Adam Posen: Good morning ladies and gentlemen. If I could ask you to take your seats please. Welcome back to the Peterson Institute for International Economics and welcome, of course, to all of our friends watching through the web, live. This is a very important day for us. We’re very proud to be hosting and putting a lot of content behind an event on the benefits of NAFTA for Mexico and the US. We’ve been partnering, in part thanks to Barbara Kotschwar, quite closely with the Mexican Embassy and we’re delighted to have had their engagement throughout. The Ambassador will be speaking in the closing session. We also are going to be starting off with a brand new report from McKinsey Global Institute on Mexico’s dual economy which we’re very excited to have the key author with us to speak and she’ll be on in just a couple moments.

Let me just say a word—I’m Adam Posen, President of the Peterson Institute—and let me just say a brief word on why, in fact, we’re doing this conference under the title we’re doing it. When I first joined the Peterson Institute in 1997, the scars of NAFTA’s debate were still fresh; they were fresh in Washington, they were fresh at the Institute where people like Gary Hufbauer, Jeffrey Schott and Fred Bergsten had fought hard, and I think well, for something in this country’s interest.

But it was very striking to me as somebody coming out of the Federal Reserve, out of context of financial markets, out of global context to see just how much vitriol there had been and bitterness against NAFTA. Now, 20 years have passed and both the Mexican and the US economies have many, many things that have contributed to and detracted from their performance over the last 20 years.
I think the bulk of professional opinion, and frankly the arguments we will make today, suggest that at a minimum, all of the exaggerated claims about negative effects from NAFTA are just that—exaggerated and misguided and that, in fact, the net benefits are quite clear for the US and for Mexico. But it is striking how today, in today’s discussions in the US, whether about TPP or TTIP or God willing, free trade area of the Asia-Pacific, NAFTA gets invoked even more as a swear word and people in Congress and people around Washington and the press will just toss it out there like hissing it.

I gave a speech in Chicago a couple months ago to the global council—the Council on Global Affairs—and I was talking about the benefits of trade and the miracle that we had raised a billion people out of poverty in the world while continuing to advance living standards in the West, and one person rose up and said, "Well, what about NAFTA?" And I said, "Well, you know, it wasn’t destiny. It wasn’t God’s will that Detroit always look the same and Charlotte never rise, you know? There was a reason. Change happens." "But just look around you. Just look what NAFTA did."

Well, NAFTA’s actually done a lot of good and that, in a sense, is the case—in a sense, it’s the purpose of today’s sessions, not to be unfair, not to ignore the displacements that occurred to workers that always occur any time commerce takes place, but to make the positive case, the sound intellectual case, the detailed case, for why this trade has been a benefit to the US, to Mexico, to the world and then to think about where it goes from here.

So we’re delighted to have you with us today for this constructive discussion and we hope to perhaps not with just today’s intellectual efforts but over time reclaim the word NAFTA in the public debate for what it is, a triumph of American statesmanship and a positive move of economic policy for all countries involved.

With no more than that, I’d like to invite my colleague, Barbara Kotschwar who, as I mentioned, has been critical to the organization of this event. She’s a research fellow here at the Institute since 2007, previously was with the Inter-American Development Bank and is a long time student of, a researcher on, and advocate for US-Mexican economic relations. She’ll chair the first panel. Barbara, please.

Barbara Kotschwar: Thank you very much, Adam, and thank you everybody for joining us here to discuss what’s a really important topic. We’re just thrilled to have on the first panel an examination of Mexico’s progress, “Growth and Prosperity in a Two-speed Economy.” Mexico is an essential trading partner for the United States. Our fortunes are inextricably interlinked. I think there is no doubt about that and so we’ve decided to start this very
important program with an examination of Mexico, which in the past year, has embarked on a series of significant economic reforms that appear to tackle some of the deep-seated distortions that have stymied economic growth and social progress in the last couple of decades.

And so as a result, and as other emerging markets have started to struggle more with growth, more emphasis has been placed on Mexico. And Mexico has started to be the "it" country again, particularly in the press. And so the author of this report, Jaana Remes from the McKinsey Global Institute has taken a really hard deep look at Mexico and is suggesting a number of provisions that are very interesting, controversial, would likely stimulate a lot of debate.

Dr. Remes is a partner at the McKinsey Global Institute. She’s the lead author of this very important new study, “A Tale of Two Mexicos: Growth and Prosperity in a Two-Speed Economy.” Dr. Remes has led the McKinsey Global Institute’s research on productivity, urbanization, competitiveness and growth, and her most recent research looks at the increasingly relevant issues of cities and the shifting global company landscape, rising urban consuming class and shifting economic power of cities.

Dr. Remes will present her report. After which, we’ll have two very distinguished economists provide comments. We’re very pleased to have with us Dr. Santiago Levy as our first discussant. Dr. Levy is currently the Vice President for Sector and Knowledge at the Inter-American Development Bank. He was previously the General Director at the Mexican Social Security Institute where he promoted changes to the Social Security Act to increase transparency and accountability.

He’s perhaps best known as being the architect of the Progresa-Oportunidades program, which as you all know, was the basis for the conditional cash transfer model in Latin America that has been adopted in Mexico, of course, but across the region it was the basis for the Brazilian Bolsa Família and for many other programs.

He’s also served as Deputy Minister of Finance and Public Credit, President of the Federal Competition Commission, Director of Economic Deregulation Program with the Ministry of Trade. He holds a PhD in economics, a Master’s in political economy. I’m not even going to start mentioning all of the books and articles that he’s published. Dr. Levy is a very bold, blunt and controversial speaker, which we enjoy here at the Institute, so we very much look forward to him. I think you’ll agree that there is no one more qualified to comment on the Mexican economy.
We’re also pleased to have our own Angel Ubide who is senior fellow here at the Peterson Institute and the force behind our emerging markets breakfast. He’s also the co-director of Global Economics for D.E. Shaw—I’d like to claim him more at Peterson but he’s also there—he’s an expert on central banking, finance, macroeconomic policies. He’s been following the markets for decades and so he comes to this with a mix of views. He was also an economist at the IMF and worked at McKinsey. He has a well-read column in El Pais, and so very influential in the Spanish-speaking world.

So without further ado, I’ll ask Jaana to come up and present her paper. After that, we’ll have the two commentators and then we’ll have a panel discussion in which we will take questions from all of you, so thank you very much. Jaana, we’re so pleased to have you.

Jaana Remes:

Thank you very much, Barbara. Thank you, Adam, and the Peterson Institute for the opportunity to come here and discuss our work and everybody else’s views on Mexico.

At the time, as Barbara said, when there is increasing concerns of emerging markets and their growth, it looks like Mexico is the exception. We have had [inaudible 00:09:26] Mexico surrendered, upgraded, multinational companies are announcing billions, literally billions of investments in different parts, and the press is talking about Mexico’s renaissance.

So even after the latest downgrades in the near-term growth prospects, there is a sense that Mexico is where the opportunity is as “the opportunities are huge” as the BlackRock CEO has put it. Yet, for many of us in this room who have been watching Mexico’s economic performance for a few decades now, there is a sense that we have seen this picture before that there were multiple times over the past few decades that there is been a sense that Mexico’s growth is just around the corner. Perhaps most notably, that was the case two decades ago at the signing of the NAFTA agreement.

So is this time now different? Is this now Mexico’s moment or are we going to be disappointed again? To start shedding light on this question, our research started by asking: so what was happening over the last two decades that kept Mexico’s performance so low? And as many of you know, the answer is really the incapacity of raising productivity.

