

THE BROOKINGS INSTITUTION

BEYOND THE CRISIS?
THINKING STRATEGICALLY ABOUT MEXICO'S ECONOMIC FUTURE

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PARTICIPANTS:

Welcoming Remarks and Introduction:

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Keynote Address:

LUIS ALBERTO MORENO
President
Inter-American Development Bank

AMBASSADOR ARTURO SARUKHAN
Ambassador of Mexico to the United States

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PROCEEDINGS

MR. CARDENAS: My name is Mauricio Cardenas and I'm the director of the Latin America Initiative here at the Brookings Institution. It is a great pleasure for us to have this event today co-sponsored by the Inter-American Dial -- the Inter-American Development Bank. Sorry. This was an idea that came through conversations with Santiago Levy. Santiago and I have been thinking about the long-term issues for Mexico and we thought that putting together this conference was an important contribution to that debate.

So, we invited a group of scholars that are thinking about these issues with the purpose of elaborating a little bit on the agenda for Mexico into the medium and long term. Ambassador Sarukhan was also very supportive of this idea and we thank him for that. This has been also worked with a great degree of collaboration from the Mexican Embassy.

I would say just to motivate a little bit what we're going to be doing today that Mexico is an economy that has many features. And in the past year or so some of those features have been emphasized more than others, and, in particular, the issue related to the problems of security, the tremendous effect of the global recession in Mexico last year. But if you go beyond that you see many, many other shades in that landscape. And the other aspects of the Mexican economy that are worth highlighting is first of all there is a more diversified economy than many others in Latin America. It has a very strong private sector, a private sector that does not depend on a particular form of subsidies or support from the government. That has access, direct access, to the international financial markets. That's a key distinction from other countries in the region. And very importantly, has a very strong and special relationship with the U.S.

Just to give you an idea, the share of Mexican exports in the U.S., total our imports, is about 12 percent and has been growing in the past few years. Mexico has gained market share in the U.S. relative to countries like Germany, the U.K., Japan, South Korea. And that is remarkable. But yet Mexico's economy has been underperforming, not just in the context of the recent global recession, but in the more medium-term perspective. During this decade, the first decade of the century, Mexico's GDP growth was relatively low, less than 2 percent on average, when the rest of the region was booming. And that, of course, poses some important questions as to why was that

happening. Why is it that Mexico's economy lost some of the steam that it had during the '90s when GDP grew at a much faster rate?

So these are the questions. And I guess the purpose is to go beyond some of these very general answers that you hear in the policy debate and in the media here in the U.S. and elsewhere when these issues are discussed. You hear that Mexico has a long pending agenda of structural reforms, but then there's not much detail about what are the specifics of those reforms. What is it that needs to be done and in what order and why? And these are some of the questions we want to ask today. To put it in other terms, if there are constraints to economy growth, which are the ones that are more binding and which should be the priorities?

Another buzz word that you hear frequently in the debate about Mexico is political gridlock that yes, there are good ideas that the country needs a lot of reform, but that those reforms cannot be enacted because of the way in which the political system operates. In particular, the fact that it is very hard to consolidate a majority in Congress to move these things forward.

But we want to go beyond that and we want to understand why is there political gridlock in Mexico and what can be done to solve that? What type of political reform is necessary so that there is greater capacity to adopt this reform? So essentially the idea is then to go beyond those broad generalizations that we hear in the debate on a daily basis.

We're going to begin with two keynote presentations. First, by Luis Alberto Moreno, the president of the Inter-American Development Bank and then by Ambassador Arturo Sarukhan, the Mexican Ambassador to the U.S. They're both truly remarkable friends of Brookings. They've been collaborating with this institution, close friends, close allies, not just for the purposes of our discussions about Mexico, but in a more and broader way in our work on Latin America. So we're delighted to have them here. We're delighted to co-sponsor this event with them.

Let me say a brief word about each one of them before I give the floor. Luis Alberto is a very well-known person in all the policy circles, not just in Latin America, but also here in Washington, having served as the Colombia ambassador in crucial years when there was the significant reengagement of the U.S. with Colombia that led to structural change in terms of the economic growth of Colombia, the security conditions of Colombia. And his role as ambassador to

the U.S. at that time was absolutely essential and he is widely recognized in Colombia where he is a very recognized and prominent individual.

And here in Washington there are many things that you can say about Luis Alberto, but I'll just mention the last one which is quite relevant. (Laughter) Which is absolutely fundamental for the future of our country. He just finished the process of capitalization of the Inter-American Development Bank that will give the bank a lot of additional space to increase lending to the region, a region that really needs the support of the Inter-American Development Bank in a different set of areas and that with that result I'm sure will be a lot better equipped to play a very significant role.

And Ambassador Sarukhan, also a great friend, has been ambassador here to the U.S. since 2007. Prior to that he served in different positions at the Mexican Foreign Ministry having been general counsel in New York, but also having worked here in the Mexican Embassy in Washington in the past. And truly a person that knows the city very well, and that shows in everything that he's been involved with in the past few years as ambassador leading to the very recent state visit by President Calderon where a series of very important agreements were signed and where the Mexican position vis-à-vis is highly recognized as an influential, as a director relationship. And much of that is the result of the work of Ambassador Sarukhan.

So, again, thank you on behalf of Brookings to both of them, the institutions they represent, for having been involved in the structuring of this important event today. So I'll give the word to President Moreno for his initial keynote remarks.

PRESIDENT MORENO: Well, thank you very much, Mauricio. It's a pleasure and honor to be here also with Ambassador Sarukhan, and more importantly to thank Brookings for doing this very important event and to do it with the IDB, of course, is something that I want to also congratulate Santiago and all the team who wanted to put this event together.

You know, I think Mauricio did a very good summary and I don't want -- I know we have a lot of good panels today that will get deeper into the many issues of Mexico. But, you know, in this city, and after being here as Mauricio was saying, that you can say many things about me. That's interesting because that happens after you stay here for a while. But the reality is this. There is still the sense of flavor of the month that is amazing in Washington and soon you seem to forget a

lot of the very basic things. And some of the basic things that one forgets is how, for instance, Mexico has advanced economically by comparison to most Latin American countries.

There's a recent report that came out this week by Deloitte that basically says how in the next three years manufacturing competitiveness in Mexico will surpass that of Japan. Or for instance, in the midst of all of this, you know, coming from Colombia, I remember coming here and trying to, you know, you always woke up and had these horrible headlines and I would just come to audiences like this and I said just watch the trend lines. Don't get bogged down in the headlines.

Well, there are headlines that people don't see about Mexico. For instance, I -- recently there was a huge investment by BMW of close to \$2 billion to basically source parts for BMW manufacturing throughout the world. And if you go deeper into this what you start to look is how strong the manufacturing sector and how sophisticated the manufacturing sector in Mexico has been over the years every -- every day more. And how, for instance, the automobile industry is perhaps the fifth largest market in the world and soon becoming a very important platform, actually, in not only the types of automobiles that it's making, but in the kind of industry and industry clusters that have been developing.

Or for that matter, what has been happening in the aerospace industry. The same thing. There's a total cluster around Querétaro. Or look at, you know, the income per capita and some of the social policy developments. I mean, true, there is a lot of gaps in Mexico. I think there are also gaps in many other Latin American countries. And as we embark in what I truly believe this is the decade for Latin America in which the challenge of all our governments to basically begin to close on some of those gaps.

But on social policies, and I think Santiago Levy and others in Mexico have a lot of responsibility for having been very much in the forefront of really experimenting in social policies that area really world class. Their conditional cash transfer programs, how deep they've become, and all these types of programs that have really begun to produce and create a safety net that basically has helped bring thousands of people out of poverty.

And the real question that you see in a country like Mexico is the growing middle classes. I mean, Mexico; it's interesting and often economics remind me of how it's always been a

leading and lighting indicator of what's happening in the U.S. economy. You know, if you look at what other economy could sustain the kind of impacts that Mexico had last year, there's few in Latin America that could take those kinds of shocks. Not only did you have a profound drop in remittances, you had a very sharp drop because of the integration into the U.S. economy. And you had, you know, the losses of jobs of close to 200,000 or 300,000 last year. And they've begun to turn around already and they're close to this year alone generated over 300,000 jobs.

So that tells you a lot of what's happening in the Mexican economy. And then on the political front I think it's always important to remember that, you know, it's very hard for any society to have a party system to be for so many years and expect that there will not be any kind of gridlock when you start to have, you know, a more fluid political system. And it's only natural that you have that. Not to mention that, you know, Mauricio was talking about gridlock. You know, we can see a lot of that here in Washington. And even with the majority party. So, this is the kind of learning that you're seeing today in Mexico.

I would like to perhaps, maybe because I'm not a Colombian and I live this thing so many years, to do some comparisons. You know, people here seem to concentrate a lot on the debts in Mexico and the debts associated with drug trafficking. Well, it turns out that nine out of 10 of those debts are basically concentrated amongst the five or six different cartels and, of course, the law enforcement that are the two unsung heroes in this war. But think for a minute the courage President Calderon had of taking this problem head-on. That's going to make Mexico better without a doubt. And if we learned anything in Colombia, just look at the last election that happened this past Sunday. And that's after decades of taking this problem on. In Colombia it really was over the last decade that you could see this kind of outcome. I'm sure that in Mexico it won't take that long because the institutionality of Mexico was far stronger than where Colombia started. And I think this is a very important comparison.

And the only way to fight this kind of war is truly with international support, the one that Mexico deserves and needs. But more importantly, the impact on the overall economy of Mexico of the drug trade is far less than it ever was in Colombia. And somehow we get bogged down in this and we're missing the real picture of Mexico. And that's the real thought. And I hope

that out of this conference today it will come out.

You know, if you look at the 32 soccer teams today in the World Cup, and I know, of course, Javier Ageva is now very much concentrated on what the three color can do against Argentina. I want to tell you a very interesting statistic I was looking at the other day. The best performing markets -- I'm referring to stock markets and this study that Goldman Sachs did recently. The three best performing stock markets since 2006, which was the last World Cup, were Mexico, Brazil, and Chile. And so that tells you something that, of course, this World Cup perhaps, as *El Pais* said the other day looks more like the *Copa América*. But in any event, enough about soccer.

The reality is that I think what is really needed, and I really applaud Brookings and Santiago and others for getting involved in this, is to look at the other untold story of Mexico and look at it with perspective. And I think and I hope that this event today begins to look deeper into the realities of Mexico and where the country is going because you find no more sophisticated talent in the, as we see it, certainly from the perspective of the bank in terms of what has been done financially. Mexico learned from so many of the crises in the past and has built a technocracy that is extremely competent and is competent world class today and certainly in Latin American terms.

And the same is true as I was saying earlier on what's been going on continuously in social policies. At the end of the day we all know that the major issues for facing most of our countries, Mexico no exception, are those that could help generate jobs and quality jobs that will come through quality of education, which is some of the tougher reforms and where most of the attention, I think, is being put today in the Mexican debate.

I will stop there and defer to my good friend, Ambassador Sarukhan. And again, thank you very much, Mauricio, for having us here. And thank you, Santiago. (Applause)

AMBASSADOR SARUKHAN: Good morning. It's a pleasure to be here and again, Luis Alberto Santiago, Mauricio, thank you for the support that Brookings and the IDB gave to make sure that this very important seminar conference could take place.

Here today, because it is true as Luis Alberto and Mauricio said a few minutes ago, the narrative today in Washington when you see Mexico on the headline of a conference or a seminar or roundtable, is usually linked to drugs and thugs. And all of us know if it bleeds, it leads.

And that's been the narrative that we have seen in the U.S. now for quite some time. But I think it is very important that we also underscore those other areas of Mexico and Mexico's development that put some of the challenges that Mexico faces certainly in context.

I'm going to start by saying that there's an old Mexican saying that in Spanish says *zapatero a sus zapatos*, "cobbler to your shoes." I'm not an economist and I'll let Alejandro Werner, who is here, do most of the talking on that specific issue. But I'll bob and weave around some of the issues that I think have a particular bearing on what happens in Mexico's economic development over the years, which are obviously related to the U.S.-Mexico bilateral relationship and to the larger picture in which I think Mexico fits into the global economy.

Let me just start by saying I think that Mexico seems to be stuck, and I know that Jesús Marquez here will also address some of these issues. Mexico seems to be stuck as a Mexican from my generation. Today Mexico seems to be stuck between nostalgia for the Mexico that no longer exists, the authoritarian Mexico that no longer exists and that we fought against, and at the same time disappointment in the democratic Mexico that we have now and that we fought for. And it's this tension which is taking place in Mexico today which I think permeates everything from politics to the discussion of economic reforms and what those economic reforms should be, and that lay the groundwork for what I think are the three basic questions that all Mexicans would like to see answered. Do we all agree that we're a democratic regime? That we're a democracy? Where do we need to go? And what do we need to achieve to get there? And those are the questions that I think are permeating a lot of the political and economic debates that are taking place in Mexico and which I hope this seminar by the end of the day will hopefully address some of those questions.

I think that -- I was asked to sort of give some opening remarks and see if I could provide some food for thought for the discussions that will take place later on in the day. And there are probably three ideas that I think that are worth considering.

The first one is the discussion of things that Mexico needs to do on its own internally to be able to boost economic development, competitiveness, economic growth. And a lot is being said. They've already been mentioned here. The famous structural reforms that Mexico needs, which ones they are, in which order do they need to go? But in true Clintonian fashion I'd probably

say that if it is true that it's an economy stupid that we're here to talk about, I would probably insult you twice by saying, yeah, but it's first going to have to be politics stupid because I'm convinced, and this may be my own particular point of view.

Santiago and Alejandro and others may have a very different perspective, but my belief is that whether it's energy, whether it's labor, whether it's pensions, whether it's deregulating the economy, whether it's anti-trust legislation, at the end of the day, the keystone for the success of all these reforms is political. It's the constitutional, political reform of Mexico. And it's the ability of Mexicans to be able to re-elect members of Congress. It's the ability of Mexicans to be re-elect mayors because the mayors are, in particular, the first conveyor belt between citizens and the body politics and policies. I think there'd still be great antibodies to put on the table the potential reelection of a president.

I don't think anyone in Mexico today is suggesting that is a feasible reform, but I think that if we think of Congress and mayors, that is a critically important piece of legislation because, A, it brings accountability into the system, it brings transparency, and I think it cements one of the weaker bonds of Mexico's democratic life today which is that citizens, like in most parts of the world, whether it's in the U.S. We've seen it with the Tea Party, whether we've seen it in Europe during the debates over the constitution of the European Union, citizens don't feel that political parties are co-state holders to their concerns, to their beliefs, to their aspirations. And I think that the ability to provide and to push for re-election in Mexico is a critical piece of this.

But it's not the only component. It's providing a president with a mandate through a second round of votes in a presidential election. It's bringing in the referendum as a way to solve some of the gridlock and some of the challenges that are faced in Congress. So even though this seminar is about the economic issues of Mexico's current circumstances, I am fully convinced that the keystone to the other reforms which I know you're going to talk about here today is the political constitutional reform that Mexico needs.

The second thing that I'd like to put on the table is things that Mexico needs to do working with others outside of Mexico's border, in particularly, obviously, with the United States because of the 3,000 kilometer border that we share with the United States and are mooring into the

global economy via NAFTA. And, you know, I do believe that the pace and the speed with which we advance in the relationship with the United States won't solve the internal debates or challenges that we face. Certainly, it won't decide whether Mexico can open up energy to foreign direct or private -- foreign direct investment, whether domestic or foreign into the energy sector, but it will set the table for enhanced competitiveness in North America. And I think that a lot of the issues that are being put on the table by both President Obama and President Calderon, if you look at the joint statement that they released almost a month ago -- a month ago -- when President Calderon came up for the state visit, that is a blueprint for how we can work together to enhance trade, trade facilitation, border infrastructure, between Mexico and the United States.

For the first time in many, many years, at least in my memory as a career diplomat who has dedicated most of his life to working with and studying the United States, this is the first time in the bilateral relationship where we have the willingness and the ability on both sides of the border to push forward a holistic vision for border management. That is, not only to think about security, but to think about how security fits into enhancing competitiveness between Mexico and the United States. How do we create a modern, secure border infrastructure that allows us to continue to grade and to allow for the free flow of goods and services and people to -- legal flows to go back and cross back and forth across our border? That's a critical component. How do we continue to harmonize our customs form? You know, there's low -- there are things out there which are certainly not rocket science which I believe are low hanging fruit.

