FINANCIAL TIMES

June 3, 2014 7:46 pm

Legitimate business unlocks Mexico's growth

By Martin Wolf Author alerts

Spur has been big improvements in policy but also in governance

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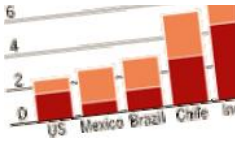
If Narendra Modi, India's prime minister, seeks an example of a democratically elected leader embarked on radical reform, he could look to Enrique Peña Nieto. True, the latter is president of a far- smaller country, and a richer one – Mexico's average standard of living is double India's, although poor economic performance in recent decades has narrowed the gap substantially. The two countries' leaders confront related challenges. Both need to generate market-oriented growth in economies that show a huge gulf between a high-productivity formal sector and a low-productivity informal one. Mr Peña Nieto has embarked on bold reforms. Is his the model to be followed?

In a recent study, the McKinsey Global Institute captures Mexico's dualism nicely. "There is a modern Mexico, a high-speed, sophisticated economy", it acknowledges. But there is also a "traditional Mexico, a land of sub-scale, low-speed technologically backward, unproductive enterprises, many of which operate outside the formal economy". Development means integrating the two.

It is often forgotten that in the 1950s, 1960s and 1970s, Mexico's economy was highly successful: gross domestic product per head rose at an annual average rate of 3.3 per cent. Then came the debt crisis of 1982 and a lost decade, a botched privatisation programme, the North American Free Trade Agreement of 1994, the financial crisis soon afterwards, macroeconomic stabilisation, a shift to multi-party democracy and the rise of Chinese competition. Throughout this period, growth was dismal: output per worker has grown at less than 1 per cent a year since 1980. Mexico's GDP per head (measured at purchasing power parity) was 30 per cent of US levels in 2012, exactly the same as in 1990.



For those who believe that opening up to trade is a guarantee of rapid growth, this is a sobering tale: the ratio of trade to GDP jumped from 39 per cent in 1990 to 65 per cent in 2011. Exports to the US rose sixfold under Nafta. Yet the economy underperformed.

Mexico suffers from a "productivity puzzle". The contrast with other emerging economies is remarkable. McKinsey's explanation is that, while productivity rose at a compound rate of 5.8 per cent a year between 1999 and 2009 in companies employing more than 500 people, it rose at just 1 per cent a year in companies employing between 10 and 500 people, and fell at a rate of 6.5 per cent in companies employing fewer than 10. The share of the latter in employment also rose in the same period from 39 per cent to 42 per cent, while the share of big companies stayed at 20 per cent and those in between fell from 41 per cent to 38 per cent (See charts).

What lies behind the falling productivity and rising share in total employment of small businesses? Why, for that matter, have midsized businesses been so undynamic? McKinsey advances three hypotheses.

First, companies remain small and informal because the regulatory and fiscal burdens of becoming large and formal are high. The solution is to lower burdens on formal businesses and raise them on informal ones.

Second, small businesses lack access to credit. At 33 per cent of GDP, outstanding loans are extraordinarily small. They are also expensive. McKinsey argues that "The unmet capital needs of firms with 10 to 250 employees represent 75 per cent of what we estimate to be a $60bn credit gap in Mexico." The solution must include improvements in property rights, legal processes and, perhaps, targeted guarantees.

Third, infrastructure, energy costs, supply of skills and quality of governance leave much to be desired. This affects businesses both big and small but makes it particularly hard for small and midsized companies to prosper. The solutions are to upgrade governance at all levels, and deregulate and enhance competition. Public-private partnerships, including foreign capital, should play a role in the supply of infrastructure.

The McKinsey analysis is right, so far as it goes. But it is limited. The informal sector is operating as a sink for Mexico's excess labour (as is true in India). Declining productivity in the informal sector is not just a product of what is happening in that sector. It is a result of slow employment growth elsewhere. The informal sector adjusts to the excess supply of relatively unskilled workers unable to find jobs in formal businesses. Since credit to small businesses is so tight, the result is falling productivity and real wages.

The answer is to make the formal sector less regulated, and the informal sector more regulated

The government of Mr Peña Nieto is aware of the country's economic underperformance. It is reshaping the energy sector – among other things, ending the monopoly of Pemex, the state-owned oil company. In telecoms, it is curbing the "dominant position" of Carlos Slim's América Móvil. It is also reforming labour markets, the tax system (unpopular with payers), education (unpopular with teachers) and competition policy.

This is a bold programme. But will it be enough? After all, the rate of productivity growth needs at least to triple. Since Mexico is already a middle-income country, that will require not just market-oriented reforms but a radical improvement in the quality of state institutions. The informal sector will need to be brought within the ambit of a supportive regulatory and legal framework. Only once these businesses are formalised can they hope to obtain credit and other crucial services. China's soaring wages offer a new opportunity to Mexico's export-oriented businesses. But exports alone will not transform economic performance. Dynamic and innovative businesses must emerge in all parts of the economy.

Mexico's past offers a warning; its present offers hope. But it is far from certain that the programme of reforms, albeit necessary, will also be sufficient to generate the much-improved performance the country needs. The further an economy has progressed, the more difficult rapid growth tends to become. That has been true for Mexico for some time. A big part of the answer must be to make the formal sector better and less regulated, and the informal sector better and more regulated.

What is needed is not just a big improvement in policy but also one in governance. This is true in Mexico and India alike. It is what both Mr Peña Nieto and Mr Modi promise. Let us now see whether these governments will be able to deliver.

martin.wolf@ft.com