When you look at Mexico’s productivity performance over the past few decades, it’s clear that you can see the picture of the nation in that chart. You start on the second half of the 20th century with the rapid growth period of import substitution, the Desarrollo Estabilizador. Then we see
that rapid boom even of the 1970s, the excess boom if you want, then the lost decade of the ‘80s and after that the slow turn to growth again.

But the big take away from this look is that, in essence, the average productivity of Mexican workers today is no higher than it was 30 years ago in real terms, and that really is Mexico’s growth challenge. Given that the productivity of workers hasn’t grown, most of Mexico’s growth has come from expanding the labor pool.

So when you look at, through history, over the last two decades since 1990—meaning after the lost decade of the ‘80s—Mexico has grown on average 2.7% a year. This is a disappointingly slow growth rate for a nation that has a rapidly growing population still. A full 2% of Mexico’s GDP growth over the last two decades came from the fact that there were more workers in the pool. Productivity contributed only a little more than a quarter to that growth; over 70% came from an expanding population.

And this picture, when you compare it to Mexico’s peers in the emerging markets, it’s dramatically different from all the other nations. It really is the lack of productivity that differentiates Mexico even from Brazil or some of its other Latin American peers.

And of course, the challenge with the population-driven growth and labor force expansion growth is that Mexico has gone through the demographic transition. In the early ‘70s, average women had seven children. That’s not the case any longer. So population growth is declining and labor force is declining. When we look forward, the picture is going to be very different.

Over the last two decades, as I said, almost two percentage points came from expanding labor force. In the coming decades, that growth is going to decline to 1.2%. If we don’t see an acceleration in productivity and we’ll get the 0.8% that we have been getting over the last two decades, that means that kind of the growth rate we should expect for Mexico going to 2025 would be something on the range of 2%. That clearly is not even close to the 3.5% which is roughly on the expectations for the medium-term growth through 2025.

And in order to make that growth target, Mexico would need to increase its productivity. It would, in essence, need to roughly triple the productivity growth rate from 0.8 to 2.5 roughly in order to meet that growth.

And this really was, then, the big question for most of our research. How realistic it is—can we expect Mexico to really boost productivity growth? And the way we do is that we start by looking at the academic data and we worked with our colleagues who worked with industries across Mexico in
different parts and different kinds of businesses and we started to look at what was happening over the last two decades in the productivity of these different industries and what do we see going forward in a way? What kind of underlying macroeconomic dynamics for productivity do we see?

And what did we find? The first finding will not surprise any of you, I think. We found that Mexico has a very dualistic economy. On one end on the right hand side of the chart, you can see the large modern operations that are—whether they are Mexican national or multinational companies or multinational companies operating in Mexico, they are relatively highly productive, they’re the export companies, and in many ways, the frontier for Mexico’s productivity.

On the other extreme, on the left hand side of the chart, you see the very small enterprises, less than ten employees. These are traditional, labor-intensive, often with subscale technology and many of them operating outside the formal economy. And there, the productivity already in the turn of the century in the 1999 census was roughly 28% of the large corporations’ productivity. So roughly a quarter of the productivity of the large corporations amongst the smallest ones.

I think this is not something dramatically different in what we see elsewhere. What really surprised us was that this gap between these two had been widening over the last decade. So let’s look at, again, the last corporations. There we saw their productivity grow between 1999 and 2009 by almost 6% a year. Not bad performance, even by the standards of the Asian tigers.

On the other hand, when you look at the small scale enterprises on the bottom, their productivity—on the left hand side—their productivity had declined by over 6% a year and that means that that productivity of the lower, to the smaller, to the larger enterprises, the gap widened. They used to be 28% of large productivity; now they are less than 10%.

In between these two extremes, we have the middle—which has been actually shrinking—these are mid-tier companies that have between 10 and 500 employees. There, their productivity has been relatively flat and their overall share has declined. So in essence, behind that very flat overall productivity performance, it’s dramatically widening trends across the large and the small enterprises.

And this, of course, means that when we look forward and see how realistic it is for us to expect the acceleration in productivity, we will need to see changes across all of these different kinds of corporations and companies, particularly the small ones.
So let’s look at the three kinds of things that we would expect to see change dramatically in order for Mexico’s productivity to accelerate. The first one is clearly the small traditional enterprises need to increase their productivity. We need to reverse the productivity decline. And here: What would it take to do that? And clearly there are many reasons why small enterprises are small—one of the reasons we said, some of them have no other employment options.

However, when we looked at it at the sector level, there were two factors that really mattered. The first one was the fact that the economic incentive of staying small and informal continues to be high. And the second is that capital constraints are very binding for these companies to grow to become mid-tier and potentially even larger companies.

So let me provide an evidence, a little bit on both. On the case of the cost of—economic cost of becoming formal and growing up, it is clear that in Mexico overall, formalizing your business is expensive. We know because of Santiago’s work, their Social Security costs are significant in for—overall, with relatively limited values seen by the employers. Labor laws continue to be restrictive and expensive particularly on the firing end which limits a desire of companies of all sizes including the large ones of hiring.

The cost of registering your business costs in Mexico roughly 10% of the annual income. This is seven times the 1.4% that it costs in the US. So it is actually very expensive. And some of the costs, like energy, are very high; so commercial energy costs are roughly 75% higher than they are in the US. So all of this means that, in order for you to run a business formally, you will have quite significant costs that unless there is—a cost that, in a way, will eat up into the margins of your small business. And that is one incentive which, together with the fact that perceived cost of the enforcement is weak, most companies don’t think there is a big risk that they will be caught, and even if they do, the cost is relatively low.

And that means that many of the companies choose to stay mall, stay informal and that way they can stay under the radar and keep their margins higher relative to their formal peers who look otherwise similar. And just to give you an example of how that influences particularly the growth of those companies in the small peers that would like to grow, we saw a small bakery where it was very successful. They were providing some new kinds of products that you typically wouldn’t see in a Mexican panaderia and they were expanding. They had three businesses, but at that time, the owner said, "Well, we really can’t expand any beyond because then it will be harder for us to grow. Instead my brother-in-law and my daughter are going to open the other three businesses under a different—they’re operating them separately." So in a way, they were growing in a
fragmented manner in order to avoid having to formalize and having to incur all of these costs.

So this was one of the big constraints that we saw across the board, and it influences, really, the incentives of becoming part of the formal economy and providing formal employment. The second factor clearly is the fact that capital is constrained particularly for the mid-tier as well as the small and medium sized enterprises. I don’t think we have ever seen an economy where small and medium sized businesses don’t consider that capital is a constraint. It is the nature of the beast, but Mexico truly is a case where that story is different and it is also a country where we can see the dual economy over the last two decades.

When you look at the cost of capital to different kinds of companies, clearly the large corporations have seen a significant benefit from the close integration to the North American markets, North American financial markets. Today, multination corporations in Mexico have access to capital at costs comparable to their peers in the US. There is really no significant difference in the costs that they need to pay. That’s not true for the mid-tier companies or the small ones.

So when you look at the SME loans for example, there the interest rates raised from 20 to 25% already which is seven times the rate that you would see in the US. So in a way, the relative cost of the smaller businesses is significantly higher and, of course, much more if you are talking about the informal sector.

So this is another example where clearly the impact of the changes of the last two decades have influenced quite significantly differently the large corporations than the small ones. And the outcome of these differences in costs is quite striking. When we looked at the financial assets of Mexico compared to their peers, at 130% of the GDP, overall equity—outstanding equity and debt of Mexico, it’s already second to last only after Russia amongst its peers.