For example, can't we harmonize our standardize our customs forms in North America so that we don't have to fill in a U.S., Canadian, and a Mexican customs form? One single North American customs form. How that would enhance trade. How that would deregulate our -- enhance competitiveness along the borders and enhance North America's ability to continue to compete with the likes of China and India.

How do we take on the critical challenge of labor mobility and not, again, I'm not using the term labor mobility as a euphemism for immigration. Immigration is part of it, certainly, but it also means the ability of U.S., Canadian, or Mexican firms to shop around freely in either one of these three countries for the best talent available for their businesses. But it also has to do with what

I think is the most powerful asset that North America has, which is its human capital. And the fact of how do these three countries in North America take advantage of what I think is their unique edge regarding other areas and regions of the world. The fact that we have two capital abundant countries living next to a labor abundant country, which is Mexico. And how do we complement the economies and the labor curves and the demographics of Canada, Mexico, and the United States?

And again, as I've always said, it's not going to be there for forever because Mexico's demographics are profoundly changing. And in 20, 25 years, ours is going to look a lot like yours. And so the trick is how do we build a bridge between now and when our demographics fundamentally shift so that we can take advantage of that labor mobility between our two countries?

The other issue which I think is solely lacking, how do we develop the next steps in the North American vision? And after, I think, I will continue to say it and I truly believe has been a success story, but how do we build the next decade of North American success and North American growth? And what are the next steps in this architecture that Canada, Mexico, and the United State developed in 1993. And here I hope that one of the results of this discussion is that a message is sent out to the private sectors of both Canada, Mexico, and the United States that they need to re-engage in the debate over the future of North America. If there has been one actor that has been solely missing the debates over trade, competitiveness, how we deepen the interaction and the supply chains that exist between the three North American countries, it is unfortunately in the private sector.

I'm not shifting all of the blame to the private sector. I think government has also been lousy in making the case as to why this is an important issue that North American citizens need to take on. But at the end of the day we need the re-engagement of the Canadian, Mexican and U.S. private sectors to rethink where North America needs to go. So, you know, and at the end of the day the common thread to all of this is that we have to -- we have to take these questions on by understanding that because we have a 3,000 kilometer border with the United States, these discussions over competitiveness and trade flows and infrastructure will have to be married to security. If Mexico and the United States were too central European countries in the landlocked central European countries, you know, maybe this issue wouldn't be so important. But in a post 9-11

world, understanding that trade, commerce, trade facilitation, economic competitiveness and security are intricately linked in North America, is critical to understanding what the road ahead looks like for both our countries.

And finally, timing matters. There's an old Chinese proverb that says the best time to do something is 20 years ago and the next best time is right now. And I think that we have the unique opportunity first of having two presidents in Mexico and the United States who are fully committed to changing the strategic tableau on which this relationship has been operating for the past decade. I think both presidents are willing to invest political capital. I think both presidents understand the need for both countries to engage and to cooperate on everything from the fight against transnational organized crime to environmental change and creating green jobs, the way both presidents I think have been leading in the debate as we head to Cancun, the Top 16 conference in Mexico that will take place in November. I think these are very powerful examples of how we need to take advantage of what we have out there today to ensure that this relationship continues to deepen and widen. Because I do believe that one of the success stories of NAFTA isn't just about trade and numbers; it's that through NAFTA Mexico became much less autotic, it stopped looking at its navel, and it became a full-fledged partner of the global community. And I think that through this relationship with the United States we need to continue deepening the engagement and the ability of both countries to move the ball down the field.

So I will leave it at that. But hopefully this seminar and the discussions that we will hear here today will provide us with some clues and with some hopefully important discussions and candid discussions as to what those challenges are, how Mexico needs to take on some of those challenges again on its own, but where are those areas and where are those fields in which the United States can and needs to step in to engage with its Mexican partner because I will continue to say several of you are sick of hearing me say this, but I am convinced that these two countries are joined at the hip for the good and that a rising tide can and will lift boats on both sides of the border.

Thank you. (Applause)

MR. CARDENAS: Thank you very much. Thank you very much. We're running a little bit behind schedule and I think we should get going to the next session, unless there is a

question that you cannot hold for our two keynote speakers. Unless, you know, you have one point. Can you just introduce yourself?

MR. DIAZ: Of course. I'm Jose Diaz with the Reformation Speaker from Mexico.

I wanted to ask both of you; you talked about development, about the creation of jobs and so on. And for the past two decades Ciudad Juarez had been, you know, one of the success stories in terms of growth in Mexico – probably the municipality that had the largest growth within Mexico. What was missing, you know, in development in Mexico for it not to be now, security be with, you know, parks, decent urban planning and, you know, not to be taken by drug dealers at this moment.

MR. CARDENAS: Good. Any other questions? And we'll go with two if anyone else -- yes, Abe. Abe Lowenthal. And then we'll just close there.

MR. LOWENTHAL: I ask the question because I think it's appropriate in this panel, but probably not in the other three and it's one of the questions I have in mind.

We fluctuate between the discussion of U.S.-Mexico relationship and the North American relationship, which presumably includes Canada. And, you know, this is an issue which is looked at from different standpoints differently. One idea that I've been thinking about and I'd like particularly Ambassador Sarukhan to respond to is whether it might make sense to develop an agenda with respect to Central America and the Caribbean in which Canada, Mexico, and the United States all have important interests and overlapping transnational relationships. This might be a way of reconstituting the North American idea.

AMBASSADOR SARUKHAN: Pepe, you've asked a very pressing question because face value the economic development that we saw in Saraquales is, especially after NAFTA because of the important role that the *maquiladora* program played in creating jobs and economic opportunities in Saraquales has created a tale of two cities. And the challenges that we see and to which you refer to in Saraquales is precisely the result of that disconnect. It is true that wages, economic opportunities, even the per capital income of Saraquales has raised dramatically over the past decade, but what was impressive and what is impressive today is if you look at indicators such as theaters, clinics, primary health care centers, day care centers, parks, sports fields, during those

10 years Saraquales was at the bottom of the pile. There was no investment in the social infrastructure of Saraquales that accompanied that dramatic economic boom that we saw in the city.

And I'm not a sociologist, but, you know, it doesn't take too much to figure out that that disconnect between what was coming in the pockets of citizens and the money that was being made and the rising levels of income unaccompanied by more schools and more hospitals and more clinics and more cinemas and theaters is one of the reasons why you have some of the social challenges and dislocations that have made Saraquales is besides its strategic location on the U.S.-Mexico border as a conduit of drugs moving north and weapons and cash moving south has made Saraquales as the breeding ground of some of the experiments that the drug syndicates are now conducting in Mexico as to how to create, regenerate, and control corner retail and distribution of drugs. But I think it's that disconnect that occurred in Saraquales which explains some of the challenges Saraquales sees there today.

Do you want to answer Saraquales and then I'll answer Abe's?

PRESIDENT MORENO: Real quick. Look. I don't know much about Ciudad Juarez other than my roommate in college was there so that's -- my context of Ciudad Juarez is colored by his speaking about Ciudad Juarez at that time and the prosperity that you were referring to. But as you asked that question I was hearing -- Arturo reminded me of Medellin. Medellin was probably the most prosperous city in Colombia. It was an industrial city, very important, but at the end of the day there is no city, no matter how sophisticated, that can take the shock of, you know, drug dealers with a lot of money, a lot of cash, trying to go around and, you know, and create the kinds of problems they created. And that was very -- I mean, if by the way you have this, which was by the same case as Medellin, 50 percent of the city, you know, has huge pockets of poverty, and it was that in which they tapped into, the only solution possible at the end was to have very strong law enforcement response, but hand-to-hand with that very strong law enforcement response was a very aggressive social investment program. And those things take a lot of time and they're very hard work. But they've got to be balanced. And that's the story of Medellin. I'm sure Mauricio could talk to you more about that as well.

But the reality is that when you have these imbalances in a society, it's perfect

ground for drugs to penetrate and, you know, especially being on the border. But the reality is that that city, as I recall, like I say from my memory was largely developed by a huge trade with El Paso.

AMBASSADOR SARUKHAN: You're touching upon one of my pet peeves, but also hobbies which is how do we deepen the North American footprint in the rest of the hemisphere? And I think that there are some baby steps that we have been able to implement, particularly related to disaster relief and emergency response capabilities of the three North American partners in the Caribbean and Central America. We have prepositioned equipment, supplies, emergency supplies in Panama, the three countries, so that the three nations can respond relatively quickly if the need arises for us to fly the North American flag in the Caribbean or Central America if there's an emergency.

But I am convinced that developing a stronger North American -- I don't want to use the word foreign policy identity, but developing a larger North American footprint as to how the three countries engage with some of the pressing challenges in the hemisphere, whether it's development, whether it's the strength of institutions and democracy, whether it's how we take on new threats to security in the region, this should be one of the instruments that we pursue to provide added lift to the North American agenda.

Now, as you started saying, the problem is for a trilateral agenda you need three and right now there aren't there; there are just two. And I'll let you figure out which ones those two are.

MR. CARDENAS: All right. Thank you very much, Ambassador. So we'll finish with that this first session.

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Washington, D.C.
Friday, June 25, 2010

PARTICIPANTS:

PANEL ONE: UNDERSTANDING MEXICO'S LONG-TERM ECONOMIC PERFORMANCE:

Moderator:

MAURICIO CARDENAS
Senior Fellow and Director, Latin America Initiative
The Brookings Institution

Panelists:

ALEJANDRO WERNER
Deputy Secretary of Finance
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P R O C E E D I N G S

MR. CARDENAS: All right. Well, let's get into the first session with the spirit of starting this discussion. And this is the way in which we are kind of like organizing the day with a micro view so that we look at the general picture and we look at essentially the recent performance of the Mexican performance, the recent numbers. And then we go throughout the morning into the more specific micro-oriented issues. That will be the next panel.

And I want to highlight the third panel because we're going to get into the issues of the political economy by analyzing first the fact that there's some risks that could undermine all the efforts that you do on the reform agenda, all the efforts that you do in terms of reinvigorating the Mexican economy can be undermined if the security situation gets worse, which goes very much at the heart of your question. And so we cannot dismiss that risk. We're going to look into it because there is always -- this is a conversation about opportunity and change, but there is always the possibility that things got worse. And that, of course, is related to the issue of organized crime. We're going to talk about that and we're going to talk also about the political reform agenda in Mexico.

So let's start with this broader view. And we have two panelists. I think we're privileged to have Deputy Minister Alejandro Werner. He is a very respected colleague, an economist, a Ph.D. from MIT, has worked extensively in the Mexican government, first at the Central Bank and lately at the Ministry of Finance where he is deputy minister. But he was also head of economic analysis at the Ministry of Finance. He was head of economic research at the Central Bank. He is a very well-respected scholar, economist, in Mexico.

And then Santiago Levy, who most of you probably know, vice president for knowledge and sectors at the Inter-American Development Bank, former deputy minister of

finance in Mexico as well, former president of the Social Security Institute in Mexico, and as President Luis Alberto Moreno was saying, a very respected and well known figure in Latin America as he is known as the father of the conditional cash transfers program, which are now praised everywhere.

So without further adieu, let's start with the Deputy Minister and then we'll go to Santiago.

MR. WERNER: Thank you, Mauricio, Santiago, for organizing this conference. I think it's a very important time to rethink the growth process in Mexico and to start thinking about we should be designing a growth strategy for the country in the next two decades. After the severe crisis that the world economy went through and how the Mexican economy was affected by it, I think it's important to think how the external environment will shape the growth process in Mexico and how our strategy should adapt to that new environment. So I think this conference should help us, and the way it has been structured, looking at what are the economic issues that we have to deal with, but also the political changes that we have to make to be able to undertake those changes I think is exactly the way to go. And I think these two issues were intertwined in the previous panel in which economics and politics I think both speakers were jumping back and forth between these two topics.

I mean, looking at the growth process in Mexico, even though I think people have concentrated a lot on how growth has slowed down in the last 10 years in Mexico vis-à-vis other Latin American country is important to recognize that. If you look at growth -- per capital growth in Mexico since 1920, it hasn't been spectacular. I think the average growth in GDP per capita has been around 1.6 percent during this period. I think this is the story of Latin America. This growth rate has been slightly higher than in the rest of Latin America. We saw an important increase in the growth rate in the '50s, '60s, and '70s, and then we

went into the debt crisis in the '80s. Some recovery in the '90s as fiscal and microeconomic stability came back to Mexico and to some Latin American countries. And I think in the last decade what it's important to recognize is that many Latin American countries have been catching up to Chile in terms of microeconomic stability. And then the international environment has been shaped in our economic development in different ways. To some extent Mexico has been much more linked to the U.S., and the manufacturing cycle in North America has been, I mean, been affected negatively in relative terms vis-à-vis those countries that are much more oriented towards Asia, towards a commodity economy, in which the significant increase in commodities prices and the growth in Asia has been pulling the growth rate significantly higher than Mexico. And I think it's -- I mean, the first time in the last 80 years in which Mexican growth in per capital GDP has been below the average of Latin America, and I think that's what's shaping a lot of the discussions that we're having in the country.

So I think it's important to highlight that when we divide the macroeconomic aspects of the growth process and the microeconomic aspects. I think we have reached a consensus that although there are important issues to be dealt with in the microeconomic area, the main shortcomings that are affecting the growth process in Mexico are institutional and microeconomic in nature.

I would highlight four of these issues. I think the first one is a cooperative framework that was put in place in the country as these political and economic institutional set up was built up during -- from let's say 1930 towards 1970 in which particular business and labor interests were benefitted to sustain, I would say, social and political instability in the country. In some other Latin American countries there were military governments that through the use of force, I mean, were maintaining power in Mexico. I think there was a much more sophisticated system in which the distribution of economic grants by the

government sustained the government in power for a long period of time. But these created -- when a full democracy came into being, a very difficult economic structure in which the relative power of real interest, let's call them economic labor, et cetera, vis-à-vis the political power of government significantly increased. The political power got distributed among the executive, local government, Congress, et cetera, and the economic power of labor unions, of big corporate groups, et cetera, remained the same.

So in relative terms, their influence in the economy to sustain their privilege is significantly higher than in many other countries in the region and this has created an economy in which everywhere you look you see important market distortions or oligopolies, monopolies, both in the product and labor -- sorry, product and factors of productions markets.

Secondly, I think we have a dysfunctional judicial system that is characterized by very lengthy and certain and this gives, opens the door for corrupt judicial process that introduces significant uncertainty to resolve economic issues. And this obviously significantly reduces incentives for investments and it was mentioned in the previous panel, the political process is not conducive to the speed introduction of efficient economic reforms.

And finally, I mean, due to the discovery of important oil fields in the '70s, our fiscal system is the system in which non-oil revenues are significant low. Non-oil, I mean, taxes in Mexico collected by the government are at around 10 percent of GDP, which is almost half of what we see in other countries of the region and even less than that when we made the comparison with OECD countries, this has led to a weak state, especially when democracy came into play.

And secondly, it has also led to a very uncertain tax system because we have, I mean, prioritize microeconomic equilibrium that I think it was the right thing to do.

Even the instability that the country has lived through in the last three decades. However, to achieve this with a very low fiscal base, what was needed was to make every time we have a negative fiscal shock to change our tax structure in a very uncertain way. So you're going to invest in the telecom sector, in the service sector, in manufacturing in Mexico. You really did not know if when the next fiscal crisis came if your sector was going to tax relatively more than the rest of the economy just to maintain microeconomic equilibrium.

I think in an economy in which you have just a general VAT and a very general and homogenous income tax, everybody knows that if you suffer a fiscal shock like is happening in the rest of the world, I mean, at the end of the day people will increase the VAT by 2 percentage points and the income tax by 1 or 2 percentage points. And the burden of the crisis will be shared by all the economy in a relatively equal fashion. In the case of Mexico, people didn't know if you were going to put the tobacco tax or you were going to put a telecom tax, if you're going to put a tax on capital gains, et cetera, and this is generated I think an important uncertainty in our tax structure that has significantly affected investment in the country. I mean, and this has led to a situation in which if you look at total factor productivity in Mexico in the last 30 years, I think at the most you can say that it has been not growing in these three decades. Our investment ratios have been significantly low and I think another key issue that explains why all these factors have fed into the growth process is basically a very low base of capital -- of human capital in the country if you measure it in any, I mean, statistics to measure the quantity and quality of education in the country.

