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
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…
\[ \log \frac{Y_t}{N_t} \]

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

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**reform**
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

Index (1877 = 100)
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
FDI inflows to Mexico and China

Percent GDP
Real GDP per working-age person in 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

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

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


Best practice
Growth accounting for China
Growth accounting for Mexico

Index (1950 = 100)

- Output
- Productivity
- Capital
- Labor

Year:
- 1950
- 1960
- 1970
- 1980
- 1990
- 2000
- 2010
### 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>
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<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 \((T_0 = 1990)\)

China \((T_0 = 1998)\)
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
Composition of GDP in Mexico

services

manufacturing

agriculture

percent


Composition of GDP in 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.