However, I would like to draw your attention to the red part of that bar and that is the bank loans which is a typical funding source for medium and small sized enterprises, and there, Mexico at 32% is dramatically below all of its peers. When we look at the global rankings across all the countries in the world, Mexico is right behind Ethiopia in the level of bank debt. So this really is significantly lower than in any other places, which suggests that clearly the credit constraints are more binding in Mexico than you would expect to see in any other places.

And this really is one of the constraints that particularly influences the mid-tier companies, the kind of growth companies that we would like to
see more of, the gazelles that we talk about in the US that tend to create a lot of jobs. That might be one of the factors and we see from what the companies say that it is a real constraint for their growth and it influences all kinds of companies. US private equity companies feel that they can’t get credit cards for their employees as new arrivals without a credit history. So in a way, it is a big challenge.

So in order for Mexico to raise its productivity, clearly the large part of the small enterprises, there needs to be a change in their productivity. We need to see more of the mid-tier growth companies and have capital play a bigger role in creating a dynamic mid-tier company. And the third component is that we clearly need the large modern local and global multinationals and local companies to continue to do what they’re doing, increase their productivity and push their frontier.

These companies have maintained their employment share at roughly 20% of employment which means they have been crawling at that 2% point a year so they have been crawling but not fast enough to gain their share. I think it’s important for them to continue to gain share, and what it would take is to continue to improve the business environment for these companies, the things like the labor laws that continue to reduce formal sector employment.

One out of nine employees in companies of 50 or more employees remains outside the books, according to some of the data, and in addition to that, the cost of electricity, the 75% higher cost, all of those factors are reducing Mexican competitiveness and I think there are more things to make it more likely for the modern sector to expand and grow faster.

So this is really at the 30,000 feet level, the main takeaways that we took from our research. Let me finish with three final thoughts before we pass on to the commentators. First, it is very clear that despite the very flat aggregate performance, NAFTA and the reforms of the last 20 years have dramatically changed many parts of Mexican economy. There are many success stories, the automotive industry, the aerospace industry being some of the great success stories. We just haven’t seen enough of it yet.

Some of it takes more, so looking at the aggregate performance, you cannot draw the conclusion that there hasn’t been some significant changes in the economy. And the good news is that we see much more of that. Clearly, the manufacturing global environment is such that Mexico has become increasingly more productive as global corporations are looking to shorten and simplify their supply chains. So in many ways, the prospects of that transformation to continue, in our view, are quite strong.
Yet, in a way you can say that the transformation and the change hasn’t
gone far enough. The biggest challenge for Mexico, now, is to really see
some change on that over 40% of even the establishments that continue to
be traditionally small and see their productivity grow. And this is of
course an area where it’s much easier for us to diagnose the problem than
create the solution. A lot of it has to do with the implementation, not just
changes at the highest level but the secondary legislation, the
implementation across the different regions et cetera, and it will take time;
however, given the facts that you saw, I think it is hard to imagine for
Mexico’s growth to dramatically change unless we see a significant
change on this segment.

And last, the good news is, just to finish on that note, when we looked
across the different industries and sectors, we saw plenty of opportunities
for change, plenty of opportunities for productivity improvements across
all kinds of companies, the small and large alike. So clearly, the potential
for really raising Mexico’s productivity trajectory is there. There is no
reason to believe that wouldn’t be the case, and in many ways, the current
Peña Nieto administration is well aware of many of the challenges and
some of the reform agenda includes many of the topics that we have
highlighted as challenges.

Of course, it will take a lot to translate those into real changes on the
ground, on how the law is implemented on the ground, but in many ways,
there is no reason to believe that Mexico couldn’t do that. I think we are
definitely, in that sense, optimistic. And hope that this will be the last time
and we’ll be asking, “Is this Mexico’s moment?” because the next time we
talk about it, it will have been realized. Thank you very much.

Barbara Kotschwar: Thank you so much, Dr. Remes. That was a fascinating diagnosis of
Mexico’s two-speed economy and you’ve left us with a lot of thoughts and
I’m sure that—I’ll ask Dr. Santiago Levy to come to the podium and
respond.

Santiago Levy: So good morning everybody. Let me begin by thanking the Peterson
Institute for inviting me to be in this event this morning. It’s really a
pleasure to be here. And let me congratulate McKinsey for a very good
report. You know, Jaana and I had some occasions to speak before and I
think the report first is very well written. It has a lot of rich information
but most importantly it’s right on the money. It has put in its finger exactly
on what I think is the core issue that needs to be tackled for Mexico to
have growth rates over 4.5%, close to 5% over the next two decades.

If the issue that the report is calling attention to is not tackled, it is
extremely unlikely that Mexico is going to grow more than 3, 3.5%. You
know, it’ll depend a little bit on the US, the cycle, a whole bunch of
external factors that we don’t control, but if you look at for the medium term, unless these issue that the report is calling attention to is tackled, growth would not be there.

The report shows a very nice graph showing what has happened to labor productivity over the last two decades or so. Actually, if you focus—and I have [inaudible 00:28:30] difference with the report—if you focus on total factor productivity, not only labor productivity but the productivity of labor and the productivity of capital jointly which is a more proper measure of productivity, the result is not really an increasing trend of productivity after the lost decade of the ‘80s but actually the result is flat productivity.

So you get the fact that, compared to United States, rather than having convergence in productivity levels vis-à-vis the United States, what is happening is if you look at total factor productivity, what we have is divergence of total factor productivity between Mexico and the United States. If you dig a little bit deeper—and the report does this in a very nice way—what you see is that at the end—and they don’t use this word but this is I think the [inaudible 00:29:22] problem—is there is a huge amount of misallocation of labor and capital inside the Mexican economy.

Behind the words, what is it, dual structure you called it? Or dual speeds or, the dual nature of what they’re calling attention to, what’s really going on is there is a huge amount of misallocation of labor and capital. Even if you look carefully at sectors at very narrowly defined levels, they look at bakeries, they look at specific sectors and I’ve also done some work in which I use census data to look at six-digit sectors. These are very narrowly defined sectors.

What you find is large, 40 to 50% differences in the marginal revenue product of capital and the marginal revenue product of labor across the same industry. Even if you control for firm size and you just control and compare firms that have zero to five workers producing shirts—and I’ll use the label formal and informal to the high speed and the low speed—what you find is that formal firms are substantially more productive than informal firms controlling for size, so it’s not an issue of small versus big, and controlling for sector at a very careful sector.

If you write an equation that says, total factor productivity is a weighted average of the productivity of growth productivity in the formal sector and growth in the informal sector, so picture in your mind total factor productivity equals alpha productivity in the formal sector plus one minus alpha productivity in the informal sector.
The report correctly says the problem is not with productivity in the formal sector. Productivity in the formal sector has been growing fairly fast. It performs well. The problem is that alpha, the share of resources of the economy that is going to the formal sector, is not growing. The problem is exactly the opposite. The share of resources that is going to the formal sector of the economy is actually shrinking.

If you compare the census data in ‘98 to 2008, what you find is that labor allocations have actually shifted from formal to the informal sector, and surprisingly, the share of capital of the economy absorbed by the informal sector between 2008 and ‘98 and comparing the last two censuses that are available, actually increased.

So it doesn’t matter how all these multinationals are going to grow their productivity very fast and it doesn’t matter how much foreign direct investment you’re going to get into the country growing if, in parallel to this process—which is very welcome—you have a larger share of resources going into the formal sector. The result is going to be stagnant productivity growth, and therefore, you’re not going to be able to grow much more than your labor per capita, your participation rate and your demographics and that’s going to give you 2, 2.5%.