And in this sense what we need going forward is what, I mean, a lot of academics looking at the Mexican economy has said in the past and from this diagnostic is very clear. First of all, we need solid fiscal reform. Although we have made two important fiscal reforms during President Calderon's government that will increase non-oil income for

the government by 3 percentage points of GDP, this will still be below what we see in the rest of the continent. And I think this will not be enough to support the growth in expenditures that will come from the increasing pensions, the increase in other initial government expenditure, and also will not be enough to compensate for the fall in oil income that is expected to take place in the future as a percentage of GDP. Even if all production remains constant during the next decade, given that the economy should be growing at around 3 percent of GDP, as a percentage of GDP oil income for Mexico will significant decline.

And on top of this, the cost of extracting oil from, I mean, harder to get oil fields will be increasing. So the net benefit for public finances from oil will be a net negative for Mexico in the future so we will need to compensate for this. We will need to compensate for the increase in government expenditures and we will need also, as I said before, to establish, let's say, a much more permanent tax structure that is efficient and does not generate the kind of uncertainty that I mentioned.

Secondly, I think we need to improve the rule of law and we need to make some changes to make our markets much more efficient. And I think along the structural reforms we have to work in three or four key sectors in the economy that when you compare Mexico to other countries in the last two decades are important factors in explaining why Mexico has been growing at a much lower pace.

First of all, if you look at our agricultural sector. We still have important land tenure issues in agriculture. Our agricultural GDP has been growing at around 1-1/2 percent for the last decade. When you compare that with similar -- I mean, Mexico is a country with the lowest rate of growth in the agricultural sector in Latin America. You compare it with other Central American countries that should have similar quality of land, et cetera; we have been growing significantly below them. That's because, I mean, we have important property

rights problems still in the agricultural sector that has led to a very low ratio of capital to land in the agricultural sector, and we have not been able to capitalize on two important issues. The increase in commodity prices and the significant productivity changes in agriculture that have been an important element in generating growth in other countries just by growing at the mean of the Latin American countries or the mean that has been observed in Latin America in the last decade or two decades. We cannot -- around 20 or 25 basis points to our general growth rate in the next decade.

Something similar can be said for the mining and energy sector. I mean, energy is a sector in which we have seen countries in the world and energy, let's say, abundant countries in the world, such as Mexico, channel significant resources for investment purposes given that a significant part of this has been subject to the budgetary process and it's still close. Only to have been produced by the government. We have seen very relatively low levels of investment in the last two or three decades, and we have seen a very small growth in the sector that has also been affected by labor issues, especially in mining. The third sector is telecommunications, in which investment in Mexico has been a multiple lower of what we have seen in other countries. And this has given rise to a much higher cost of the telecom sector affecting the rest of the economy.

Just being relatively quick, the growth strategy of the current administration has been focusing on these issues. On the fiscal front, as I mentioned, we made two important fiscal reforms. But more than that we revamped our pension system. We made reform of the public sector workers' pension system to move from the fine benefit with the fine contribution system and we have made the same thing with the workers of two very important public sector companies, the Instituto Mexicano del Seguro Social and the Compañía Federal de Electricidad, reducing public sector implicit liabilities in the pension systems by around 30 percentage points of GDP. There are several initiatives now in

Congress to strengthen our anti-trust commission and flexibilize our labor markets. And several initiatives that have been mentioned by Ambassador Sarukhan in trying to reform our political system to make it much more efficient in reaching a consensus along with the major economic reforms that we have to do.

We have also made important steps in modernizing our energy sector by reforming the law that governs Pemex, our private sector company in the oil sector, to allow it to be much more efficient in the way that it contracts out with the private sector for exploration, development, and production of oil, gas, and refining products. And we closed down an electrical distribution company that distributed 20 percent of the energy in the country with very inefficient means. I mean, in terms of any efficiency indicator it was a multiple above what we had in the other public sector company, the CFE, in terms of its inefficiency and by closing this company down we're going to have a significant reduction in cost. But more than that, a significant increase in the provision or the quality of the provision of electricity in the central part of the country.

In terms of telecommunications, we're basically selling to the private sector important public sector assets such as the fiber optic network that was put in place by CFE to manage the electricity grid. But it has excessive capacity and this can be put to use by the private sector to generate an alternative public network that will compete with the one we have in place generating much more competition in the sector, hopefully reducing -- significantly reducing telecom rates and therefore impacting the competitiveness of the economy.

With respect to the financial sector, I think an important thing to note is in those sectors in which we have opened up, we have seen significant changes in growth. I mean, in the previous panel there was a lot of talk about the manufacturing sector in Mexico. The manufacturing sector in Mexico was fully transformed by the introduction of NAFTA.

And therefore, we have a very competitive, a very open, and a very productive sector in Mexico. The same thing can be said, let's say, in the retail sector. You see very dynamic firms investing around \$2 billion per year in expanding retail distribution capacity in Mexico, and we have seen significant drop in prices, I mean, from TVs to food stuff, et cetera, due to the significant changes that have taken place in the logistical process to distribute goods in the Mexican economy. And the same can be said in the financial sector in which the number of banks have increased by 40 percent. The share of the market by the 6 largest banks have been falling by around 6 percentage points in the last 4 years, and the pension system that was put in place 10 years ago is becoming the most important source of long-term savings for the country, supporting not only the government first by buying our public sector debt, but more and more the private sector by buying debt from private sector companies, but also investing in equity position and infrastructure projects and productive projects in the economy.

This is some of the main guidelines of the growth strategy for the country, but it is very true that in the next two decades, as the U.S. economy and especially the U.S. consumer is expected to, I mean, have let's say a very mediocre rate of growth in terms of consumption of durable goods, the growth process of Mexico should be redesigned by have a much more solid domestic component in terms of growth. And for that what we need is to significantly increase the expected profitability of investments into Mexico by opening up these key sectors that I mentioned. And we also need to diversify our exporting destinations, such as has been done in the last five years. But I think we need to do this by moving towards a much more general opening of our economy by significantly reducing the remaining targets that we have and just moving from a free trade agreement with the U.S. to let's say a de facto trade union in which we have a very low common target, vis-à-vis the rest of the world. And therefore, the -- all the custom issues in our border become more

oriented towards a security and health issues and not towards customs and tariff issues that, I mean, are imposing a significant administrative cost to the economy and not providing any type of help to the develop some key sectors in the economy.

Thank you.

MR. CARDENAS: Thank you very much, Alejandro. (Applause)

Let's now move to Santiago's presentation.

MR. LEVY: So, good morning, everybody. I'd like to begin by thanking Brookings Institution, and in particular Mauricio Cardenas, for organizing this seminar in Mexico. It really is a pleasure to be here. And it's also a pleasure to share the panel with Alejandro Werner, who is not only one of our best undersecretaries in the Ministry of Finance, but also a very good friend. So I'm really quite pleased to be here.

What I'd like to do is I called the talk "Notes on Mexico's Growth Problem" and provide a little bit of a long-term view. And then I'll come back to the issues that Alejandro was talking about during his own presentation.

So this is a very long-term view. It's almost a half century of what has happened in Mexico, comparing Mexico vis-à-vis the United States. And basically what it shows is regardless of whether you measure the labor force of Mexico vis-à-vis the United States or the years of education -- not the quality, but the years of education of Mexico vis-à-vis the United States, or even the capital stock of Mexico vis-à-vis the United States, Mexico has been catching up to the United States. You can see slight deceleration in the rate of capital accumulation that Alejandro was talking about, but still over the half century what you see is that Mexico, in terms of factor accumulation, investment, workers, years of education of workers, has been moving ahead.

However, for the past quarter century -- and this is kind of the big puzzle -- Mexico has actually lost ground vis-à-vis the United States. That graph is income per capita

in Mexico vis-à-vis income per capital in the United States. And what you see is exactly the opposite of what you would expect. You would have expected convergence between a less developed country and a developed country, and because Mexico over the whole period has been putting more factor inputs, more capital, more labor, more use of education, you would have expected the opposite. So this is a puzzle.

I'm still not getting this right.

And the explanation for the puzzle is that basically productivity in Mexico has collapsed. If productivity in Mexico had grown exactly at the same rate as productivity in the United States, with the same amount of factor accumulation that we experienced over these last years, income per capita in Mexico would be the green line up there, would be 24 percent higher today compared to 1960 vis-à-vis the United States. And yet it's slower. And the reason it's slower is because productivity growth in Mexico compared to the United States, particularly over the last quarter century, has actually collapsed.

And if you compared Mexico, the absolute level of productivity in Mexico, vis-à-vis what has happened in the blue line is the United States; in the black line is other countries of the world not in Latin America; in the green line is the large countries of Latin America, except Mexico; and in the red line is Mexico. What you can see is that Mexico's productivity collapse is actually even worse than the rest of Latin America, even though for Latin America as a whole productivity is a big issue vis-à-vis the rest of the world. And this comes from a recent IDB report that was suggested by President Moreno that we do. And in these long-term comparisons you really get a clue as to exactly what is happening in Mexico.

The story that Alejandro was telling before can be translated into this graph. And this is a way of saying why all these reforms and markets are essential to catch up in productivity? That graph is actually a very interesting graph. It comes again from the IDB

report on productivity that was issued just a few months ago and it basically does a very ambitious exercise. It compares all manufacturing plants in the United States from the census of U.S. manufacturing plants with all manufacturing plants in Mexico from the census of manufacturing plants. And it compares the productivity of manufacturing plants in the U.S. and in Mexico.

The red line is the middle. So if you are to the right of the red line, plants have higher productivity than the average. And to the left of the red line, plants have lower productivity than the average. The dotted line is a distribution of productivities of plants in the United States in the manufacturing sector, and what it shows is that, you know, they're bunched up. They're bunched up, but the more productive plant is about four times more productive than the average, and the least productive plant is about 1/16th less productive than the average.

The gray area is a distribution of the productivity of the same -- of manufacturing plants in Mexico. And what you can see is first there is more dispersion of productivities. They're both more productive plants. And these are the NAFTA plants associated with all the transformation that has occurred in Mexico short of NAFTA. But on the left side there is a huge number of very unproductive firms. And the difference between the most productive firm and the least productive firm is much wider than the United States.

Ideally, in a perfect world, all plants would be equally productive and it wouldn't matter whether you would put one peso of labor in this plant of that or one peso of capital in this plant or that plant. It would yield the same for society and everybody would be in the red line. Now, that's kind of the ideal. No country behaves like that, but you can take the U.S. as a country with a reasonable amount of, you know, well functioning markets and you get the dotted line that's the U.S.

If you now ask yourself the question if distortions in Mexico of the

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productivity of plants were the same as the United States, total factor productivity in the manufacturing sector would actually be, with the same number of Mexicans and the same amount of investment by Mexicans, 36 percent higher. So we're not being as productive as we could potentially be. And that's part of the productivity story. If you do the same exercise for services and commerce, you actually get even bigger gains.

So economists use this famous word "distortion", you know, which is a summary word for malfunctioning of markets. And Alejandro doing his intervention, and I fully agree with most of what he said, basically gave a list of some of the markets in which we have trouble. That malfunction of markets is summarized in the graph that I had before, and there are many sources of these distortions in Mexico. And that's why understanding is happening is making it so complex.

I've elsewhere argued, and I'm not going to go into a lot of detail here, that we have unfortunately in Mexico a social policy that segments the labor market between an informal sector and a formal sector. And this is a distortion because the same firms pay differently for workers depending on whether they're hired formally or informally. And therefore, the productivity of workers differs. Tax policy is also a social distortion. Alejandro mentioned it before. We have a very erratic income tax that introduces some behavior of firms that forces them to be small. Because if they grow they pay much more higher taxes and it's not convenient for them to grow.

Alejandro mentioned, and I agree with him, competition issues and regulation issues, particularly in the energy sector, in the telecommunications sector, and in the banking sector. And it must be recognized during the past administration and this administration there have been substantive advancements in the regulation of the financial sector. Credit is functioning much better than before, but still access to credit by small firms in particular is limited.

And if you add that insufficient investment in infrastructure, associated with a low tax base that Alejandro was mentioning and low quality education, this is kind of the summary in one slide of the distortions that somehow are behind that collapse in productivity. And if growth is going to pick up in Mexico, it is because productivity is going to pick up in Mexico. Because it is not going to be because more workers are there. You can't change that. Or actually, because there's going to be that much more investment.

I want to emphasize one aspect of this productivity problem because I don't have time to go into the issues. And some of them were issued by Alejandro in energy and telecommunications. I want to emphasize one aspect of this productivity problem which has to do with informality. Because I think it has been underestimated in terms of why informality is bad for growth and is bad for productivity.

The central point that it does is it creates a distortion in the price of the most important good in Mexico, labor. The most important good in Mexico that is non-traded is high distorted because depending on whether a firm hires a worker formally or informally, it pays very different for the same worker. So it introduces a very large distortion, and some research that we're doing at the IDB right now provides numbers that say the distortion is large.

It also affects the composition of investment because -- and I'll show you some numbers in a minute -- it actually makes it more profitable to invest in small firms that can be informal than to invest in large firms that cannot be informal because it would be caught by the authorities. And therefore, the distribution and the allocation of investment is still tipped towards the informal sector. And there is some research, and Bill is here with some part of this research that says in the informal sector firms adopt less technologies; they invest less in training their workers; they're less economies of scale; and all this punishes productivity.

So informality is bad for growth. And the sad picture here, and this is impossible for Mexico, is that informal employment has been growing more than formal employment. What you see there is "F" for formal, "I" for informal. Zero-five are plants of 0 to 5 workers; 6 to 10 plants are 0 -- 6 to 10 workers; 11 to 50, et cetera. That's data from the census comparing the census of 2008 to the census of 2003. And then to the right hand side we match the census data with surveys from the employment data to get a picture of what is happening to employment

The bottom line is this. Over the period 2003 to 2005, if you take away the public sector workers hired by state governments and the federal government, if you take away the public sector workers, more informal jobs were created in Mexico than formal jumps. And you can see the very large blue bar there. Most of the jobs were informally created in very small firms.

Actually, interestingly, in large firms of 51 or more workers, employment actually decreased in absolute terms. So it's a puzzle. Why is it that in an economy that is growing, that is experiencing no crisis, during the period 2003-2008, the world economy is growing very well. International financial markets are abundant. There's microeconomic stability in Mexico. Actually, credit to private firms is expanding. There are no major regulatory changes in taxation. There were a couple of small reforms, particularly in 2008, and yet you have this result in which informal employment is growing.

Now, let me show you this graph. What is happening to the number of firms? So in orange are firms of 0 to 5 workers; in green, firms of 6 to 10 workers; in blue, firms of 11 to 50 workers; and in yellow, firms of 50 workers or more.

And then the two circles at the top are firms as captured in the census data. The two circles at the bottom are firms as captured in the registry of firms of the social security institute, which captures all the firms that are formal and that enroll their workers in

social security. And the circles, and my assistant Vicky is here who sold me into doing this re drawn to proportions. So the circles speak by themselves.

There were 3 million firms in New Mexico in 2003. But only 772,000 were actually formal firms. Between 2003 and 2008, the number of firms increases from 3 million to 3.7 million. But the number of registered firms increases from 772,000 to a little bit under 800,000. So in this 5-year period, 700,000 firms are created and only 20,000 firms of those firms are registered as formal firms. And most of the growth in firms is in the very small firms as you can see from the orange color there.

So if you actually compute the proportion of forms that are registered by each firm's size -- and I've done it also with the '98 census -- what you see is that in firms of 1 to 2 workers, about 85 percent of firms are unregistered. They're informal. In firms if 3 to 5, about 80; in firms of 6 to 10, et cetera, et cetera, et cetera. But what is important is that the proportion of informal firms in all sizes between 0 and 50 workers -- and 50 workers is a large firm by Mexican standards -- has actually increased over the last 10 years.

So my hypothesis is that Mexico might be caught in a vicious circle of low productivity and informality. And what do I mean by this vicious circle? For reasons that I don't have enough time, but maybe in the questions and answers we can explore it a little bit more, the government feels obliged, and rightly so, to provide social benefits to informal workers. But social benefits to informal workers are factor equivalent to a subsidy to informal firms and a subsidy to informal employment, where at the same time taxing formal firms and taxing formal workers and what you have is in the informal sector jobs are low productivity jobs because the firms are small, because there's no labor training, because there's no adoption of technology, because they're low economies of scale, and because the firms are illegal, so therefore, they don't have a very long-term horizon.

So they're bad jobs. The government responds in a particular -- in a

democratic context with more social programs, but de facto what you're doing is you're subsidizing even more the informal sector and in the informal sector there's less productivity, there's more evasion, and you're doing more like that. And if you see the numbers for the budget, I have here in the blue line the amount of money that the government is putting into programs for the informal sector to subsidize informality, and the red line below are the money that the government is putting to subsidize the formal sector through the labor market.

