Structural Reforms for Sustainable Growth

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Challenges and Opportunities for the Global Economy

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Based on


Real GDP per working-age person in the United States

Index (1900=100)
A digression on economic growth:

Real GDP per working-age person has grown by 2 percent per year in the United States since 1875.

This growth is a combination of technological progress and improvements in management.

Any country with stable institutions and policies should grow at roughly 2 percent per year.

A country that improves its institutions and policies should grow faster, until it reaches a new balanced growth path.

A country whose institutions deteriorate or whose policies worsen…
\[ \log \frac{Y_t}{N_t} \]

- **leader**
- **less developed country**

- **reform**

- **t**
Real GDP per working-age person in Mexico
Mexican economic history, 1877–2010

- Porfirato
- Revolución and reconstruction
- Great Depression and recovery
- Import substitution and catch-up growth
- Fiscal imbalances and collapse of import substitution
- Crisis and reform
- Recovery and slow growth
- Great Recession
Between 1984 and 1995, Mexico implemented an impressive set of economic reforms, yet its growth has been modest compared to that of China…
Trade in Mexico and China

The graph shows the percentage of GDP devoted to trade for Mexico and China from 1985 to 2005. The percentage for Mexico is represented by a continuous green line, while the percentage for China is shown by a dashed red line. Both countries have experienced an increase in trade as a percentage of GDP over the years, with Mexico showing a more stable trend and China experiencing greater fluctuations, especially after 2000.
FDI inflows to Mexico and China
Did Mexico gain from trade?

“The evidence points overwhelmingly to the conclusion that Mexico’s reforms, backed by NAFTA, have largely been a disappointment for the country. Despite dramatic increases in trade and foreign investment, economic growth has been slow and job creation has been weak.”

“Rethinking Trade Policy for Development: Lessons from Mexico under NAFTA.”
The empirics: Does trade cause growth?

Yes!

No!
Sources of Growth

\[ Y_t = A_t K_t^\alpha L_t^{1-\alpha} \]

\[ \frac{Y_t}{N_t} = A_t^{1-\alpha} \left( \frac{K_t}{Y_t} \right)^\alpha \left( \frac{L_t}{N_t} \right) \]


Best practice
Growth accounting for the United States

index (1950 = 100)

output
productivity
capital
labor


100 200 300 400
Growth accounting for Mexico

-1.0 0.0 1.0 2.0

index (1950 = 100)

output
productivity
capital
labor

100 110 120 130 140 150 160 170 180 190 200 210 220 230 240 250 260 270 280 290 300 310 320 330 340 350 360 370 380 390 400


index (1950 = 100)
Gains from trade

Real GDP growth versus real income growth in Mexico and China

<table>
<thead>
<tr>
<th>Annual growth rate (percent)</th>
<th>Real GDP per capita</th>
<th>Terms of trade premium</th>
<th>Gain from variety</th>
<th>Real income per capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>China 1998-2008</td>
<td>8.989</td>
<td>-0.761</td>
<td>0.101</td>
<td>8.329</td>
</tr>
<tr>
<td>Mexico 1990-2000</td>
<td>1.782</td>
<td>0.169</td>
<td>0.142</td>
<td>2.093</td>
</tr>
</tbody>
</table>
Terms of trade premium in Mexico and China

Mexico (T₀ = 1990)

China (T₀ = 1998)
Standard trade theory does not explain this productivity growth.

What theories of openness can do so?


Incentives for internal reforms: Bajona-Chu (2008)
What are the barriers to growth in Mexico?

Poor financial institutions
Lack of contract enforcement
Problems in labor markets
…also problems with crime

But China has many of these same sorts of problems

Poor financial institutions
Lack of contract enforcement
Problems in labor markets
…also problems with the political system
But why is China growing so rapidly?
But why is China growing so rapidly?

For the same reasons that Mexico grew rapidly between 1950 and 1980:

- Urbanization
- Industrialization
- Basic education
Urban population Mexico
Literacy rate, population age 10 and older in Mexico
Urban population in China
Literacy rate, population age 15 and older in China
But why is China growing so rapidly?

For the same reasons that Mexico grew rapidly between 1950 and 1980:
  - Urbanization
  - Industrialization
  - Basic education

Hypothesis: Mexico would have grown more rapidly between 1950 and 1980 if it had been open to foreign trade and investment.
When will the barriers to growth that are limiting Mexico’s growth start to bind on China?
Purchasing power parity GDP in Mexico and China

- Mexico GDP per working-age person
- Mexico GDP per capita
- China GDP per working-age person
- China GDP per capita
When will the barriers to growth that are limiting Mexico’s growth start to bind on China?

Hypothesis: Absent major reforms, China’s growth will slow to about 2 percent per year within the next 10, perhaps before China reaches the level of real GDP per working-age person of Mexico.
What reforms does Mexico need to resume rapid growth?

Eliminate barriers to growth:

Reform financial institutions
Improve contract enforcement and rule of law
Make labor markets more flexible
What reforms does Mexico need to resume rapid growth?

Eliminate barriers to growth:

Reform financial institutions
Improve contract enforcement and rule of law
Make labor markets more flexible

Also

Reduce monopoly and inefficiencies in nonmanufacturing sectors like electricity, telecommunications, transportation, and petroleum extraction.

Reduce violence related to drug trafficking.