So the key question is why? Why is this going on? What is the equilibrium structure for prices and incentives that supports an allocation of capital and labor that is tilted into the informal sector and that over time has been tilting even more in the direction of the informal sector? So if you rule out DNA, if you rule out—look, there is something in the Mexican DNA that says that, you know, “There is going to be a large informal sector.” So if you rule that as an explanation, you’ve got to start looking at sort of the incentives that firms and workers are facing and why they’re responding in such manner.

It is clearly not a trade story. You know, the conference of NAFTA, 20 years after NAFTA, NAFTA has been a success. We export $360 billion worth of exports. About 80% of those exports are manufactured exports. Compared to Latin America, Mexico has the best export performance and NAFTA has clearly been a success. So it is not an export story; it’s not a trade story.

The trade liberalization of the mid-1980s, plus NAFTA, plus a whole bunch of free trade agreements—by and large firms in Mexico are facing international prices and the leeway and the push that you could have gotten from trade, you’ve gotten it and actually you’re doing very well in that dimension but that’s not taking care of the problem so it’s not a trade story.
It’s not a macro story either. We sell bonds in pesos at 8% at 100 years maturity and Mexico’s had an excellent macroeconomic performance for the last few years in terms of the, you know, the current account, the fiscal deficit, inflation, you name it, independence of the Central Bank, we all know the story. It’s not a macro story.

It’s not a human capital story. There is been important progress in education in Mexico. If you look at data over the last two decades, what you find is that the quality of education has increased slowly, has actually increased—yes, there is a big gap relative to other OECD countries—and the quantity of education has increased even more so that human capital factors have actually favored the Mexican economy.

I did this exercise which is really, really interesting. I looked at firms in a radius of ten miles from the point, the center, the Zócalo of Mexico City and then I looked at firms in the rest of the country. The share of informal firms, the share of formal firms, the share of firms from zero to five workers from five to ten is pretty much the same in the circle of Mexico City, the heart of Mexico City, with the rest of the country.

But the average education of the population of Mexico City is about three more years than the population of the rest of the country. So you have much more access to human capital, much more access to infrastructure, and yet, you have the same levels of informality and the same shares of informal firms and the same shares of small firms in Mexico City than the rest of the country.

So if it’s not a human capital story, if it’s not a macro story, if it’s not a trade story, what kind of a story is it? I think the reports of McKinsey—and I’ve done some work on this—points to: there must be an underlying structure of incentives to which firms and workers are reacting and this structure of incentives must imply that there is a tax on formality and a subsidy to informality, and I actually think this is the core of the story.

Mexico is an economy that operates with a very high tax on formality and a large subsidy to informality. The tax on formality not only comes from formal taxes—the income tax structure and the structure of value added taxes—the tax on formality also comes from the fact that the cost of hiring a formal worker is very high. It’s actually slightly higher than the 30-some percent that Jaana showed on the slide because if we take into account the contingency costs of hiring because of severance pay and whatnot, what you find is that the cost of hiring a formal worker is high.

But actually, there is a subsidy to hiring an informal worker, a subsidy equivalent to about 2% of GDP, because the way social insurance is structured in Mexico when formal workers are hired by firms, firms and
workers must internalize the cost of social insurance for labor tax which is part of the tax on formality. But when informal firms hire workers, the social insurance of those workers is actually paid from general revenues even if firms hire those workers illegally, as salaried workers, not enrolling them in Social Security.

So the structure of social insurance generates perverse incentives to actually favor informality than tax formality. You can add to that something directly coming in the tax side because up until 2014, the tax regime had discontinuities that implied that if you’re a very small firm, the tax treatment was different than if you were a firm larger.

The combination of very badly structured social insurance that translates into a tax on formality and a subsidy to informality and taxes that also tax formality through the output taxes are at the core of what must be a large tax on formality and a large subsidy to informality. And then, to this, you add something that the report points out, but which is slightly a more complex story, which has to do with the way capital markets function and here untangling costs [inaudible 00:37:58].

They show a very important graph in which they showed that the share of bank loans to firms in Mexico is very small compared to many other countries. So the question is this, because banks don’t lend to firms and firms can’t become formal or because the existence of a large share of informal firms implies that there is no demand for formal credit? And untangling one from the other is actually difficult because this is kind of all simultaneously determined.

So to sort of begin to wrap up, what you find is an economy that has gone through major change over the last two decades, substantive achievement on the macro front, substantive achievement on the trade front—actually, even though there is a long way to go—important achievements on the formation of human capital but you find an economy that is still facing a structure of incentives at the level of factor prices on the labor market and on the capital market that strongly distorts allocations of capital and labor in the economy in the direction of informality and against formality and this is a source of stagnant productivity growth.

And if this is the problem, then the policy implications are important because it says that growing only through more investment can be done, but you would have to raise the investment rate by about 5, 6% of GDP, 5, 6 percentage points of GDP and this is very costly because you have to raise savings rate by about 6%, 6 points of GDP. So clearly an agenda of growth through more investment is very welcome. Mexico’s investment rates are not high compared to East Asia although they’re reasonable compared to the rest of Latin America.
And certainly, any reform that promotes investment is welcome—like the reforms in energy that are being covered today and the reforms on telecom that are being covered today—certainly welcome. But the point of the report and the point that I’m trying to make is that an only investment-led strategy will not be enough.

You have to worry about misallocation. You have to worry about the informal sector and for that, you need a theory of what is causing all this informality. You need a diagnosis of what is behind this very large informal sector, why is it growing and then drive to complement a reform agenda focused on promoting large investment in large sectors of the economy that I repeat is very, very welcome [inaudible 00:40:18] to be done to align incentives in the direction of everybody moving into the high productivity sectors of economy so that we’re no longer a tale of two countries or a tale of two sectors. We’re a tale of only one country that if that’s done could potentially grow at 4.5 to 5% over the next decade. Thank you very much.

Barbara Kotschwar: Thank you very much, Dr. Levy. Some very interesting points made and I’m sure we’ll be eager to get there in the discussion. Now I turn to my colleague, Dr. Angel Ubide to give us a further discussion and a comparative analysis of [inaudible 00:41:03].

Angel Ubide: Good morning, and thank you, Barbara, for the kind introduction. I’m just going to try to put the report a little bit context. I think the report is incredibly good in detail and the first discussion we had was even better and more detailed. So it’s not really clear to me how I can add to that but I’m going to try to tell you a story of why I think this report is so important for Mexico.

When you look at Mexico from a markets standpoint—and I’m going to put on my markets hat for a second—there are two things, right? Mexico is not a BRIC country and that’s good in the sense that it’s above that category of countries that are expected to be growing very fast and achieve a lot of things in a very short period of time. Why? Because it’s already above that threshold, right? It’s a higher per capita income country that has achieved a lot of things. The topic of Mexico [inaudible 00:42:09] has been floating on the market for a long time now.

Now, I was reading the article for a report that my former colleagues at the IMF wrote last year, and I was impressed by the introduction because it was talking about the macro context of Mexico. Now every article for—has two paragraphs at the beginning that give you the background, and when you go down the list of things, it is a very good picture from a macro standpoint. So you have low inflation, you have a stable fiscal situation,
low debt, a current account situation that is reasonably balanced, a
credible inflation targeting regime with an independent central bank and
remember, an inflation target at three, not at six or seven that you see in
other places.