So this is consistent with the data from 2003 to 2008 with the data from '98 to 2003. I want to emphasize that this is not a problem of this government. This is a problem of this government, of the previous government, of the previous government, and of the previous and previous governments because this is a structural problem very much embedded in the architecture of Mexico's constitution, particularly Article 123 that regulates labor, the most important good in Mexico and the regulation of the labor market, which is the most important market in Mexico. And which is strongly distorting, as I showed before, firms' decisions with the very large growth in firms in the informal sector which is part of the explanation for the low productivity.

So let me conclude. Mexico's growth problem is by and large a productivity problem. Alejandro mentioned it in different words, but it's another way of stating the same thing. The labor force has been contributing to growth. It's actually also been contributing to growth in the U.S. through migration. Labor force growth has been a factor of growth. There has been some deceleration in the rate of capital accumulation, but over the whole period capital has contributed to growth. And after '94-'95, Mexico has experienced a credible stabilization. I think the macroeconomic outlook in Mexico for the last 20 years has been actually very good. I think there has been a very serious job at stabilizing the economy. The fact that we went through 2009 without a major crisis in terms of financial

crisis and having crises in the past speaks of the effort that has been done by all the administrations, including this administration.

So that the problems for Mexico's growth are not in microeconomic management. If you want to look where is Mexico's growth problem, you have to look in the microeconomic distortions that are behind it. There are very many reasons that explain this lagging productivity growth in Mexico. I have emphasized very, very quickly because I think it is underestimated the role of informality and how informality hurts productivity. But there are also fiscal regulations. Alejandro mentioned a little bit the uncertainty associate with tax regulations. There are clearly some competition issues in sectors like telecommunications and energy. There's an issue about the quality of education and there's an issue of underinvestment in infrastructure.

I focused on informality because there is a true puzzle. And again I want to put it back on the table. Why is it that between 2003 and 2008, in a period in which there is world growth, abundant access to international capital, high oil prices, microeconomic stability, low inflation, and expansion of credit to the private sector, you have such an increase in informality both of workers and of firms. And why is that hurting productivity?

These distortions, which is the technical word that economists use to capture what is happening in these markets are very complex and they are the result of Mexico's history. They are the result of long held beliefs about the role of public enterprises in the energy sector. They're the result of ransacking behavior by very strong unions, by very strong groups in the private sector. And they're the result of some social programs that are associated with the political legitimacy of a government that tries to gain it. Not -- I speak about this administration, the past, the previous one, and the previous one, and the previous ones behind that in an embedded system that, as Alejandro was discussing before, is the inheritance of this corporate estate that we have.

Unless these issues are tackled, it is extremely difficult to think that Mexico's growth rate is going to go beyond the 3-1/2 percent, chugging along while the rest of the world, particularly emerging countries, are growing at double those rates at 7 percent. The challenge to Mexico's democracy, and I guess some of the panels that'll be here, will be to actually speak about the ransacking behavior, the issues of political legitimacy, and the issues of democracy to tackle the very hard groups that are behind the reasons that are holding back productivity in Mexico and that are also a source of inequality in Mexico.

And in my view, and I close here, a particular challenge is a complete redesign of the fiscal system of the social pact in an understanding that we ain't going to get neither growth nor equity in an economy that is continually subsidizing formality and taxing formality. A new fiscal and social pact that can allow a reconstruction of the social pact with a much stronger fiscal base is, in my view, an essential component to retake growth in Mexico.

Thank you.

MR. CARDENAS: Thank you, Santiago. (Applause)

We're supposed to be finishing in two or three minutes. Well, oh, we're supposed to have finished already at 10:30, but it will be just an injustice to these excellent panel and these presentations not to basically have a discussion. And I'm going to ask for your indulgence and allow us to have 5 or 10 minutes of conversation about these topics.

So, let me start and then I'll ask the audience to make some comments. I -- when listening to the presentations that both start with this long-term view about growth in Mexico, you can be talking about any Latin American country. I mean, this problem of lack of convergence towards the U.S., and especially that happened after 1980 that we had gained some ground relative to the U.S., but then we lost it. It's common. It's absolutely common throughout the region. And the fact that it is a total fact of relativity, that is also

common. That's not unique to Mexico.

This last point that Santiago made on the vicious circle of informality and low productivity, that's also quite generalized. I mean, that graph I just -- I can't resist telling you that that same graph has been used in Colombia so many times to explain that there is dysfunctionality with the way we're providing social security that it's actually discouraging formal employment. And that's one of the issues that we have to tackle.

I was mentioning to Santiago that listening to President-elect Santos this last Sunday, it was interesting to see him using the opportunity for that very important speech to talk about this. To essentially say this is the next issue we have to deal with in Colombia. And the point is the same. Employment has been generally informal. Formal employment has not grown, and that results in low productivity. That actually explains why you have this distribution with these fat tails where there are a lot of firms with low productivity. Those are the informal firms. And our system of social protection is inducing that result.

So this is not Mexico. This is Latin America. And we're here to talk about Mexico. We want to know what is specific to Mexico. And I have a very simple idea. I mean, it's not -- it's something that I don't think you have emphasized enough, both of you, which is that looking at this from the outside knowing nothing about Mexico, the one thing that is remarkable is this country in the 1960s had 50 billion barrels in oil reserves. 1960s. 1980s, 25 billion. Today, 12 billion oil reserves. Five years ago, oil production in Mexico was 3.8 million barrels per day. That's 2004, 3.8 million barrels per day. Last year, 3 million.

So there is something contracting very fast and something that is very important for Mexico. It has been the source of fiscal revenue, so at the bottom of this question of the uncertainty about the tax system is the fact that Mexico permanently needs to compensate for the losses in the rents from oil.

So, I couldn't agree more with Alejandro Werner's point that Mexico just has to follow its own successes. Follow your own successes in the retail sector, in the manufacturing sector, but apply them in a more horizontal way to the other sectors. What has been so successful about the manufacturing sector? Well, there has been a lot of foreign direct investment. It's been a very open sector. Same for the financial sector. So you wonder, you know, why is it that you try to find these very kind of like indirect ways to promote energy, like saying, well, we're going to allow PEMEX to hire private contractors to do exploration, but it's always under contract with PEMEX. Why not just open it under certain regulations?

So I think that this is a crucial issue that the answer cannot be it's constitutionally prohibited. That cannot be the answer. The answer has to be it exists in the constitution because there is a reason for that. And the reason is this and that and we cannot change those fundamental factors. I explain what is in the constitution.

Now, what I think is that there is a way of connecting this idea of the energy reform with the point that Santiago was making, the social contract. The new social contract has to emerge from the change in the energy sector. It is precisely with the idea that there will be these new resources that you can say, well, we're going to use these new resources to pay for the social protection without imposing taxes on formal labor. So I think you have to combine these two stories to solve the problem of a vicious circle of informality, but looking at the heart of the problem which is, I think, a sector has been the source of revenue for Mexico for many years that is basically imploding.

These are my own views. Again, with not enough knowledge of Mexico, but just, sometimes it's good not to know the details because you see, kind of like the general issues. But sorry I took too long.

MS. BABBITT: My name is Hattie Babbitt. I'm an attorney with a long-time

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interest in Mexico. And my question is for Alejandro Werner. But kind of building on Santiago Levy's point that these problems are not the problems created by this president. They were inherited by this president and existed for decades in Mexico. But also asking Alejandro Werner, you made it very clear that in sectors that have been opened up there's been significant growth. And I want to dig a little bit deeper into this nexus between the economy and politics. Have you all gotten enough credit for the growth in those sectors that have opened? If you haven't gotten the political credit, why haven't you gotten the political credit? Why isn't there a platform there from which to make the political -- in which to make the social and economic reforms that everyone has talked about?

MR. CARDENAS: Kevin? I'm going to take two more. Kevin and then you.

MR. CASAS-ZAMORA: Thank you. Thank you very much for, you know, a couple of really splendid presentations. I mean, one of the things that struck me in Santiago Levy's presentation is that the collapse of Mexican productivity over the past 25 years or so in particular happens to coincide with the period in which free market reforms were pursued in Mexico. And not just in Mexico. So at the very least this begs the question, you know, weren't free market reforms supposed to do away with the inefficiencies of a government run economy? So ultimately the question here is were free market reforms a failure? Or is it a case of free market reforms not going far enough?

MR. NEWMAN: Thank you very much. Gray Newman from Morgan Stanley.

I know this is a discussion on Mexico and I'd like to keep it there, but just to ask Santiago, you know, briefly if you could also maybe elaborate on how you would put the case of, for example, Brazil in this context of Mexico where you've had an important growth in the Bolsa Familia, which is also a program that, you know, might be seen as encouraging

informality. And yet it's accompanied by the same period of extraordinary growth in Brazil. Just to flesh that out. Thank you.

MR. WEINTRAUB: Thank you. Sidney Weintraub.

Let me elaborate a little bit on the energy sector and put it in a slightly different context than the way you put it Mauricio. Let's assume it's going to be hard to change the energy sector to get the kind of investment you want because, well, for a lot of reasons. Let's assume that. And it's quite clear as everybody sort of knows in looking -- make sure the revenue coming to PEMEX that finances the government is diminishing. And it's not going to be there possibly in the next decade. You must be thinking about what you do to the tax system in order to be able to deal with that problem. And I'd love to have some of the thoughts you're making on the assumption, one, you won't have the PEMEX revenue and two, you've got to run the government. How are you going to do it?

MR. CARDENAS: Thank you. Well, we'll finish it up and let's go back to the panelists. Which order do you want? In the same order?

MR. LEVY: So thank you for the questions from the panelists. Let me take the question from Kevin on productivity.

It's a very good question. So these are my thoughts. One would have expected after NAFTA a transitory fall in productivity. Why? Because a lot of the capital stock installed in many sectors of the economy was probably "in the wrong sectors" and therefore, as plants adjust to more competition and to a very different environment, initially there's some actually welcomed destruction of capital because you have capital in everything which you had no comparative advantage. Some reallocation of labor. This is not instantaneous and therefore initially what you would expect is, you know, after big shocks some collapse in productivity. The real puzzle is after some years, and this is, you know, five, seven years, but after some years you would have expected that productivity

would now be growing much faster than before.

So NAFTA fixed the tradable sectors of the economy. What NAFTA did is it put the manufacturing sector in particular and to a lesser degree services to compete with Canadians and with the Americans. NAFTA did O.O to change the most important labor market in Mexico, which is the labor market. And a lot of the distortions that are emanating here are coming from a market that was not only very distorted back then, but that is even more distorted today than it was back then. So you have firms competing in an international context, but in a market where the regulation of labor really is actually very inconducive, is actually contrary to helping firms adjust. And what you see with the sad situation of firms, what I showed you before and what you see with the sad situation of employment is not a result of the free market reforms; it's a result that you haven't really complemented the reforms with regulation of labor.

Now, before -- and I'll just finish with this point, this is not an issue of just changing labor regulations. The labor laws are a reflection of a social contract. They're a reflection of a vision of society about how it's treated workers. Mexico has a very important vision emanating from its constitution in 1917. The problem is that that contract is incompatible with productivity growth as it is implemented. Not with the objectives of the contract, but with the implementation of the contract. And it has to do with the financing that Mauricio was speaking about.

The real challenge here and the real art is going to be how do I comply with the true social objectives of a country that wants more equity while at the same time I regulate the labor market such that firms can be competitive and create more productive jobs. And that NAFTA couldn't solve, was not meant to solve, and hasn't been solved yet.

MR. CARDENAS: Alejandro.

MR. WERNER: Thanks. I think just following up on what Santiago was

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saying, I think, I mean, especially working at the Treasury, but you end up coming back to our fiscal situation in a sense that you can't -- I mean, having a weak fiscal situation also throws us to try to accomplish many of these aims through protection or through other legal elements. I think, I mean, just reacting to what Santiago was saying it would be much better to have a much more efficient labor market on a wider and non-distortionary unemployment insurance scheme than having all restrictions being embedded in the labor laws and generating all this distortion that he's claiming, and therefore moving towards a system in which we have more efficient labor laws and more unemployment protection could generate a much better equilibrium than the one we're having today.

I mean, turning to the oil issue, I fully agree with Mauricio and I think maybe what has been hiding this discussion is that throughout this period in which oil production dropped by 20, almost 25 percent, the price of oil more than doubled. And in that sense, society did not -- government and, I mean, federal, local governments did not feel the significant income effect of the drop in oil production because we had been compensated with a significant increase in the price of oil. But on real terms in the economy, it's there because, I mean, oil production has significantly dropped. And as I said before, our oil and mining sector grew at an average rate of 1 percent in the last 10 years when I think it grew at 15 percent in Saudi Arabia. It has been growing at 5 or 6 percent in Brazil, et cetera.

So by not investing significantly in this sector 20 years ago, now we're suffering from a significant drop in production that we shouldn't be suffering from and linking these with Sidney's question. I mean, when we presented the first fiscal reform in 2007, the minister back then actually said to the president, this is the first of many steps that we need to do to increase non-oil income of the public sector by around 10 percentage points of GDP. I mean, at the end of the day we need to do two things. First, have a much solid public sector income and substitute for oil income that eventually is going to disappear given

that oil represents around 6 percent of GDP or 5 percent of GDP today, however it represents -- people say 38 percent of public sector income. Significantly less than that because an important part of that is taxes on gasoline that you will levy them even if you're a gasoline importing company. But at least it should be like 25 percent of public sector income.

So in some sense we need to realign the dependence of the government on oil to the significant structural change that the Mexican economy has gone through that has become a non-oil economy. And in that sense we need to significantly increase either sources of income for the government and also in terms of relative prices, I mean, I think subsidizing energy in many ways has had and is having a significant fiscal cost on the economy as well.

So at the end of the day you need to redesign your fiscal stance and your pricing policies to an economy that will not be as abundant in energy as it was 20 years ago. The first step was the two fiscal reforms that we did, but I think you need to move much faster on that front. And basically having a much more solid consumption tax and a much more solid income tax in the country and reducing the amount of resources that are being allocated to energy subsidies.

I think along those three lines you could gradually accomplish this fiscal transition. And the other important, I think very important issue is to significantly increase the efficiency of public sector spending. I think there we haven't done enough. There have been important institutional changes, but the implementation of them has been slow and I think there are important savings that could be accomplished along these lines.

I think, too, other limits. I mean, somebody talked about free market reforms. I think he answered the question himself. I think we haven't gone far enough. I think from this discussion I think the consensus at the table is there are significant parts of

the Mexican economy that are significantly close to competition, either from outside or from within the country, and I think we have opened up significantly in a couple of sectors, but there are many very important sectors in the economy. And overall, on average, I wouldn't claim that the Mexican economy is more open to competition than any other economy in Latin America. So in that sense I think we haven't gone far enough.

In terms of credit for those things that have been done and have changed significantly the lives of many Mexicans, I fully agree. I think this political conflict -- I think we haven't reached in the democratic system some type of consensus on what are the things we're going to fight about and what are the things that we're going to agree about. And in that sense every field seems to be a good field to continue the political battle. I think nobody has fully recognized, for example, the changes we have done in the mortgage market in Mexico. I mean, in a sense we are, I mean, building around 600,000 houses -- new houses per year. I mean, we are funding these houses for low income workers through a public sector institution that is, I mean, lending this money to workers at low rates. Even in the private sector you can get a mortgage at 12, 13 percent peso rate, 20 year rate, something that, I mean, we have never seen in Mexico. And I mean that's, let's say, from the financial sector, that's a very clear aspect in which you can claim that in the last six years you have changed the lives of 3.5 million families.

And I think nobody has stressed those points. I mean, and maybe we end up concentrating the discussion in that the houses are very small or they're far away from where the jobs are and there are many problems with these houses, but I think these people are much better than what they were before these changes took place. And I think the same thing happens with opening up to trade. I mean, there are many issues with Saraquales, with how urban development has shaped up in these new industrial centers. However, when you look at the quality of jobs, the payment of jobs, et cetera, as Santiago was saying

in the formal sector and many of these new jobs were created from 1995, maybe to 2000 in the manufacturing sector, they're much better than what we had before these changes took place.

And the same is true -- and the same will be true if you change agriculture. I think a Mexican farmer will be better off working in a large agro-industrial complex than owning a very small plot of land that cannot -- where he cannot finance his crops, where he is subject to significant climatological uncertainty, and that climatological uncertainty could eventually could put his whole family under a very stressful situation if he has two bad crops in succession year after year. So I think the welfare of these families could significantly improve and I think what you said is a reflection of not having accomplished a significant, I think, political agreement on what are the things in which as a country we agree and that is the direction we are taking. And what at the tail end of that consensus are the things we're going to fight about?

