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THINKING STRATEGICALLY ABOUT MEXICO'S ECONOMIC FUTURE

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

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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 uncertainly 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 uncertainly 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 sold 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 Compania 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 lets' 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 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 forms 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 tales 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 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 0.0 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 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 uncertainly, 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)