You have a robust fiscal framework that has been upgraded and reinforced
recently. You have a flexible exchange rate which is fully convertible and
there are no capital controls. In fact, it’s the most liquid emerging market
currency that you have out there if you still want to consider the Mexican
peso as an emerging market currency. You have a very well capitalized
and profitable banking sector.

In case you don’t know, the capital ratio of Mexican banks is around 15,
16% and the profitability return on equity is over 20%. This is a very
strong financial sector that they have. And you have competitive export
highly integrated into the US. Essentially from a market standpoint, you
buying Mexican bonds is buying US bonds with a spread which is quite
convenient, frankly.

I just want to give you an idea of where Mexico basically is placed in the
mindset of investors and market participants and why the macro story is
good. Now, what I think this report tells us is that there is weakness inside
and there is weakness inside any macro story, so it’s good that we look at
it.

Now, this report is very MECE. I did work at McKinsey once and MECE
means Mutually Exclusive and Comprehensively Exhaustive, which
essentially means they look at every single detail of what they are looking
at in exhaustive focus. And so it’s very difficult to pick things there. But
what they basically tell us is that Mexico is a dual economy square.

So you have duality on large versus the small firms and you have duality
in informal versus formal which gives another dimension to what you see
in other OECD countries where normally the dichotomy is only between
the small and large firms. The result is the same. It’s weak productivity
growth, and the reasons I think the report pinpoints are the ones that you
see in many other countries: you have labor market restrictions and those
labor market restrictions are the ones that create a barrier for firms to grow
in terms of size and I will show you a bit of pictures later.

You have financial market restrictions. I wonder why banks are not
lending to those small firms and whether there could be a market failure
somewhere there. There are legal restrictions that refers to the
enforcement and there is the infrastructure gap that has been discussed
before and that I think the reforms that the current administration is
putting in place, is trying to address but the point I’m trying to make is
that this is a general problem of many economies. It just doesn’t happen in Mexico.

So ignore the slide. This is intended to tell you that it happens everywhere in the world. So there is research that shows that half of the productivity differential between the US and Canada is due to differences in firm size. That’s Canada; I’m not talking about a smaller country or a less developed country.

You look at France and you see that labor market legislation what it does that it truncates the distribution of firms according to the number of employees so it goes like this and then there is a spike at 50 employees. Why? Because if you go above 50 employees, you enter into a different labor regulation regime and life becomes more complicated. You have exactly the same problem in Italy with Article 18 of the labor legislation. You have the same problem in Spain.

You look at the Spanish and German firms and they are equally productive once you control for size. The difference is the amount of firms that Germany has that are bigger that makes for the difference in productivity between Spain and Germany. You look at Spain and you look at another aspect of it that is taxation, if you are a firm below 6 million euros of revenue, you are small. You have a different tax regime. There is a bunching of firms below 6 million euros of revenue.

When you look at Portuguese firms, there is a paper by a couple of researchers that they titled “The Incredibly Shrinking Portuguese Firm” because the size of firms has declined steadily over the last two decades in Portugal and you wonder why. Well, again, it is a question of incentive. It is a question of micro regulations.

So let me show you a couple of charts, right? On the right, you have Greece—I’m sorry on the left. Greece, Portugal, Italy and Spain, the countries that are not competitive. On the right you have Sweden, Ireland, and Germany. And what you see is that the blue line essentially goes down. That’s the amount of small firms. The green line is the amount of big firms. It goes in the opposite direction. So you can find a relationship between countries that exhibit high competitiveness in external markets and the firm’s size.

You find something similar when you look at productivity, right? What you have there in the horizontal chart is the share of employment in firms of less than 20 workers. What you have in the vertical chart is hourly productivity. What we have is another way of looking at the same picture. So essentially what these charts are telling you is that firm size is key. It is
probably more important, in my view, than exchange rate or wage competitiveness.

So what are the implications of this dual economy square? I think one interesting implication is that you may have too many small businesses in your country—and I’m not only talking about Mexico, but in general—many of these workers would probably be better off from a macro standpoint and individually if they were working for bigger firms rather than being small business owners.

Now, there is this myth out there that most of the job creation happens at the small firms, right? It is part true, part not. Once you control for firm H, the difference this appears. So the question is, when you are a competitive start-up, let’s put it that way, you do create more jobs. Now if you get stuck at a small size, then you are no longer that machinery that is creating jobs. And so the key is to lower barriers to the growth of firms—which I think is what Jaana was talking about before when talking about the panaderia—it’s better to have a bigger one than three smaller ones.

So essentially, the objective has to be to lower barriers to churn. So it’s up or out that is necessary. Those are the [inaudible 00:49:32]. That’s the culture of Silicon Valley. Either you are good and you grow or you are out. Call it “life”, in some sense, but that is the key at the end of the day to increasing productivity.

There is one question that I think appears in other countries that is why are banks so risk averse? So banks in Mexico are incredibly profitable but they don’t really give many loans to the corporate sector. Why is that? Do they think that there is no profit opportunity in all that space? Are there barriers to entry? Is there a problem with credit information?

For example, one situation that arose in Spain after the savings banks essentially disappeared is that the credit history of a lot of SMEs went away with the savings bank and because SMEs are not listed, they have sort of start from scratch. It’s like having your driver’s insurance when you come to the US—if you have gone through that experience—no matter how many years you’ve been driving, you have to start from scratch.

So one piece of advice is to create a good credit bureau, not just a bad credit bureau. You want to make sure that the small companies have a track record and that then banks can access that information and that they can be more comfortable in terms of giving them loans and participate in their growth. So at the end of the day, it’s probably time to move from wage competitiveness into firm size competitiveness and I think this is the main message that this report gives.
So let me just give you a couple of final points. The first one is you are going to have reforms and you are going to be overwhelmed by capital inflows. When they come, please don’t try to manage the exchange rate, that’s my advice. A strong exchange rate will force the churn; will force the creative destruction in the corporate sector. If you want to put it this way, you may become German, and that’s not necessarily bad.

We have seen the negative impact of capital controls. You have a good macro framework; don’t create a situation where capital controls give you--let’s call it moral hazard to weaken your macro framework because that would be a pity.

And the final point is the political economy of reforms. I think Mexico is in a situation where the reforms have been put in place and the problem they’re having is that they are not generating growth immediately and political support may be weakening because the growth is not coming there. And I think it’s very important to communicate clearly to all their constituencies that growth will come, it’s a question of time.

Now there is a couple of French economists [inaudible 00:52:15] who published a book a few years ago called [inaudible 00:52:19] reform, which essentially they were trying to say that reforms are going to be good in the long run even if you have to yield a little bit in the near term and buy some people out in order to achieve the reforms. Do it because it’s worth it. So think about this. Whatever you need to do to generate the growth in the near term to achieve the reforms, I think it will be worth it. Thank you.

Barbara Kotschwar: Thank you very much for an excellent set of presentations. I think we all have a lot to think about now. And I would highly encourage those of you who have not yet to read the McKinsey report, it’s available at our front door. It’s also on the website.

The one thing that really does jump out at you reading the report, Jaana, is this difference between the informal and the formal companies which tend to be highly correlated by size—and Angel mentioned this—Santiago Levy said that size doesn’t really matter that if you control for size, that some of these other issues still appear, but I wanted to push a little bit on the issue of size.

Angel mentioned some of the research that talks about the importance of firm size. Our colleague Caroline Freund, who unfortunately couldn’t be here today because she’s in Europe, but has also done some important work on exporting firms, the export superstars where large countries or companies are the most efficient and effective exporters. And so I wonder
if you could talk, all of you, a little bit more about this dichotomy. I think in the report also the growing gap between the small firm productivity and large firm productivity is quite remarkable.