MR. CARDENAS: Thank you, Alejandro.

Well, we're going to move into the next session. I think from this session you conclude that the problem is not the economists. (Laughter) So the problem has to be somewhere and that's for you -- that's an incentive for you to stay for the rest of the morning because we're going to be talking about the politics of Mexico, too.

So let me welcome to the table Kevin and our two panelists, William Maloney and Manuel Molano. (Applause)

THE BROOKINGS INSTITUTION

BEYOND THE CRISIS?
THINKING STRATEGICALLY ABOUT MEXICO'S ECONOMIC FUTURE

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PANEL TWO: THE MICROECONOMICS OF GROWTH -- ISSUES IN MEXICO:

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PROCEEDINGS

MR. CASAS-ZAMORA: Thank you very much to you all for being here. I'm Kevin Casas, senior fellow at the Foreign Policy Program and the Latin America Initiative at Brookings.

I had written in my notes that we were going to be focusing on a different set of issues from those that were tackled on the first panel, but that's just not the case. Because apparently from the word go, there seems to be agreement on the notion that the basic problem that we're tackling in Mexico is a problem of productivity.

So -- and actually I found some of the figures and the charts that were presented to us in the previous panel quite striking. A few weeks ago, Mauricio wrote a very good and, frankly, terrifying piece on development strategies in Latin America. And I say terrifying because it included a comparison over the past 40 years or so of the evolution of the productivity per worker in Latin America and East Asia. And that comparison, as we just saw, is simply dismal, from the standpoint of Latin America. I mean, in 1960 output per worker was more than 1-1/2 times greater than in East Asia. It is now 50 percent smaller.

So, I guess what I would like us to do in this session is to scratch a little bit more, this issue of productivity. Why is it that productivity has remained stubbornly low in Mexico and what can be done to improve it? And I guess it would be good to bring a little -- you know, a few more elements to the table. I mean, we've heard Santiago Levy making a very compelling case for informality being a crucial part of this story. But I guess it is worth also focusing on things like education standards, infrastructure, research, development, and innovation investment. I mean, what is it? Is it a question of revamping a legal framework that allows monopolies -- both public and private -- to operate undisturbed in Mexico?

And finally, I would like us to discuss these questions in the context of two critical trade relationships that Mexico has today. I mean, one of them is obviously with the U.S. and also with China.

Has NAFTA had any significant effect on the productivity of Mexican firms? And on the other hand, does Mexico have any strategy to increase productivity in order to cope with the onslaught that the emergence of China has meant for many manufacturing activities?

So, these are, of course, vital questions for which there are no simple answers. It is,

therefore, a great fortune to have here a couple of very, very distinguished speakers that I hope will unlock for us the mysteries of Mexican productivity in 10 minutes.

To my immediate left we have Dr. William Maloney. He is the lead economist at the development economics research group at the World Bank. Before that, he was professor of economics at the University of Illinois Urbana-Champaign. And then he joined the World Bank and worked, again, as the lead economist in the office of the chief economist for Latin America until 2009. And on the extreme left we have Manuel Molano, who is the deputy director of the Mexican Institute for Competitiveness. And before that, he's had a very interesting career sort of going back and forth between the private sector and the public sector in Mexico, which I think it's a great vantage point to gauge the challenges that the Mexican economy is facing regarding productivity.

So, without further ado, Dr. Maloney? We're all ears.

MR. MALONEY: Thank you very much. Thank you to Santiago, the IDB. Thank you very much to Brookings.

I'm not going to live up to the expectations of explaining productivity growth in 12 minutes. I did want to raise an issue which is the role of innovation in Mexican productivity growth and why I think it's been an enormous missed opportunity for 300 years that will become increasingly important -- we need to talk about. Santiago demonstrated that there'd been a lag in what we call total factor productivity, which is the part of growth that we can't explain with the accumulation of physical factors like labor, capital -- and even innovation, actually.

A large chunk of that is exactly what he was talking about when he was talking about the misallocation of factors across sectors and across firms, okay? And the number he gave -- which is something like 36 percent of GDP if you had a better allocation of factors is an enormous number that we have to pay attention to and it puts the competitiveness agenda and the distortion agenda firmly in the -- at the center of the discussion.

But there's also a large chunk of that total factor productivity which is commonly attributed to what we call -- well, to the management and generation of knowledge. And that's what I want to focus on. And I think it's really central because of Mexico's position right below the United States, which is actually very good at managing and generating knowledge, and yet it has had a

tremendous fall in total factor productivity over the years.

So these guys think they're talking long-term, 50 years. I want to go back 200. I want to look at one case 200 years ago, and one case that's pretty much going on as illustrative of some of the issues we need to talk about.

Oops, that's not what I want to do. Sorry.

Okay. 1800, Mexico, as we all know, is one of the largest exporters of mining products in the world, certainly in Spanish America. What probably didn't know was that actually it probably had the only university in all of Latin America that taught mathematics, chemistry, physics. And is probably the only university in the entire hemisphere that taught hydraulics, which was critical to getting the water out of mines, okay? Mexico is the vice president of the World Mining Association, okay? It was the intellectual powerhouse for mining in the western hemisphere.

Fast forward to 1900. Mexican mining firms are slowly going bankrupt, and they are bought up one by one by U.S. interests, okay? This is a process going on in Spain; it's a process going on in Chile. It eventually moved to mines to the processing part of -- smelting, and the like as well. All that was bought up by Guggenheim and other firms.

Why was this? I think it was this. However good they were in 1800 in terms of knowledge, if we take a proxy for sort of your applied ability to manage technology during the second wave of the Industrial Revolution, which is sort of 1870 to 1920, Mexico was pretty much surfing without a board, okay? What we have here is a number of engineers per 100,000 people. And the darker you are the better. So, we see Massachusetts and New England way ahead of the curve, lots of engineers. About 120 -- actually Massachusetts would be more like almost 200 per 100,000 workers. You get to the Midwest it's a little bit lower. All this big block over here to the left, that's western mining. That's the opening up of mining and that's just engineers going frantically to parts of what used to be Mexico.

The thing is, look at Mexico. It's nobody, it's got nothing. It's got 15 engineers per 100,000 people on average. It is systematically below even the deep south of the United States, which had 66 engineers per 100,000, okay? Nothing. You want to know why they couldn't manage the new technologies, why they couldn't manage the Bessemer process? Why they felt so

dependent on foreign companies for technology and the like? It's because they were, okay?

This is important because a large chunk of that TFP is that management of knowledge. It's also important because there are models out there -- for instance, one by Peter Howard at Brown and David Meyer at CIDE in Mexico -- which say, look, if you're really good at managing knowledge, you're going to be one of those inventing types. You're going to grow really fast, have a really high level of income. If you're okay, you can adapt, you'll grow at the world rate but you're never going to be as rich as the United States. And if you don't manage, you go out of business. Okay? And that's what happened in Mexico here.

So, let's fast forward to now, 1982 to the present. If you look at two countries, Korea and Mexico, and their exports of computers -- HP and -- Hewlett-Packard and IBM set up in Guadalajara in about 30 years ago. Let's just take as a measure of management of knowledge and the generation of new knowledge, patenting, okay? If I take Mexico's share of patents, yeah. Computing patents -- patents in computers as a share of its total and divide it by the worlds -- if that's greater than one we say it has a comparative advantage in innovation in computers. That's to say, you're producing relatively more patents. Mexico started ahead of Korea in 1982 at about .5. That's to say it wasn't actually relatively producing many patents, but it was ahead of Korea. Right now, it's at .2, okay, and Korea is at 3.5. Okay?

What does this tell you? Well, all this stuff about what you export matters? Chuck it out the window. They're both producing the same stuff, okay? But somehow in the process Korea made this into a dynamic industry that managed knowledge, generated new knowledge, and was able to spin off new firms that could actually really stimulate growth. That' hasn't been the case in Mexico.

So, then the question is, why is this? We're sitting the closest Latin American country to Silicon Valley and yet we're not putting out patents in computing. What the heck? Okay. Let's just -- I want to go quickly through some slides that kind of benchmark where we are.

Math scores, okay? This is a Latin American problem. We're spending as much per capita as a share of our GDP as anybody else, but we're way below in terms of mathematical literacy. We're way below competitor countries like, say, Czech Republic or Ireland, countries who

should be -- we should be comparing to. We're not.

Just take a look at a very bad proxy for innovative effort, which captures a lot of stuff. But research and development expenditures as a share of GDP. Our dotted line here, as you see, is the average across the development process for countries, okay? That's generally -- as you get richer, you invest more in R&D, and most of that comes from the private sector.

We have our superstars: Israel, Finland, and South Korea. They're just breaking with the trend, breaking with the pack. They're investing hugely in research and development across the board.

Latin America sort of noodles around the average. Okay? And those are the big countries of Latin America. You don't want to talk about Guatemala. And Mexico, you can see has increased up to .5 over the last couple years. But China is already at 1 and it's a much poorer country. And India is an even poorer country and it has been close to 1.

Now, is this the whole story about innovation? No. There are a bunch of dimensions which, if I had another 12 minutes we could talk about. But this is saying something. It's saying that if we're thinking about, okay, we're manufacturing and these are high tech industries and we should be -- we're not making the investment as a country in research and development -- and in innovation effort more generally -- that we're going to have to make.

Why is this? Well, this gets back to a lot of questions. We could talk about, for instance, the overall business climate. If I have a monopoly on some particular sector, I don't really have to innovate very much because no one's going to challenge me, all right? You open doors to NAFTA, all of a sudden you've got a lot of competitors. Well, you're going to have to manage the best knowledge out in the world. Otherwise, you're going to have your lunch eaten by China. In that sense is, my guess is if we looked carefully at firms that were exposed to NAFTA that their productivity would have risen. And we know from study after study that firms that are more outwardly focused tend to invest more in innovation.

We could also talk about labor law, okay? Not a particularly segmentation -- I think Santiago and I are in agreement that there's not a huge amount of segmentation in the labor code. But it is, however, the case that if I want to lay off a worker, if I need to lay off a worker for -- then for

economic reasons, it's very costly and very litigious. And if I do it because I'm introducing new technologies, it's even more expensive. Okay? And then you combine that with a political economy where unions and -- where firms and workers are not exactly on the same page, okay? We're going to work together to increase the productivity -- it's kind of a zero sum game. Dudes, we're growing at 1.5 percent, it's a question of whether I get some of that or you get some of that. If you're growing at 8 percent you could be a little bit more generous.

The Finnish unions, the Swedish unions, they're the ones who are saying, look, you've got to get rid of this old technology. We'll retrain that worker and put him somewhere else. That's not how it is in Mexico. That's very important.

Let's look at some other things. We spend a lot on Unam; we spend a lot on universities in Mexico. But this is just a measure from the World Economic Review of interviews with entrepreneurs on the quality of scientific institutions and the degree of collaboration with scientific institutions, okay?

And we see that the quality is not so high -- or, not perceived as so high in Mexico. In Latin America, in general -- as usually the good -- as usual, the good boys -- Israel, Finland -- yeah, all right, superstars. That's great. We're not there. And because the quality is maybe not so high, that's maybe why the firms don't find a big premium in going to work with the universities and saying, okay, what have you got for me? What can I do, how can we be more productive? Well, maybe those guys don't have the right set of incentives and the like. That's critical when we're talking about a national innovation system; we need to have both the best quality people possible, and the incentives for collaboration with the productive sector of the economy. That's not happening in Mexico.

Another thing, you'll remember, I'm sure, Old Willie Sutton. Willie Sutton was the guy who was -- when he was asked, why do you rob banks? He said, well, that's where the money is. Okay? Well, let me ask you why Taiwan and Korea study in the United States, so many students. This is the students studying in the United States for their share of tertiary graduates in -- tertiary enrollment in these countries.

Taiwan and Korea are not coming to the United States because they're learning

English. It's because that's where the knowledge is, right? They're parking in Silicon Valley; they're parking at MIT, that whole area. Okay? Look at Mexico. Mexico is next door, okay? We're both quasi-romance languages, okay? Flights are cheap. We should have hundreds and hundreds of thousands of Mexican students at MIT, at Harvard, at Illinois. At Illinois and Berkeley -- Mauricio will tell you -- we had thousands of Brazilians. Very few Mexicans, maybe one. So, okay, so what's happening? We can talk about, okay, historical problems, you stole California, cool. The Vietnamese are here, okay? The Vietnamese are a much poorer economy, and they know where the money is, okay? They're sending their kids here, all right?

So there's this (speaking Spanish) -- I don't know if that's the correct way to do it -- which continues in Latin America, all throughout Latin America. Now, we could do it ourselves. Okay. Well, as the Finns will tell you, very proudly last year we generated .4 percent of globally knowledge. We need the rest, okay? So, they're out there. And Nokia, very small fraction of Nokia's workforce right now works there.

Just before I get to this point, the question about whether NAFTA did anything for these issues. As I've already said that more open firms are more productive -- I'll be done in a second. But I also want to say, it's very recently Nick Bloom at Stanford and John Vanree at LOC have been conducting a series of standardized management surveys around the world. And we commissioned them to do it for Mexico and for Argentina; we have it for Brazil.

So, Argentina and Brazil are terrible. We're talking India; we're talking among the worst in the world in terms of management quality, all right? Mexico's not. Mexico is a notch above, it's in the lower -- it's just below the middle for management quality. And as we go through these data, I'm sure that we're going to find that firms that are more exposed to U.S. management techniques and are working more with U.S. firms are going to show that they've absorbed a lot of those management practices.

I think the question is, we need to be -- have a much broader based effort across all levels of the economy. Basic learning by doing organizational technology and SMEs -- all sorts of different ways of transfers, better linkages with universities -- we need to do it across the board to take advantage of something which is very basic. Which is, Mexico is still very far from God -- that's

not going to change much. But it's so close to the most dynamic generator of productive ideas in human history, okay?

This is a gift. You don't have to like the Americans, okay? Don't like the Americans, but take what they're generating, for God's sake and bring it to Mexico and become much more productive. Let's get the TFP numbers up.

I would say, poor U.S. It's losing its traditional leadership in Latin America. You can't talk about social policy at all when our inequality numbers are going through the roof and -- but we're still there in innovation. Okay? We're still in ideas. Okay? And I would say that if the United States really wanted to somehow connect, if we talked about an alliance for innovation or something where we really said, okay, look. We all -- as Mauricio said, we all have this TFP problem, okay? Let's figure out how you're going to use knowledge better than you have been in the past.

Thanks. (Applause)

MR. MOLANO: Okay. Well, after so many remarkable presentations, it's going to be rather hard to say anything new. But I'm going to try.

I give this the title, "Hinder the Winners, Lose the Losers." Because that's exactly what we've been doing in Mexico for the last three, four, five decades. Mexico intervenes in economic sectors, and it does it really, really badly. And I think many other things that have been said by Dr. Levy or by Dr. Werner pretty much tells us this.

So, to not spend time with chitchat, I'd like you to take a look at this one. Usually in Mexico when companies seek some sort of government protection, support, help, subsidy, or whatever you want to call it, they say, hey, I'm profitable and I hire a lot of people. So, the government official will look at numbers, yeah, this guy's profitable, he has a lot of people, so right, let's help him. But we're not looking at where do those profits come from? A lot of the time, these profit comes from market power. And it doesn't come from competition that leads you to be productive and, like Bill said, then would lead to profits. It basically comes from extracting something from somebody else. And when you're extracting things, you're extracting value from somebody else, you're destroying value, you're basically leaving society worse off. And this happens a lot in Mexico.

So, because government officials won't stop doing this, at least we economists should be giving them a road map about how to go about it. And this is what I thought. What we asked -- well, it's okay. Let's ask if companies are profitable, if -- the more profitable, the better. I think that's a good idea. But how about if you also ask if they're exposed to competition and those two questions are easy questions to answer.

After that, you would have to ask, okay. Are you en route of becoming bigger or specialized? Because if you don't become bigger or specialized, you're probably going to fail in the global landscape. And then you would have to ask, okay, how is innovation there? Are you going to become a world player? Are you going to change the world? And those are really hard questions to answer. So, I'm not going to leave that for my 10 minutes. I'm going to stick to the first two questions.

Profitable and exposed to competition. So first, we took from the latest census -- we took some manufacturers and services. Most of it is in the private sector. We don't have here all the mining and energy. We don't have here some of the government services, medical services provided by the government. But we do have private. And if you divide it and you take the gross margin of companies, you will find that there is a gap. That the non-tradeables make a larger profit, which is the difference of 23-something percent, you see there. Difference is probably some sort of rent extraction.

