- *Promote the development of nonbank financial institutions.* It has been shown that when banks face competition, either from other banks or from other financial intermediaries, they react as one would expect: they reduce their margins and compete on the basis of both price and quality of service. It is therefore essential to promote the development of new financial institutions.
- *Eliminate or reduce monopoly power in certain activities.* For example, there seem to be important barriers to entry into specific activities such as credit card issuance and government bond sales. Recently, some retail stores such as Wal-Mart have opened their own banks in order to participate in the consumer credit market, and in particular the credit card market. Although this outcome is desirable from the point of view of greater competition, it raises an important question: should it be necessary to become a formal bank in order to get access to the credit card market? We believe that lowering barriers to entry into the credit card industry is necessary. A similar story applies to government bond sales. Most financial institutions require a minimum purchase of between $30,000 and $50,000. Of course, this excludes small savers from the market, who must then purchase mutual funds, where high fees and commissions are charged, in order to participate. Here a scheme similar to that in the United States could be imple-

mented, where government bonds are sold even over the Internet and participants can invest as little as $1,000.

Conclusions

In this chapter we have analyzed the relationship between economic reform and economic growth in Mexico. We have discussed why some of the reforms of the 1980s and 1990s might have failed to generate rapid and sustained economic growth. We argue that the main reason was that some of the reforms did not positively affect the foundations for growth in Mexico, either because they were not intended to do so or because they failed in their design or implementation. That was the case with both privatization and pension reform and, to a much lesser extent, with trade liberalization. These outcomes, together with a negative popular perception of the reforms and the emergence of a more complex political environment, have given rise to reform inaction and reform fatigue in Mexico since the late 1990s.

The second part of the chapter analyzed how this inaction might be overcome, and how some specific reforms might help to restore economic growth in Mexico. We proposed and discussed reforms in three areas—legal reform, competition policy reform, and financial reform—that we believe are politically viable and that should positively affect the weakest foundations for growth in Mexico. These reforms, besides being relevant in their own right, may also help some of the earlier reforms work better. The proposed reforms may also interact with and reinforce each other, and together they could have a positive effect on the foundations for growth of the Mexican economy.

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