Why is this and what are some of the policy measures that you might recommend that could be taken in order to lessen this gap? What are the measures that perhaps could be put into place to help in the transition from small firm to large firm if that’s a desirable transition? There are many programs in Mexico that support PyMES, the micro, small and medium enterprises. Is this a misfocused attempt? Should there actually be initiatives that try to get small firms to become larger and what have other countries done in order to perhaps promote a path towards a more optimal firm size? Jaana, do you want to ...

Jaana Remes: Thank you, Barbara. Indeed, I think it is very clear—and I think Angel shared some of the data—is that the size of a company is a very significant factor explaining its productivity and from when we look at it at the micro level, the explanation is relatively simple. It’s the economies of scale. It makes sense to invest on productivity improvements in technology, in capital, et cetera particularly when you’re focusing on labor productivity when you are larger because you can get the benefits.

I’ll give you an example that you might not have thought of before, which is European freight transport. This was an industry that used to be fragmented by country. In a way, it was regulated heavily on what you could transport across nations, and you may hear a parallel with North America. When those regulations were put down, that dramatically changed the industry because prior in these fragmented industries, the freight companies didn’t have an incentive to invest on IT, optimized route, do many of the things that US freight companies had done and that dramatically changed the industry and led to real productivity growth and this was purely on impact of scale. So it’s just one of the many examples.

In the case of Mexico, and on particularly the decline of the small companies, which I think is a real—it’s not unprecedented anywhere in the world. I think Dani Rodrik’s data has shown that we have seen somewhat similar patterns in some parts of Africa, for example, but it is a really disappointing outcome after the reforms on—that we had seen in Mexico. And we have mentioned some of the factors that we saw as the important ones at the industry level, whether it’s the regulatory incentives, whether it is the capital et cetera and I think many of these things are changes that will take time and it will take—it will change things slower than I think most of us would want to see.

However, I would like to highlight one thing we didn’t talk about which is there are opportunities for the modern large corporations to really be
catalysts for change for the small enterprises. This is something we have seen in many nations.

So, for example, the buildup of the supply chain in the automotive industry in Mexico, despite the fact that there have been foreign OEMs for decades, their supply chains have been relatively limited and there are many reasons for that. Some of them used to be the relatively the small scale of the nation, the scale needed to put many of the parts, plants for example, is much larger than it is for OEMs, something we don’t often think about.

So it is still economically viable to in a way put an OEM and import some of the parts. That is changing when you’re integrating NAFTA and at the same time, we used to have some of the incentives to import from the US and assemble, and export back.

So in many ways, now we have seen that change as the scale and the environment have changed. We expect that to happen more. The foreign and Mexican corporations can do a lot on their supply chains. And we clearly are hearing from both multinationals as well as Mexican companies that they have a lot of appetite for doing that. So in many ways, I think that is the positive story even though the profound reforms will take a long time, there is a lot the private sector can do to really transform the tale of the small companies and train the management in a way it—we have seen many examples where the supply chains then lead to clusters of growth as the managers go and start their own businesses, et cetera. So that is just an example of, even without more regulatory changes, there is a lot the private sector and the companies can do to hopefully turn that decline into productivity growth.

Santiago Levy: So let me throw in my bit. There is a big discussion as to what is the sort of the optimal size situation of firms? And it is clear that, in any industry, there are firms of different sizes that coexist. More productive firms will tend to be bigger and less productive firms will tend to be smaller but that doesn’t mean that the allocation is inefficient. It just means that at the margin, the allocation is efficient.

What matters, I argue, is the type of firm more than the size of firm because in Mexico as opposed to France, the examples that were given by Angel, the regulation on taxes and the regulation on social insurance is not by size of firm but by type of firm, and this is very important. Labor contracts are regulated very, very differently. A firm that hires wage workers is subject to a whole bunch of regulations on social insurance and labor law with respect to severance pay, hiring and firing. And if exactly the same firm was organized as a firm with nonwage contracts, the regulations that would apply to that firm would be different.
The story of the bakery that Jaana told before is a very interesting example. Most likely that bakery was a family firm. If the bakery grew from five workers say to ten workers, maybe they still have another cousin and then another cousin and then the aunt and maybe the uncle and their a ten-worker firm is still a family firm.

But if it grows again and it’s going to be a 20-worker firm, they begin to run out of relatives. You have to organize yourself as a wage firm with salaried contracts. When you do that, the regulatory burden on the firm changes in a dramatic way from social insurance, from labor and from many other dimensions.

So it’s the regulation on the size, on the type of firms that really matters. It is reflected in the size of firms because the enforcement of the regulation is imperfect because the tax authorities and the social insurance authorities and all the authorities that are in charge and the labor authorities in charge of enforcing these regulations, on many occasions, don’t bother enforcing the regulations on small firms that are illegal, not the workers, the firms are doing illegal behavior and this is large in Mexico because the cost of enforcement from the point of view of the tax authority is actually bigger than the revenue they’re going to get from enforcing the law.

So the mix of regulating the type of labor contracts and enforcing them imperfectly on the function of the size or the firm, generates a very distorted size distribution of firms. But I want to emphasize that what really is driving this whole thing is the asymmetry in the regulations. And to make the point, assume the following: holding constant the size distribution of firms, if all firms are exactly the same size, all of a sudden all of them became formal, the productivity economy would be different with exactly the same size.

The reason being is that formal firms have much greater access to credit, will do labor training, have less rotation of the labor force, there is more on the job learning, and there is a better organization within the firm. So all these advantages translate into a very large productivity difference from the firm that when you multiply by the millions of firms that are in Mexico add up to the [inaudible 01:02:48] productivity and that’s why it’s the type that matters.

Angel Ubide: No, I don’t really have anything to add. Yes, as I was listening to him, I’ve become more convinced of this duality square which I think makes the difference between Mexico and others. It’s the informality that, at the end of the day, generates the difference and that needs to be addressed.
Barbara Kotschwar: Thank you. We will open this to questions. There is a traveling microphone and there is a microphone at the back. So those of you with a burning question can start lining up at the back. I will take the moderator’s privilege to ask another question or two and I’m wondering, Dr. Levy, you’ve basically said that you need to reduce the one minus alpha, but you discussed a number of factors and you say these require some—what seem pretty complicated—regulatory changes.

And the administration has been undertaking some pretty wide ranging economic reforms, but some of the changes that seem to be needed in order to reduce that one minus alpha to the extent that it doesn’t overwhelm a growing alpha seem very, very complicated and seem to be some—one would expect that this would get into rather entrenched interest, into the political economy of the way that business is done in Mexico. What do you think would need to happen in order to change this? What would it take to shift the political economy that leads towards this one minus alpha?

Santiago Levy: That’s a really difficult question. What I think at this stage is most important—and that’s why I think the report is really useful and really welcome—is that this issue should be put on the table. This needs to be socialized more, discussed more and we need to construct a shared diagnostic that this is indeed a big problem.

Actually, it might be more of an ideas problem than of an interest problem in the sense that, entrenched interests might not be as powerful as entrenched ideas. The current equilibrium is really very bad. It’s actually lose-lose equilibrium because Mexico as a whole is not getting all the potential output that it could get from the workers that it already has and the capital that it has already invested.

So it’s feasible to have a much bigger equilibrium. And the reason that you don’t move there is because there are these ideas—some of them coming from the 19th century—about the way labor should be regulated, social insurance should be constructed and taxation should be enforced and changing this requires at this stage I believe more national conversation and diagnostic that, I would emphasize, is complementary to the very important reforms that are being undertaken right now, not a substitute for but a complement to.