And why? Well, I agree with Dr. Werner. When we integrated into NAFTA being roughly the size of the Florida economy, well, we integrated with the U.S. economy. So in manufacturing, we do pretty good. We could do better -- recently *The Economist* reported that the trade between the bricks and the developing world is growing at twice the pace of world trade. And Mexico is really disconnected from those trade flows. So, we could improve that and we could be importing fibers from the Far East to do textiles, and we could be doing other things that we are not doing currently in North America.

Right now, we are kind of inheriting the second order complications of sectors that are also protected in North America. And all the agro-industrial sectors that Dr. Werner mentioned are a fine example of that. We have a horrible sugar market, where I worked for a while. Why?

Well, because the sugar market is also horrible here in the United States, so we pretty much have exactly the same thing.

But when you look at sectors and the problem with dealing with census data at the level that I have access is that swarms of information get lost in the averages. What you will see is that the services are the best and the worst of a Mexican economy. And when you see sectors that are destroying value, a lot of those sectors that are destroying value are associated with sectors that create value in the other side. So, you have a sector that provides, nurses, and doctors for hospitals and then you get some hospitals that lose a lot of money, like houses for the elder or orphanages, or basically low added value medical services. And these things act both as a fiscal shield, but also as a social lever to extract grants from government.

I mean, if you are in the sugar sector, again, the only thing you need to extract money from government is you say, look, look at the poverty of the people that work in the fields. And the government will throw money at these things. They just do it.

So, if you take all the non-tradables, everything that you cannot bring from the U.S. - - from haircuts to whatever you can think of -- and you try to divide this between less contestable and more contestable markets -- and this is no small feat, because also the data doesn't help. What we're doing this is trying to approximate this with the number of establishments that we have in each sector, which makes us prone to errors. But a lot of the work is there.

So, what you will see is that in the bottom to your right quadrant, you have 24 percent of the total income of the services economy in Mexico. And those are very good winners. This is companies that deal in contestable markets, and you get there -- all the Wal-Marts and all the Oxos, which are convenience stores, and the 7-Elevens. Professional services -- and there you get very good profits and those profits are in contestable markets, so what we think is that these people got really productive. How productive? If you compare those -- you compare the labor productivity growth between the '04 census and the '08 census, what you will see is that productivity grew 10 times more in these more contestable sectors than in lousy, monopolized sectors like TV, or radio, or hospitals, which, by the way, are very important to spur things like political reform. I mean, government could easily intervene in the radio and TV sector to bring in more content, to bring in

more media -- which is a commodity right now -- and that should spur a political competence in Mexico that should change things. So, there are things that government can do.

But also, in things like retail -- if you talk to the social and economic development secretaries at Mexican states and you tell them, well, you know people here are very poor. So, you should probably have a Wal-Mart here in Oaxaca because if people are poor they could benefit from really low prices. And what the guy will answer is, no, we won't do that. Why? Because that destroys the local economy. Where's the mom-and-pop shop going to do after that? And that's it. So, at the very local level of people who aren't making subsidy decisions, they cannot make distinction between the bad profits that come from the rent extraction and the good profits that come from productivity.

So, I probably have like two minutes more? I totally agree with Dr. Levy. What we have is a bad bed in where are we putting our factors of production. Bad resource allocation is the main culprit for Mexico's sluggish growth. We have severe distortions in markets which come from serious misconceptions of the role of public policy, and we're not -- go over that if I have enough time.

So, factors of production cannot easily find their base use. We create abundance of factors in some sectors and scarcity in others. And that induces a bad technological choice. This is the United Nations Industrial Development Organization data. The productivity in Mexico is not horribly low. I mean, if you look at China or India's, it's probably lower. It comes from very, very -- in China and India, it comes from a lower place. So that's what -- that was impressive. This has tripled in probably the last decade. And Mexico has, at best, stagnated. I assure you of that.

But why? I mean, if you look at China, where was China? China was in balance with their current account deficit? And in labor-intensive and low-tech things -- and they moved really fast to high-tech. Mexico stayed in the mid-technology things like assembling cars or doing large TV sets, like this, which is probably what we do best and our most high-tech thing. And we just moved a little bit. And why did we move just a little bit?

For this, I have an example. This comes from the services economy. If you go to Mexico City and you park your car in the airport, you will find that they have machines to collect

money from the people who park their cars. But there's not only machines, but there's a union guy standing next to the machine. And the union guy has pockets loaded with cash, and he helps you to operate the machine. And the dispenser in the machine never works right, it never has change. It's - - by the way, the only place in Mexico City where this happens. Because if you go to every mall in the city, you will find that the machines work perfectly. But here, that just doesn't work.

And what happened here? Well, we had a labor intensive process, we tried to automate this labor intensive process because probably money was getting stolen or probably something was happening that was really bad. And we couldn't fire the union guys. So now we're using capital and labor to do the same process. So now it's become really expensive. Bravo, kudos. And that's really the story.

If Mexico can't make anything to move from point A to the frontier of possibilities of production to move that direction up, then we shouldn't be changing technology for -- at least for these kind of things.

What happens with human capital? Well, assuming that people who studied in Mexico have knowledge that's worth something, because our math skills are very bad, our English skills are very bad -- we are not giving a very good reward to talent. In the world, the ratio of these to goods unqualified labor to qualified labor is 4 to 5 times. And in Mexico, it's 2.2 times.

It probably has to do, also, with the lower productivity over talent. And maybe we are just paying exactly what this talent is worth. But looking -- where are these talented people working? They're in professional services and they're in social services and they're in government. They have -- there you have probably like social services 25 percent of the talented labor force? And there's 35 of the salaries that these people earn, which is really, really amazing.

And if these people were really talented, they would be all above the blue line. They would be getting more than the fair share, and the people who are uneducated would be getting less than the first shares. So you would be moving people from the lower left -- or to your right -- triangle to the upper right. But this is just happening.

When you see the unqualified labor, which is most of the people in Mexico, what you will see then is trapped in things that do not add any value, like agriculture. So, sorry.

Being trapped in things like agriculture in a country that is in the same latitude as the Gobi desert or -- a lot of people think that Mexican agriculture would do exceptionally well. I think that's a fallacy. I think that -- and if we continue to throw money at corn production in Mexico and if we continue to throw money at other things, like water subsidies, diesel subsidies, we won't be able to give the signal to these people in agriculture they should get out of there and move to the closest manufacturing plant or miscellaneous services where they should be.

And the scale, of course. What you see here in the red bars is the small companies. And the pink line gives us the weighted average cost of capital. So these small firms do not cover the cost of capital. They suffer some sort of Peter Pan syndrome, they refuse to grow. And why is that? Well, because if they grown they'll come under the radar of the tax authority and of a large union, which will extract a rent from them.

Also, in the talent piece, you will see that these companies do not attract any talent. So, that also explains why manufacturing processes in Mexico do not move on. We are not attracting talent in manufacturing.

Many misconceptions comes from this. We think that by subsidizing sectors they will develop. That labor must be compensated for exploitation, that protective sectors will eventually grow. When they grow, they'll become competitive. The real people should stay off cities and should not create urban distress; that producers are boundlessly rich and we can tax them at infinitum. That the only efficient owner of natural resources is the state, that only a small set of regulations like opening up shop affect entrepreneurs and the monopolies are really not bad for the economy.

In fact, it's a headache to get a passport in Mexico or to hire somebody that is foreign. Our growth during the 1960s can be in a lot of ways explained by the fact that we imported a lot of talent from the European wars. And that's probably a best explanation for the Mexican miracle in the '60s than the oil.

So, we give them all of these distortions. And if we keep on having water with zero price for agriculture, we are going to continue having people invest in trying to cultivate in the desert, which is horrible. And just to end, I'm going to try to do some conclusions.

I think that markets need to be contestable in all services. And this means that I should be able to import (inaudible) into Mexico to work for a Mexican firm, because those are talented guys -- come from India -- and I should be able to import them. Right now, I cannot do that.

We need a more sophisticated triage process for industrial development policy. We're throwing a lot of money at that, and when we make bets on economic sectors we should be giving them public goods available for every firm in the sector and avoid subsidizing capital. If entrepreneurs cannot raise capital, they're not much of entrepreneurs. They're just people taking money from government, and we should do that.

Labor reform, of course. Strengthen signals and rewards to young human capital. Tax reform and functionality of capital -- bankruptcy laws could also help. Having a failed company in Mexico is a headache, and if we could expedite bankruptcy and have less consequences on people from bankruptcies, capital could be able to move from sectors.

Universal social security. This is something that Dr. Levy has said extensively. I think this could help a lot. If we will be able to finance a system of universal social security with value added taxes that should be generalized, then we would give a boon to entrepreneurial drive, risk taking -- because people do not have to stay in low value jobs just to have health covered.

And also, use every crisis possible to solve productivity problems. Right now, when an economic sector comes with a crisis to government, they just throw money at it. That should be the exact opportunity to try and fix it.

And I'm sorry, I took more time. Thank you so much. (Applause)

MR. CASAS-ZAMORA: Thank you very much for two terrific presentations. I'm just going to put on the table one very concrete questions to both speakers.

It is great when you get to hear academics and policy wonks, you know, saying these things. But that, of course, is no guarantee that they will get done. So my question for both speakers is of a purely political nature.

What's the social and political coalition that will advocate a more competitive and innovative economy in Mexico? Because in the end, you know, I don't see Mr. Slim or Mr. Azcarraga having a strong incentive to pursue the kind of things that you're mentioning here. So, (speaking

Spanish).

MR. MOLANO: I think that's one for me, right?

MR. CASAS-ZAMORA: But both of you. Feel free to --

MR. MOLANO: I will -- I'm not an expert on solving things in the political arena, and I was hoping to learn a lot from the next panel where Jesus Silva-Herzog and others will be talking about it. And this is probably the reason why when change has come about in Mexico, it has come in either weird, silent, unnoticeable ways or in abrupt, violent, and complicated ways. And we don't have a definite answer for that.

I think that it is not entirely true that the economy does not innovate. We don't do original patents or build planes like Brazil. But we do have a lot of industrial process improvements, and we've learned quite a bit from the U.S. and Japanese manufacturing practices in automotive and so on and so forth.

But I think that what we need is a lot more of that. I wouldn't be more in agreement with Bill in saying that we should be sending all of our children to study to the U.S., and we should be trying to integrate much more with a knowledge economy that's happening here. That's the only thing that would bring a change -- a significant change -- that doesn't have to move through Congress. And I think that that should be a very important bet in Mexico.

So, Bill?

MR. MALONEY: Just very quickly. I think there's a lot in which any society doesn't know what it doesn't know. And that's a lot of what you see in the success stories of Finland, Japan, and Korea has been changing how people view the whole issue of how you make your economy grow.

Just trivially, in Korea they said, we have a problem with entrepreneurship. Okay? So, they made it so there's an annual prize for the best entrepreneur and you get, you know, everything. You know, it's televised and everything. Japan, when they started out this whole thing, trying to reorient the mindset, if you started a major company you got a samurai sword to generate the prestige associated with traditional values in Japan. Finland, every new elected member of the Parliament goes through like a month-long course where they learn about the Finnish model of

innovation, okay? How Nokia works, how all the different parts of the national innovation system fit together, why education is so key, why the labor legislation is designed the way it is.

Everyone -- okay. So, this is higher level human capital in a very small country which you would presume would already know this stuff. But they don't, so everyone gets extruded to try to generate a consensus. I mean, I think I can look at my own country and it's -- you know, don't you get it? Don't you see what's going on in the rest of the world, where China and India are going to be in 10 years and you're doodling with your education system in the U.S.? We have a problem -- I think all of Latin America has a problem, too. It's all Spain's fault, fundamentally.

(Laughter)

Actually, it is and actually if you take it further, it's Rome's fault. But -- so, yeah.

SPEAKER: (inaudible)

MR. CASAS-ZAMORA: And, I mean, just before -- I mean, I would like to interject. And what about things like reforming anti-trust laws? I meant that's a very specific political task. Who's going to do that?

MR. MOLANO: I think that that has been done to a great extent. I mean, there's just a good niche there in Congress right now to give forwarded powers to the anti-trust commission, and -- but there are many things that are embedded in our culture that avoid us to think in terms of competition. There is a very bad notion of merit in the Mexican economy.

And this starts in school. I mean, anyone who went to school in Mexico will know that people who study a lot are *el matado*. This is the way you call very much these people out, because they're nerds, you know. And academic fraud is rife in Mexican schools, even at the youngest levels. So, when these people go out in the labor market, instead of competing they set up cartels. And I think that we need to change that mindset. And that's probably a more long-term process, because you can change as many laws in anti-trust, in consumer protection as you want. If people do not have the competition culture embedded, it's not going to work.

MR. CASAS-ZAMORA: Okay, we're going to open it up to the audience. We're going to take about four or five questions. And I just would like to remind you to identify yourselves before you ask your question.

Over there.

MR. CROOK-CASTAN: Yes. Clark Crook-Castan from the U.S.-Mexico Chamber of Commerce.

Taking your point and Santiago Levy's point about all the reforms and all the counter-productive business practices, I would just like to say if we thought for a second that here in Washington, D.C., I can form a consulting company for less than \$100 and less than 1 hour of paperwork, wouldn't help if the Mexican authorities tackled some of the more personal and smaller-scale problems, such as registering a company? And making it easier to handle without masses of lawyers and without having to have a personal accountant for every company and a whole staff of people to run the paperwork.

So, that's my question.

SPEAKER: Thank you. A question for Bill. In the previous panel, we talked a lot about the low productivity firms that are, you know, many of them informal and the strategies to bring them into formality and therefore make them more productive. But I wonder if there is a problem in the upper tail of the distribution as well? If the higher productivity firms in Mexico are truly world-class or if there is a problem with those firms as well associated with innovation, even capital -- all those things?

Because just focusing on these idea of making sure that the level of informality is brought down does not necessarily do the trick. Maybe we also have to think about these other firms. And we hear stories -- and I don't know if they are true or not, but we hear stories that these, you know, fast-growing firms in Mexico are really the *maquilas* that are not really doing a lot of innovation. And they're not really becoming, you know, the engine of growth.

MR. CASAS-ZAMORA: You have a question?

MR. STEIN: Yes. Armento Stein from the ADB. Question for Walter. There are all these policies that Mexican government is carrying out about the *incubadoras*, *aceladoras*, *teclas*, and the *empresa acela*. I was wondering if you wanted to comment on -- how do you see those policies in that area?

MR. MOLANO: I -- probably you said "Walter" because you think I'm Walter Molano

-- Manuel Molano. We're unrelated.

But the thing with clusters and *acelas* and *incubadoras* is also a misconception in policy. Clusters cannot be created by government decree. Clusters grow indigenously. Nobody in the government of California said, well, let's create a cluster in the Silicon Valley. This just happened. And the general conditions for these things to happen are not in place in the Mexican economy.

If we are not forming the talent, we should be importing the talent, plainly. I mean, how many oil engineers do you think Venezuela has in idleness right now? We should be importing that people, and we're not. It's hard to do that. It's -- so, doing things like speeding up the regulations to set up shop certainly helps, but we -- what you need is a major overhauling of the public policy in doing things like generating and importing talent you need for the economy to move.

Trying to answer the question on if -- Mauricio's question -- if the problem of human capital and innovation is pervasive in all firms in the distribution, it probably is. But in the high value-added sectors, you can more easily overcome these problems. So, what you find is that where there's a lot of value added, you are able to capture talent and you're able to capture capital probably more expensive than at other places in the world. But in low value-added things -- which are, by the way, the things where most Mexicans can work right now due to their current level of labor qualifications -- you cannot. So, you're in a deadlock of what was first, the egg or the chicken?

But I think that also the problem is that the government has no clue in what total factor productivity is. Our productivity measures are totally labor-centric, and we don't sometimes even have productivity measures. We're just interested in having any company hire people in any job, and we're not worried if that is adding value or not.

So, we get confused in our objective. Our objective should be productivity and, in fact, is some weird form of poverty alleviation through the labor market. And that just doesn't work.

MR. MALONEY: If I can quickly segue on that point, I think there is a -- you look at China and you look at Mexico and how they approach foreign direct investment. And I have -- this -- I'm shooting completely from the hip. But I have this feeling that when the Chinese look at a foreign investor they say, okay. You've got world class technology, you're the frontier, we've got one of the

world's cheapest workforces -- or had. Okay. Huge rent possibilities there. We're going to divide those rents. You're going to take home some nice profits, and I'm going to take technological transfer.

And you can see that in the recent dispute with Embraer. Embraer said, sure, we'll open a plant in Beijing or wherever it was, Shanghai. It's going to be the last generation plant for the last generation airplane -- fine, fine, fine, fine. Then they start breaking ground and the Chinese say, you know, actually it would be much better if we had the latest version. Of course, the Chinese don't want last year's technology; they want this year's technology. And of course, the Brazilians didn't want to give that technology. At that point, you realize they're working at the margin -- at the correct margin, right?

You kind of get the feeling that a lot of -- just to parrot Manuel -- that a lot of willing -- you know, the FDI was sort of viewed as, okay. You're going to provide jobs and taxes, and that's kind of how it is. And I don't know what I would have gone back and done when Hewlett-Packard and IBM set up shop in Guadalajara 30 years ago, but somehow you feel it should be, you know, Silicon West South. Right? By now. And I don't know what more aggressive government policies would have need to be in order, or maybe just better human capital policies or something.

But just on Mauricio's point, Santiago and I have been talking a lot about the informal sector and I think we have a similar view of it. What I'm struggling with a little bit is how much of a growth drag we can attribute to it. I mean, if you just plot self employment, which is a large chunk of informality, against GDP -- against productivity in the formal sector, it's linear. It's logged linear across the world, and it's logged linear in time in the United States and in Europe. So in some sense there is a process by which productivity rises in the formal sector and people get drawn in. That doesn't mean that the effects he's talking about aren't key, it's just -- I don't know that Mexico is particularly off trend in terms of its growth process.

Mexico clearly has some excellent high level firms. And as I said, management quality seems to be quite high by Latin American standards. Where I have a feeling that there's a lot to be done is in the middle tier. And the -- my graph with the big swoop on R&D. The sneaky thing -- and there's a -- Spain. Spain is a dismal underperformer in this. It's about half of what average R&D

is for a country of its level of development. But I have a feeling that somewhere in 1950, the late '50s, technocrats were saying, I'm not sure what's going on with this integration of Europe, but I think it's time for us to see how Germans are making cars. I think it's time for us to figure out how the French are making textiles. And they started sending people abroad -- and this is mid-level firms that are just getting best practice in organizational technologies and the like. So, it's not R&D effort, but a huge possibly gain in productivity from fairly un-sexy innovations, so I think that's really important.

MR. CASAS-ZAMORA: Well, thank you very much. We now move to the third panel, and the political economy of low growth in Mexico. Please join me in thanking our two speakers. (Applause)

(Recess)

THE BROOKINGS INSTITUTION

BEYOND THE CRISIS?
THINKING STRATEGICALLY ABOUT MEXICO'S ECONOMIC FUTURE

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PARTICIPANTS:

PANEL THREE: THE POLITICAL ECONOMY OF LOW GROWTH IN MEXICO:

Moderator:

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Global Economy and Development
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Panelists:

JESUS SILVA-HERZOG MARQUEZ
Instituto Tecnológico Autónomo de México

VANDA FELBAB-BROWN
Fellow
The Brookings Institution

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PROCEEDINGS

MS. GRAHAM: Okay. Well, welcome to the last panel. Please, *si se puedan tomar asiento por favor*. This is a panel on the political economy of change, so how do we actually make all the changes happen in reality?

I'm Carol Graham. I'm a senior fellow here at Brookings.

We have two wonderful panelists here today. The first is Jesus Silva-Herzog. He's a professor at ITAM in Mexico in the law school. He's been a Mexico public policy scholar at the Woodrow Wilson Center. He writes a weekly column in the newspaper *Reforma* and is a regular contributor to other Mexican publications. He's the author of books with wonderful titles I must note, in particular, *La Idiotez De Lo Perfecto* and *Andar y Ver*. So, we look forward to hearing from him.

Our second speaker is my colleague here at Brookings, Vanda Felbab-Brown. She's an expert on international and internal conflict issues and their management, including counterinsurgency, and focuses in particular on the interaction between illicit economies and military conflict. She's a fellow in the Foreign Policy program here at Brookings and focuses on Southeast Asia, the Andean region, Mexico, and Somalia. She's also the author of a book with a wonderful title. Her book is called *Shooting up Counterinsurgency and the War on Drugs*. It was published by Brookings, and it's here in the bookstore if you want to get it after if she interests you, sparks your interest enough with her remarks.

So, with that I'll turn it over to --

MR. SILVA-HERZOG: Thank you. Thank you very much. It's been a really wonderful seminar. I want to thank for the opportunity of talking today here. And I think we've been hearing a lot about a success story that has somehow stagnated, the success story of NAFTA, something that hasn't been able to deliver up to its expectations, and I think that's basically the same story that we can tell about political change in Mexico that has been an outstanding success story. Mexico has changed its political system from a basically one-party system, an extremely centralized political system, an authoritarian political system up to pluralistic, democratic system in which federalism has come alive, in which criticism in the media has grown enormously, and in which there is no longer an owner of politics as it used to have. Mexico's politic hat had an owner, and it was its

president. But that success story has also stagnated and has also become one of the main obstacles for change -- economic change, social change -- that Mexico needs.

I think that Mexico's democracy has come up to create a very broad, a very powerful coalition for the status quo. The child of democracy has been this very wide coalition for a very wide conservative coalition, and if that exists, it's basically because there have been winners. There are clearly winners of the status quo. There are very powerful actors that know what their interests are, that know what they need to do to preserve their privileges, and that are also well connected to the political structure.

I would emphasize also that this very broad coalition, very broad conservative coalition, has also been helped by an idea of politics, an idea of change that has been defining Mexican history throughout the 20th century and in this decade of the 21st century, and that is the extreme value of consensual politics in Mexico.

Mexico had basically one century ago a very violent episode, its revolution. After that episode of conflict, Mexico generated a political system that privileged consensual politics above all, and it was not a democratic system, but it was in comparison to its Latin American neighbors. It was not a dictatorship; it was not a political regime that established violence, force, military measures to hold its control of power. It was a consensual authoritarianism.

That might have been the basic characteristic of Mexican authoritarianism during the 20th century, and consensualism was not only the rule of the game in authoritarian politics, but it was also the basic path of democratic transition in Mexico. It was a transition in which the authoritarian regime had the first and maybe the last word in defining the path, the rhythm, and the goals of electoral transition. It was therefore a transition, a democratic transition that had only -- basically had one arena and that was electoral change. It had basically one space in which change was enacted, and it was electoral rules and the rules of parliamentary representation. But it basically left all the structures of that authoritarian regime in tact. During these panels, we've been hearing about those arenas of the authoritarian regime that are in tact, and they are still pretty much alive in Mexico's democratic structure.

What are the elements that define this broad, conservative coalition in Mexico? I

would say that the elements that are keeping this conservative coalition are institutional; also have a stronghold in political culture, in political organizational, and also in the styles of leadership.

Institutionally, we lived in Mexico. An important change that, as I said just a moment ago, had basically the arena of electoral change.

But in terms of constitutional structures, almost no change has been enacted in Mexico's recent history. The presidency therefore in Mexico is basically a very weak presidency. Mexico was under the spell that we had a very strong presidency and the legend that we even had an imperial presidency, because during the *aprista* era, one president could blink an eye and nationalize banks, and the other one can blink the other eye and privatize banks.

But that power of the presidency was not based on constitutional powers, but it was based on the links between the party, the president, a disciplined party, and a noncompetitive electoral system. The president was the leader of an agumonic political party. The party was disciplined to the leader of that party which was the president. Those conditions are no longer in place in Mexico, and therefore we see that the emperor is naked. We see that it does not have the powers that it enjoyed during the last half of Mexico's 20th century. It is a weak president in comparison to its colleagues in Latin America. It's not as powerful as an Argentinean president, as a Brazilian president. Of course it's not as constitutionally powerful as the Venezuelan president.

It has in front of itself a very powerful congress, a congress that is basically the source of all relevant reforms in Mexico. But what can we tell about that congress? As Ambassador Sarukhan said a couple of hours ago, it is a nonaccountable congress; it is a nonresponsible congress; and it is also a nonprofessional congress.

Mexico's revolutionary institutions created a strange anomaly in the structuring of Mexican congress, that it was -- in the absence of competition, there was a way in which political class was renovated, and that was the provision in which congressmen could not be reelected. That was a brilliant idea in a noncompetitive system. It was a brilliant idea to establish a measure to force renovation of the political class through the prohibition of a professional parliament. But it's a terrible idea if you have a democratic structure. It is not only a very bad idea in a democratic congress to have non-reelection provisions, because it prevents professionalism in Congress, but it also limits the

scope of time in political calculations, and Mexico has the drama of living up to a very short period of political calculations. The Mexican political clock has no possibility of medium- and long-term calculations because of the constitutional provisions.

We have in Mexican congress also something that could have been valuable for negotiation and agreement that we basically have a limited, pluralistic congress. We do not have a terribly polarized congress. Almost 90 percent of congressmen in today's lower chamber come from three big political parties. Mexico has basically, in our House of Representatives, a political system that's basically a 2-1/2-party system, because the PRI and the PAN basically have almost 75 percent of the representatives in the lower chamber. But we vowed reelection, and having basically disciplined parties, it is a congress of veto structures that from 1997 to this date have defined Mexico's politics.

From 1997, Mexico has had a political structure with no governing coalition. Mexico has had the renovation of its politics through elections. Mexico has regenerated its electoral coalitions. But it has not been able to generate a new governing coalition. So, therefore, since 1997 we've been living with a democratic structure that has been unable to deliver political economic change.

Wow, I have to speed up.

Change has been living in Mexico's recent history in the electoral arena but not in the constitutional arena, but it has also been unable to deliver in the arena of social organizations. And maybe one of the strongest elements of this conservative coalition is living outside of the constitutional structure and it's basically the space of Mexican corporatism. Mexican corporatism, that very strong alliance between the government and social organization and workers unions but also in the arena of big businesses, was one of the instruments of governance in the authoritarian time. Governance was helped. Corporatism was instrumental for that authoritarian governance.

With a democratic structure, those very strong unions that were conducive for authoritarian governance are basically one of the most -- one of the strongest veto players for Mexican change. They are non-democratic as there used to be, but they are no longer allies of the government. They have been able -- these corporate structures -- they have been able to

understand political change and their benefit, and they are no longer one party corporate structures. But they're basically three-party corporate structures in which we can say that they are unions that are allied to the PRI, that they are unions that are allied to the leftist party, the PRD, and unions that are allied even to a conservative party as the National Action Party. But they are finally, ultimately, veto players that have control over congress and that are successful in blocking the opportunity of change.

I would end the presentation with three basic characteristics of Mexico's new democracy, Mexico's democracy that was I believe born in 1997 when the president lost control of congress. Mexico's democracy has been an unproductive democracy that has not expanded the possibilities of politics but even has restricted the spaces of what's politically possible. It has been a captured democracy in which democracy has not been able to deliver for the public good but to deliver for the special interests that have a hold in its political structures and, finally, has become an enchanted democracy in the sense that there are those areas in which a change is urgently needed - - have been considered by the political actors in Mexico's system as untouchable in which there's a wide consensus that there's urgent need to change education policy, energy regulations, competition regulation. All these things are necessary or urgent, but they are enchanted in the way that no one could be able to touch them, because there is the defeat of the ability of politics of delivering change, and the threat that if those things are touched, if those things are to be changed by the political class, Mexico would go again into a chaotic synergy. So, we are trapped in these threats of what is urgent but what's impossible.

Thank you.

MS. GRAHAM: Jesus, thank you very much. I can't say you've left me too optimistic, and knowing what Vanda works on and some of her work, I hesitate to say we look to her for enlightenment, but I'm sure we look to her for an insightful comment.

MS. FELBAB-BROWN: Oh, thank you.

Ambassador Sarukhan and President Moreno opened today's conference by stressing that the talk would be about other issues than drugs in Mexico and that the focus would be on deeper structural issues that move beyond the current grip of the drug violence, and it is perhaps

ironic then that Mauricio asked me to be the last panelist to speak about drug violence and its economic implications and sources. And indeed Mexico opportunities and challenges are of course much more multifaceted than the immediate violent crisis, and the U.S.-Mexican relationship is far more multifaceted than the drug trade. Nonetheless, the violence of the current levels cannot escape public attention and has deep effects on the economic situation in Mexico and is also fed by the structure of Mexico's economy. And so in my presentation I'm going to weave in and out of talking about how socioeconomic tools can be used to combat criminal violence and criminality in general but also talk about how the basic political economic and macroeconomic design of Mexico limits and influences what kind of anti-organized crime tools and anti-criminality tools can be adopted and what kind of changes can be expected from policy such as the Merida Initiative and the recent follow-up to it, Beyond Merida.

Let me start by giving you some grim dynamics on the violence. According to *La Reforma* as of mid-June, drug-related murders this year reached 5,230 murders, which is just about 1,300 less than what was the total for last year, and last year was already another yet record-breaking year. If you look at Ciudad Juarez, the levels of murders there continue to be particularly bad despite all the policies that have gone into Ciudad Juarez.

The U.N. usually classifies an epidemic level of homicide about 10 per 100,000 per year. In Washington, D.C., one of the very violent cities in the United States, over the past decade there has been about four. In Juarez today it's about 200.

Let me stress here that violence itself is not necessarily a good indication of the one party, the state, or the criminal organizations are making progress. It might very well be that you have no violence and drug organizations are fully in control, or it might be that despite the violence, policy is in fact generating some substantial pressures. Nonetheless, this level of violence does matter very substantially for society, including for economic businesses.

It is often said that while the violence is not so bad because it's the narcos killing the narcos; it's the bad guys killing the bad guys. So, you know, we can somehow live with that. Well, that would be the case if they were killing each other on the moon. But as long as they are killing each other on the streets of Mexico, as long as the bullets are flying around and over and

increasingly hitting the civilians, they are having very deep impacts on how society organizes itself.

Such levels of violence deeply eviscerate the associational capacity of a society. That has implications for economic activity. Such levels of violence of course totally overwhelm law enforcement, which then breeds other forms of illegality, and in fact we have seen great rise in kidnappings in Mexico, great rise in extortion of legal businesses. In fact, in Juarez, the city really is just acutely and at this point almost chronically hit by the issues. Many streets are simply the word of life. Restaurants are shut down the middle of day. Various *la casinas* just won't be serving food. You see many businesses with signs For Rent.

And of course, Juarez is a transient community. It's a community whose vast expansion was very much driven by the *maquiladoras*. It's a community that is not deeply integrated, but all of that compounds the effects on economic separation, and also a lot of economic separation cannot just be attributed to the general downturn in Mexican economy and in the U.S. economy. Nonetheless, violence is clearly having an impact. And you hear steady reports of businessmen complaining that they are moving out because they face the need either to pay extortion rents or face violence to themselves and their families or they simply shut down.

Another discouraging development over the past several months has been the expansion of violence into major tourist areas. It's no longer just the major cities along the north, but it's increasingly Cancun; it's increasingly Acapulco. Recently Taxco. All cities that have had drug violence have had drug trade, maybe with the exception of Taxco. But certainly I haven't seen the level of violence that they are seeing.

And why this is bad is of course because the tourism economy, apart from being an important sector, is also one of the few economic sectors that were actually generating new jobs and employing people. So, in a downturn day, it has big social effects.

Yet another very discouraging development has been the systematic effort on the part of the drug trafficking organization over the past two, three years to take over the informal economy, and Dr. Levy gave a very elucidating presentation on how detrimental and how structurally driven the informal economy is. Well, the political implications of illegal entities -- violent illegal entities, like crime organizations -- to have control over the informal economy are of course profound.

We have to remember that by some measures the illegal economy accounts for about 40 percent of Mexico's economy. It's a very large number. The level of poverty is also roughly about 40 percent.

Now, there is no easy relationship between poverty and crime, but nonetheless when (inaudible) one-on-one correlation, but nonetheless when crime becomes acutely violent and highly motivated to acquire political power, it is far easier for it to do so in the context of great poverty and informality, because the marginalized people in informal economies and illegal economies are highly susceptible to becoming dependent for employment on organized crime groups and also seeing them as the political distributors -- the new patrons.

And this is not simply a problem of the very poor states in the south and in the center of Mexico, like Querétaro. But even in places like Sonora, based on estimates the illegal economy related to the drug trade is about 20 percent of the state's GDP, which includes spillover effects related to restaurants, hotels, etc., as drugs are moving through the city.