Barbara Kotschwar: Great, thank you very much and I think it is important to put this on the table particularly as we look to the evolving relationship between the US and Mexico in the context of North America and increasing North American competitiveness. I’d like to open the floor to questions. If you have a question, please raise your hand and please introduce yourself.
State your name and your affiliation. Please, I think Mireya Solís over there.

Mireya Solís: Thank you, Mireya Solís from Brookings. I think that the panel has offered a really illuminating diagnosis on what ails the Mexican economy. I’m following up on Barbara’s question. I would like to ask if you have any sense where the administration of President Peña Nieto shares and knows about this diagnosis and the series of reforms that are on the table have anything that will touch upon these distorted incentives. And what would be the hurdles again for the implementation of any reform that will go and tackle the dual economy in Mexico? Thank you.

Jaana Remes: We conducted our research at that time that was relatively early in the reform agenda. So in many ways, we did not do an assessment of the reforms themselves. However, I do know from our discussions with many of the people in the administration is that I think many of the issues are very—people are aware of that. I know that we have discussed the report findings and I think their own research, some of the public’s research for example from the Unidad de Productividad at Secretaría de Hacienda have shown some similar issues.

So I think the awareness definitely is there. As I said before, I think the—it is easy to see the problem and I think it’s important to continue to emphasize it. I think the challenge of translating that into not just regulatory challenges that reduce the incentives but the implementation, that is the hard road and so that’s all I can say. Unfortunately, we haven’t assessed the current reform agenda.

Barbara Kotschwar: Thank you. Dr. Gonzales in the middle table, please.

Dr. Gonzales: Good morning. Thanks very much for the invitation, a great panel and wonderful to keep propelling this report that everyone is quoting around the world, so Peña Nieto and his people are obviously aware about it because it’s being quoted throughout the press, think tanks, governments, everywhere.

The question is to Dr. Levy regarding the issue of investment. You did mention that without higher rates of capital formation—and this is a problem for Mexico since the last decade—this might be a necessary, though not a sufficient condition to bring the country back to growth rates of about 5, 6% annually rather than 2 or 3%. You said the key problem is not necessarily just low investment. It’s also big misallocation of investment.

When Jaana Remes showed us that timeline showing the growth of productivity and contrasted very clearly Desarrollo Estabilizador with post
1980s, are you suggesting that during those years Desarrollo Estabilizador with high rates of both public and private investment, there were lower rates of misallocation of resources and therefore the economy was able to grow at higher rates or is it a different story? Did something fundamentally happen during the ‘80s and ‘90s when we were drained of resources given two or three successive financial crises which have not allowed the country to invest at high rates. But misallocation has happened from Ávila Camacho until now, more or less at constant levels, but investment certainly has been significantly low, public and private, the last two and a half decades compared to previous ones. Thanks.

Santiago Levy: Thank you for the question. We don’t have good data to answer your question. There is no data comparable to the sort of data that the McKinsey report used or that I’ve used in some of my own papers for the 1960s or ‘70s. That data is not there. So I could not give you a proper answer to say is the misallocation in the Mexican economy today bigger than what it was in the 1960s, or ‘70s. The comparison that I made is if you take the ‘98 census and you take the 2008 census which is the two largest, latest available data sets that you have, indeed misallocation did increase between ‘98 and 2008. That’s kind of an empirical finding.

I separate that from the question of investment in the following sense: growth can come either because productivity growth is higher, because investment is higher, or because labor input is higher. Those are basically the three sources. Labor input—Jaana discussed that in the report—demography at the margin is not going to help you that much more going forward. And that’s you know, participation you might get a little bit, particularly on the female participation rate, but the margin there is not significant.

You could get more growth for more investment, which is you know growing by perspiration as opposed to by inspiration. The point that I made is if you want the investment rate to grow by … say, five points of GDP, which we very welcome, you also have to do something on the saving side to ensure that this investment effort is sustainable and that is a very difficult thing to do to raise saving rates by the equivalent of 5% to GDP. So sure, more investment is welcome, but given any investment effort, the allocation point that the report makes and that I’m making is that it would be much better if that investment was actually much better allocated and that the misallocation of investment is one of the sources of low productivity growth.

Think of her bakery. Where did they get the money to buy the ovens and to buy whatever other equipment they needed for the bakery? Most likely from owned household savings, very unlikely that they got a bank loan. So
there is a huge amount of intermediation of savings and investment that is occurring outside of the financial sector.

The notion that we have that households save, they put their money in the financial sector, the financial sector turns around, picks the highest productivity investments and allocates investment in the best way, is a very incomplete picture of what goes on in Mexico. That goes on in the alpha part of economy, not in the one minus alpha part of the economy. There is a lot of savings and intermediation that goes on at the household level.

That’s very profitable from the point of view of the family, but it’s very unproductive from the point of view of the economy as a whole. And that is the issue that I think the report is calling attention to and that I’m trying to call attention to. That intermediation of savings and investment and that allocation of investment could be much improved.

Jaana Remes: A very quick comment on the early period of the second half of the 20th century and today. I think we are really looking at two different periods of growth. At that time, Mexico was reducing agricultural employment and urbanizing, exactly what China is doing today. That’s the easy way to grow if you want because you are starting from a very low subsistence income at a certain income level. So in a way, it is not really a fair comparison. Mexico is already at the level where I think getting that kind of gains is harder. So I think we shouldn’t forget that broader picture.

Barbara Kotschwar: We have time for a few additional questions. Adam.

Adam Posen: Hello, Adam Posen from the Peterson Institute. This was terrific and I just want to say a bit of appreciation for Angel for putting it in the global comparative context. We’ve had a lot of concern from various of us—Barbara mentioned Caroline’s work on champion firms. I’ve done a lot of stuff in the past on failure to get SME funding in Europe—I think this is a theme we’re going to have to return to.

But let me pose a question to each of the other two panelists. Jaana, you seem to be saying that, by implication, that this wasn’t a trade story. There are people who might suggest that the competitive alpha sector is sucking in all the good talented people—or a lot of them—and, in that sense, distorting the economy and leaving you with less good people or less good opportunities in the rest of the economy. Do you think that that’s a reasonable characterization of Mexico or is it the reason why you seem to say that the human capital was not the issue, that trade was not the issue in the informal sector?
Santiago, sort of related, as you’ve put it—and I think the report from Jaana and her colleagues puts it—Mexico really does stand out in some ways about the informality or the informality squared. How much do you think that possibly relates to there being such a large migrant labor force going up to the US. I mean, does that do something either causally in terms of changing the relationships at home? You know of other countries obviously in the region that have large expat workers, are they the same? Alternatively, is it just a marker about rule of law and violence and things like that that contributes to informality, or again, it was what—you guys’ right to omit talking about that. Thank you.

Jaana Remes: Thank you, Adam. On education, clearly we always—typically would want more of it but when we—everywhere even in this country, even Finland, which is where I’m from, which typically is at the top of the education ranking. However, I think when we look at the industries in Mexico, we did hear from many of them that middle management and senior management, there is a shortage of folks but we hear that in many different places and it’s particularly acute in emerging markets where in a way you start from a smaller base and you need to grow by apprenticeship in many places.

Beyond that, education is much less of an issue that people raise. We hear from companies who say, "Well, in Mexico, people are very hardworking. They are very motivated." And training, in house, is critical for success in most corporations. And in many ways, we don’t see it as the binding constraint particularly for the expansion of the modern sector. The companies complain about the way you can contract; not the kinds of people you can find.