One of the things that would be very high priority for me if I was designing the counternarcotics efforts as Mexico or efforts to minimize violence would be think how in view of the fact that it is this very systematic push by the drug trafficking organization to take over the informal sector, to dictate who can sell on the Zocalo, be it tortillas that are made in the home or be it a much greater skill in the informal sector. What can one do today to prevent this takeover? How can one make the informal sector more resilient to efforts by the drug trafficking organizations? And one is, of course, to say well, we can formalize a sector, but that goes into all the difficulties that Dr. Levy mentioned.

And this also then presents a very acute dilemma with respect to designing policy. On the one hand, the structural changes that would reduce the informal sector are of course critically needed -- difficult to achieve, but particularly needed -- but at least in the short term they would likely result in substantial socioeconomic dislocation and perhaps far greater susceptibility by the informal sector to be mobilized and captured by illegal organized crime entities. And at the same time of course, in the long term, to address the structural drivers and the structural deficiencies that allow organized crime to be so strong if not so violent in Mexico, one needs to look at this deeper sociopolitical, economic setup and arrangements.

Beyond Merida has introduced many great improvements to policy, in my view, and I just want to single one of them, and this is now recognition that socioeconomic policies need to be part of the package of addressing criminal violence, and specifically one pillar of the policy called Building Resilient Communities specifically focuses on how people will not become feeders for the drug trafficking organization, how to re-use the inflow of hit men, how to preserve the capacity of communities to organize, to associate, and not be debilitated by violence.

Nonetheless, employing such socioeconomic policies is very hard and often takes a lot of time, and there is a great danger in over promising too much too quickly. One of the initiatives unveiled was the hundred days of Juarez, which I believe now are expired or if they are not expired now they will expired in a day; and in many ways it was a wish list of economic -- socioeconomic goodies that would be great to have in Juarez, but that did not easily materialize. And one then needs to be wary about expecting too much of socioeconomic policies to deal with organized crime quickly, but also over-promising too much to communities so that they don't become very disappointed and lose even greater faith in the state that they might have to start with.

One of the key issues of course is how to generate jobs in the legal sector so that people could be pulled out from informality and outright illegality, and for many economic development issues, this is always the hardest one. It is far easier to do infrastructure development; it's far easier to do even microeconomic reform than to focus on how one generates growth, especially in challenging environments, highly violent environments, and environments with structural inefficiencies. And so in the context of Mexico's economy, even with it was growing it was not generating very many jobs. This remains an acute challenge.

So, if you think about it in the context of Juarez, what are the options for generating jobs from the at least immediate shorter need to reduce the problem of the cartels? Well, the typical policies include infrastructure building. We can do more of that certainly. They include housing, building more housing; and they include hiring people in the security sector. Well, infrastructure implement is one option for Juarez. The problem is that these jobs usually run out very quickly, and they are limited time duration. Housing? Well, there already are so many houses for rent in Juarez that there is really no point in building any more housing. And hiring people into the police or even

into the military of course needs to be balanced against the need of conducting police reform in Mexico and vetting recruits so that people are not simply hired as informers for the drugging. So, no easy project. Important, very important to understand that a key part of using the organized crime is focusing on generation of legal jobs but very difficult to do.

Let me then conclude by stressing that ultimately for even the socioeconomic programs to be limited, they require -- to be effective even on a limited scale, they require a degree of security. It is simply very, very hard to get any legal economy going in the context of violence. There is no coincidence that illegal economies usually thrive in violent areas, just one consequence that legal economy doesn't thrive, and then people need to be employed somewhere.

The requirements that an illegal economy have are far smaller than those that a legal economy have. Nonetheless, even the illegal market is deeply distorted in Mexico today. These levels of violence are truly extraordinary. Drug markets are usually not this violent by any stretch of imagination. I mean, we have drug markets being caught up in civil war, like, for example, in Columbia or elsewhere, but normal drug markets do not behave this way. So it is perhaps a hope that the market will simply burn itself out in the illegal sector.

But nonetheless, it needs to be a key priority in Mexico to bring the levels of violence down, because without bringing the levels of violence down, political support will fall off for reforms in police and other institutional reform. All macroeconomic reforms, even limited socioeconomic programs, to address the burning needs on a micro level in cities will not work or they'll be at least deeply hampered and ultimately because the important function of a state is to provide public safety.

MS. GRAHAM: Thank you to both of you.

Well, sir, I'm left thinking that we've got an enchanted congress that's nonfunctional and the only solution to the drug market is that it burn itself out. Not a very positive picture, so let me just take advantage of the Chair for a second and go back to the two panelists and ask you to each think in the area of the intersect between this political system with its limitations and the challenges that the drug violence poses and ask each of you if you can think of or identify any kind of glimmers of positive progress or positive change, and then we'll open it up for discussion.

MR. SILVA-HERZOG: Well, I think there's an area of optimism in the sense that there's a growing agreement in Mexico that things are not working well in the political arena, that things are not doing as good as they should be. The recent elections or federal elections last year in 2009 were interesting because they sort of showed that there's a growing distance between the citizenry and the political parties, and in that sense I believe that the parties realized that and there are now in place several initiatives to tackle political reform. I think that's an important change in Mexico, that if we believed a couple of years ago that things were basically the responsibility of several persons or people that were not able to deliver, I think we have been reaching an agreement that there's some institutional trap, that it's not the inability of one president or another, but there's an institutional trap that should be tackled. In that sense, I think that's important, and I would say that there are basically two ways to address the issue of political gridlock in Mexico. One is the initiative that President Calderon and some leaders of the PRI have been stressing that is the idea that we should engineer political reform in Mexico so that the president is likely to have a majority in congress, to have a second round in the presidential election as President Calderon believes, and also he thinks that congress should be elected in the second round so that there's a likelihood that the president -- that the party that wins the presidency also wins congress.

But there's also another perspective that believes that instead of giving the president a majority, which President Calderon would believe that it's a good thing, the other perspective is to establish more of a parliamentary structure in Mexico that would create a coalition not giving the president a majority but furnishing that coalition in congress so that there is a majority that has been born after negotiation in congress. So, if I believe that there's an optimist thread, an optimist avenue, in Mexico, it is the realization that political change is needed nowadays.

MS. GRAHAM: Thank you.

Vanda?

MS. FELBAB-BROWN: I do believe there have been many great improvements in the impotite of policy in Mexico to tackle the drug violence, and indeed the Beyond Mérida that focuses on not simply high-value targets, stress on institutional reform and capacity building, civilian capacity building in Mexico, focusing on building resilient communities and building secure but

competitive borders are all going very much in the right direction.

I also do believe that Mexico is fortunate to have a very committed leadership to prevail, and there has been progress on police reform issues certainly. There has been progress on implementing judicial system reform. One of the big outliers that still need to be tackled is correction of facilities reform.

The big issue of course is that a lot of this reform often takes a generation. For this reform under the most optimistic scenarios -- and it very rarely happens that it will be achieved easily -- it's a generational issue. Judicial system reform can easily take longer. Seeing the impact of socioeconomic programs is in some ways immediate but often takes far more than a matter of months or a year and to be visible. And at the same time, if these institutional reforms -- the inputs are taking a place in the right direction, but there is no immediate visibility of outcomes. It's extraordinarily hard to manage public support. And the levels of violence -- it'll be just very, very hard for Mexico to continue on the pace of the good policies that are being implemented and to continue that even after President Calderon leaves office.

So, in my view, there is a need, perhaps an opportunity then, to focus on some critical areas where progress can be demonstrated. Juarez has been selected to be one of these model examples, and unfortunately we have yet to see the result. It has really not been panning out over the past few months.

But it's very hard to imagine that you could -- unless there is policy -- annulated change in the drug market, the violence just burn itself out because the cartels cannot keep up the pace that they are keeping -- and there is no indication right now that we are at that point -- there is no immediate or inevitable causal effect of policy inputs generating election violence in the near-term future. So, in that case, focusing on some critical areas to demonstrate progress to shore up public support would be very important, and that means concentrating law enforcement forces, but it also means concentrating socioeconomic forces rather than promising a big wish list, moving neighborhood by neighborhood, showing progress on a very low level, but nonetheless showing demonstrable progress is one way to keep political support under extraordinarily challenging circumstances.

MS. GRAHAM: Thanks to both of you.

Now we have a little bit of time for questions. Maybe we could collect two or three and then we'll let the panelists respond as briefly as you can.

Back there --

MR. DESAI: Yes, Rahul Desai from the Inter-American Development Bank.

My comment is I guess when we talk about Mexican democracy we're being a little bit generous, because I guess with all the impediments that Dr. Silva-Herzog and Ambassador Sarukhan talked about, in some ways today it's more of a "partyocracy" than a democracy, because one of the effects of not having reelection of legislators is that they are more responsive to their party leaders and not really to their constituents, and most constituents -- you ask people in Mexico who's your congressman, I found very few people who even know.

I wanted to ask, Dr. Silva-Herzog, more specifically that President Calderon did have a big initiative that he announced earlier in this legislative session to deal with things like reelection and *segundo vuelta* and things like that, and it seemed like it had a lot of momentum for a while, but it sort of, you know, was on the top of the papers every day, but then suddenly it just kind of disappeared, so just his view of has this thing really died or can we see it come back to life in the next session?

The other comment I just wanted to make on the drug situation is that clearly it's bad, but I think -- my view is there's a lack of equilibrium right now, because there's competition between the cartels and competition between the cartels and the government to see where this thing will -- and hopefully win some equilibrium, and, I mean, it's not pleasant to talk about -- is established, I would hope to see lulls. I mean, look at this city. There are drugs trafficked in every nightclub of this city. Just go to the park on 14th Street and see all the drug traffickers there. But we don't have the levels of violence. So, we need to be a little bit less hypocritical, too, if we think that drugs is just an issue there. I mean, my view is id drug trafficking in Cancun has increased; it's probably because there are so many American tourists who are buying the drugs there.

SPEAKER: Pass.

MS. GRAHAM: Okay, we can take two more questions. Please be brief if you

could, because we're really overtime.

MR. HUGHES: Philip Hughes from the White House Writer's Group. Brevity is impossible for me, but I'll see what I can do.

Listening to the presentations on panels 1 and 2 would lead to the conclusion that more than anything else, to overcome some of these economic challenges Mexico requires decisive leadership, and that will require in turn a considerable measure of political consensus. But Dr. Silva-Herzog has described to us a kind of paralyzed political system with large sort of no-go zones, if you would, for political action, because those are sacrosanct areas, and between the two of these panelists, we've further been introduced to -- well, actually you didn't comment on it, Dr. Silva-Herzog, but it seems to me it's there -- two Swords of Damocles that hang over this Mexican political system. One is the PRD, the extreme left, and the likelihood, I would argue, of a counter-reaction to the market-oriented and opening initiatives that were implied by the first two panels and, of course, the Sword of Damocles of violence and organized crime, which will take advantage of anything that weakens the government to open space for their further action. So, isn't that a prescription for the safest thing to do -- to be -- to do nothing?

SPEAKER: I'll try to be very brief. If you could comment at all on any of the differences in the political structure or the -- let's even say the state in Mexico versus Columbia and what that might mean for progress on the attack on drug criminality.

MS. GRAHAM: Okay, well, you have some rather major issues. Just if -- again, we're really overtime, so if you can just take the ones that you really want to as briefly as possible.

MR. SILVA-HERZOG: First of all, in the issue of political reform, the reform that President Calderon proposed, I think it's a very ambitious political change in Mexico. I think it has a merit that it -- that it's a second generation political reform in Mexico, the second generation of reforms that I think we are needed. But I agree with you. I think it generated a lot of expectation. Everybody was talking about that initiative. But it sort of -- it wasn't carried out by the administration and was almost rejected by the opposition parties. It was basically rejected, because they have other ideas of political reform and they have been negotiating these reforms in Congress.

I have the -- I am under the impression that a political reform will be passed. There

are areas of agreement between the government party and the PRI in several issues. I think that there might be important changes in maybe reelection of congressmen, maybe in the establishment of a referendum procedure in Mexican constitution in several other areas but not as big a reform as President Calderon believed.

And then I agree with you. There's -- underneath the issue of institution lies the protagonism of leadership. I think if Mexico has lacked something in the last generation, it has been a generation of political leaders in the basic three parties of Mexico. Mexico has not had the leaders it needed in these three parties.

Is this is a recipe for inaction? I don't know. I think that there's something that worries me is that the PRI is headed for recovering power without an internal reform. I think that is a very troubling message for Mexico, that the lack of success of the panista government, the implosion of a leftist alternative just lifts the PRI in the way to recover power without the need of defining itself, of defining its proposal to the future, and without a real change in its ideas and culture.

MS. GRAHAM: Thank you.

Vanda, you have the last word, but a brief one.

MS. FELBAB-BROWN: With difficult questions. I'll answer them quickly.

On the equilibrium in the drug market, I agree with you. I mean, I stress that this is a very aberrant market. This is not the way drug markets normally look. The reality, however, is that a lot of the policy inputs, as well as the internal dynamics on the drug market, are all pushing toward disequilibrium. They are not pushing toward equilibrium, and there is no easy way to imagine how even the expansion of the policy away from high-value target generated a lot of the instability, but even the more broader approach to the drug trafficking organizations quickly leads to reduction in violence. And, similarly, there is too much uncertainty from the perspective of the drug trafficking organizations with respect to balances of power, with respect to networks of corruption and networks of access to generate equilibrium among them yet; and there have been attempts at negotiation among the groups, and they all collapsed. There's been big fight -- continues to be a big fight over Juarez because there is no easy way right now to establish some sort of balance of power and equilibrium, and I don't see that we have reached the stage where there is either internal pressure or

policy pressure that leads toward equilibrium.

That comes to the question -- the second question of the gentleman -- is this not a prescription for doing nothing? Certainly in the security public sector, public safety sphere, I would say that it isn't, because the current levels are just simply unsustainable.

So, my worry is not that the government will decide to do nothing. The government has to respond. My worry, however, is what the government could decide to do. And if PRI wins power, there is lot of speculation would they ever try to go to a negotiated agreement, corporatist agreement with the drug trafficking organization they used to have. I mean, I'm not really worried that this will take place at the national level, because I think the political circumstances have changed, and also the drug trafficking organizations are way too fractured to be able to imagine that they could enter into such a bargain. But I am very worried that you could see this kind of corporatism arrangement being established at the local and the municipal level.

And in some cases you, in fact, already have the drug trafficking organization dictating the political terms at the municipal level. In some cases, you, in fact, already have the drug trafficking organization dictating the political terms at the municipal level. And that in my view is a very bad outcome that the whole purpose of the policy should have been to reclaim the authority of the state, the territorial control, and the domination of the public safety sector.

On Mexico and Colombia, they are very different cases. First of all, as I stressed, Colombia was going through a very major civil war with the leftists getting lost to FARC, numbering around 20,000 at their peak. Today they number about 9,000. The paramilitary groups numbering maybe 30,000, the ELN being, you know, at its peak 5,000. The numbers are considerably down. And they function as organized army that controlled entire, very large sectors of Colombia's territory, especially, of course, the periphery.

In Mexico we don't have that. We don't have the civil war political component that we have seen in Colombia. We also don't have anything on the scale of the armies that we saw in Colombia. That said -- and actually not a very important difference is that the drug trade in Colombia was very much driven by the cultivation of coke on a very large scale, and although there is robust and apparently higher-up cultivation of poppy and marijuana in Mexico, a lot of the drug creation is in

processing of drugs and in smuggling. And it's very important from political reasons, because these last two aspects are not labor intensive.

So, while the Colombian paras and the guerillas could tap into hundreds of thousands if not millions of people, depending on outright illegality, you don't have these same numbers at all in Mexico. We're talking maybe a hundred thousand people in outright illegal drug sector. But the more the cartels will be able to take over the informal economy, the greater their political power, and that's why I'm very worried about this increasing link and pressure.

I think that both countries are benefiting from U.S. assistance, and clearly one of the reasons why Colombia was able to achieve such great turnaround in the situation was as a result of effective U.S. help in reforming the military especially. And Mexico is now in the unprecedented cooperation with the U.S. in police reform and security, public safety sector reform, as well as in building institutional capacity. But all of our experience tells us that it's far easier to do military reform, it's far easier to bring our militaries up to speed and make them effective against insurgents than it is to do police. It is far harder -- urban fight or urban anti-crime is far harder and police reform is just much more challenging, and the United States and the world globally has far, smaller levels, in fact very, very small levels of success in effective police reform, and it takes a lot of time.

MS. GRAHAM: Well, thank you very much to both our panelists. I feel a little more optimistic now than I did at the end of both presentations, but a lot of challenges there. It's been a wonderful conference.

Mauricio, do you have anything to say, or we'll close with that? And thank you all for attending.

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