And as someone who has been living on this side, in California and watching many migrants come and be extremely successful and hardworking, and looking at, for example, the world’s most productive construction workers in Texas that are often non-English speaking Mexicans, it’s hard to make the case that there is—the productivity at the operational level of many corporations is a question of skills.

Santiago Levy: Thank you for the question. And I agree with Jaana on the human capital. I don’t think this is a skills story or an education story. How much Mexico stands out, this is a landmark and phenomenon at various degrees. If you look at Colombia, you’ll find even higher rates of informality than you do in Mexico. If you look at Peru, you find even higher rates of informality. Central America, we don’t have good data, but the likelihood is that it’s probably even bigger than in Mexico.

So with the imperfect data that we have, yes, Mexico within the OECD comparators truly stands out as a country with very high—I think
Colombia is about to enter the OECD so you know, Colombia—but vis-à-vis Latin America, this is a systemic problem in the region.

Your question about migration is very, very difficult because your question on migration is …. Given the allocations that are occurring in Mexico, real wages are lower than they would otherwise be. So, clearly, some of this migration to the extent that it is induced by the differences in real wages between—across the border are the result of, you know, the fact that there is a very large informal sector in Mexico where productivity is not going up and real wages aren’t going up.

That said, migration laws are very complex because they’re driven also by you know longstanding way back family relations and things like that and not all of the migration is not necessarily low skilled labor. There is an important amount of migration of high skilled labor, which might also be a reflection that some of these medium-sized firms are not demanding the skills that you are actually having.

There is a really interesting piece of data that people need to look at more carefully, which is really telling. If you look at the returns to education in Mexico—a surprising fact and we don’t understand this 100%—is that the returns to higher education relative to the returns to middle and primary education are actually falling and I don’t understand why 100% but this is connected to the demand for skills not taking at the same level the supply of skills and that’s why it’s very difficult to think of it as a skills story.

Angel Ubide: The comment that was made before about the intermediation of savings, right, and I think it’s key. When you think about the successful countries in terms of having a vibrant middle, not a small but middle enterprise, they have a dedicated banking sector, a financial sector for them. Think of the Sparkasse in Germany for the middle [inaudible 01:20:15] or think of the capital markets in the US for the sort of Silicon Valley or venture capital, and I continue to be puzzled by the very inactive role that the banking sector is playing in Mexico. And whether, as I said, I don’t want to call it a market failure, but there is something there that if you can get the financial sector to become more proactive in terms of supporting the informal sector and the transition into formality that you could get a lot of problems solved in that way.

Barbara Kotschwar: We’ll take one more question. Dr. Bergsten.

Fred Bergsten: Fred Bergsten from the Peterson Institute. One thing I would like to take away from the discussion is a judgment on prospective growth rate for Mexico and if I understood the three of you, you had very different views. I think the McKinsey report said it would be very ambitious and difficult to get up to three-and-a-half. And Santiago, almost in passing, talked
about five or six and Angel didn’t give a number I didn’t hear, but said you’re going to get a lot of capital inflow and that implies relative good performance vis-à-vis other emerging markets. So that sounds like a pretty high number.

So we may have a considerable range and I’d like to pin you down to the extent, as possible, to get you to say a little more what you think is feasible. And in terms of the point Santiago just made about financing it, need for domestic saving, if Angel is right and Mexico is going to get an awful lot of foreign capital inflow to reinforce what’s already a big share of foreign banks but other FDI, couldn’t part of the strategy be to consciously run a current account deficit for a substantial period of time, finance it with reasonably stable capital inflows, play the Australia, New Zealand, Canada game and get into a higher growth pattern from that strategy?

Barbara Kotschwar: Very provocative question. Do you want to go first?

Jaana Remes: Okay. Well we obviously have not done any forecasting so I won’t be able to give you a number what we think is going to happen in Mexico but let me respond on—I think a lot depends on your timeframe. In the near term today, there is both the fact that many of the regulations and reforms that take place on the larger share of the economy, on the 80, not the 20% if you want, on the one minus alpha instead of the alpha part, they will take time. So that means in the near term, a dramatic change there is less likely than it taking off in the longer term.

In addition to that, I think there is some uncertainty about how the regulations will play around and investors, they are waiting and seeing, some of them, on where and how to go particularly on those industries that will be influenced. That’s it. I think the investment-led potential particularly given the significance of some of the reforms, I think that’s a very real one and that can make a difference. However, you need to see pretty significant growth given that we are talking about a relatively small part of the sector.

When you look at the longer term—and we’re looking at 2025 so that’s ten plus years of the growth rate—I think, in that case, the range of changes is much broader in a way. You can expect anything from two to—we looked at 3.5 and so significant, I mean, clear opportunities to meet that goal. There is no doubt about that. I think pushing it further to five, I’m curious to hear what Santiago’s views there are. There is really, I think, given that Mexico’s investment rate is 25% and everything else, I think in the long term, it’s hard to see real constraints for it in the ten plus timeframe to reach significantly higher growth rates.
Santiago Levy: Thanks for the question, Fred. So I’ll make a distinction between transition path and a steady state. We did this calculation at the IDB. Assume that the extent of misallocation in Mexico was the same as the extent of misallocation in US industry. So we took the manufacturing sector—this was done at four digits because we didn’t have the data at six digits—but we said, “If the amount of misallocation that occurs in Mexican manufacturing was the same amount in US misallocation, which there is, by how much would total factor productivity grow in Mexico?” The answer to that is about 35%. So there is excess loss of total factor productivity relative to the US, not to the perfect equilibrium but relative to the US of about 35%.

So think now of a transition path, not a steady state in which you ask yourself the question, “Over how many years would it take to correct these distortions and to gain in each year as I approach the new steady state some gains in TFP that are going to add to the growth rate during the transition path even though they’re not going to be part of the growth rate over the steady state?” Arbitrarily divide 35% by 10, 12, voilà.

Mexico’s growth rate in the steady state is not 5% or 6%; the demographics are not there and the savings rate for that is not there. But there is a lot of low hanging fruit that you could capture in a growth path of about 10, 12 years and then your growth rate would decline a little bit. When you said, “Why don’t you grow taking advantage of these capital flows?” you made a very important qualification which said I quote, "reasonably stable capital inflows". So we want those, but we don’t want the other ones and we’ve already suffered the other ones. And I don’t like to see a 5% current account deficit unless I’m assured that these “reasonably stable capital inflows” are there and the sort of capital that will come as a result of this is not all of it of this nature. So I’d rather bet in upping the savings rate a couple of points.

Angel Ubide: I think Fred basically was paraphrasing what I was trying to say, which is the Australian model, right? I mean, one can expect a large amount of inflows in the next few years in Mexico as a result of these reforms. Now, when you look at Australia, the problem is what happens after the inflows. There is a gap, and there is a gap in growth because you transition from the growth in investment to the growth from the product of the investment and there is a time gap. So they key is to build fiscal space during the inflow boom so you can fill that gap later on with fiscal resources and that would avoid essentially that these inflows "degenerate" into a too large current account deficit.

So to answer your question is, tell me what fiscal policy is going to be like during the inflows and I will tell you how sustainable the high level of
growth is going to be. It’s possible to be done. It’s just a question of having the right framework in place.

Barbara Kotschwar: And I think we’ve come to the end of a fascinating panel. I’d like to thank Jaana Remes for the presentation of a very interesting study and Dr. Santiago Levy and Angel Ubide for interesting comments and all of you for your questions. Please join me in thanking the panel.