Credit constraints and economic growth in a dual economy

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A B S T R A C T
Pervasive credit constraints have been seen as major sources of slow growth in developing economies. This paper clarifies a mechanism through which an inefficient financial system can reduce productivity growth. Using a two-sector model, second, we examine the implications for employment and the distribution of income. Both classical and Keynesian versions of the model are considered; saving decisions are central in the classical version while firms’ investment and pricing decisions take center stage in the Keynesian version. We find that, although boosting the asymmetric rate of growth, a relaxation of credit constraints may reduce the share of the formal sector, increase inequality and underemployment, and have little or no effect on the medium-run rate of growth.

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1. Introduction

Poor financial systems and pervasive credit constraints have been seen as major sources of slow growth in developing economies. Mexico is a striking example, and the Mexican experience provides the primary motivation for the analysis in this paper; the general argument, however, may apply more widely.

The Mexican economy has gone through a series of structural reforms since the 1980s. It has been opened to foreign trade and capital flows, state participation in economic affairs has been significantly diminished, and an export-led growth strategy has displaced the earlier import-substitution strategy. Each new round of reforms was introduced with promises of high and sustained growth. The results have been disappointing. The economic growth predicted by the reformers has not materialized. Exports have increased but not yielded growth in the economy as a whole. Macroeconomic stability in the form of low inflation and reductions in the fiscal deficit may have been achieved, but even these achievements should be seen in the context of severe crises in 1982–1983, 1986, 1995, and 2008–2009; Lustig (2001) presents an early assessment of the economic shift; Moreno-Brid and Ros (2009), Hanson (2010, 2012), and Ros Bosch (2013a, 2015) are more recent studies. The literature on Mexican slow growth has two broad strands. The dominant strand points to stagnant total factor productivity. An alternative view regards the low rate of capital accumulation as the most important proximate cause of the sluggishness, and considers low productivity growth to be a consequence of low capital accumulation. Both strands agree that many firms, especially medium and small enterprises, have experienced significant credit constraints and that those constraints have been an important reason for slow growth. In the dominant view, inefficient financial systems contribute directly to low productivity growth; Hanson (2010), and Keohoe and Ruhl (2010), Tinoco-Zermeño et al. (2014), and Bolio et al. (2014). In the alternative view, credit constraints, may have contributed to the low rates of capital formation, with derived effects on productivity growth; Moreno-Brid et al. (2005),

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The model in Razmi et al. (2012) comes closest to the one in this paper. We extend this model by introducing credit constraints and endogenous changes in productivity; to keep the analysis tractable, we simplify the analysis by assuming constant returns to scale in the informal sector and fixed consumption shares.

The paper is organized as follows. Section 2 outlines some stylized facts and provides a selective survey of the applied literature on credit constraints in the Mexican economy. Section 3 analyzes the effects of credit constraints on technical change in the modern sector. Section 4 presents a two-sector model with financial constraints in the modern sector. Sections 5 and 6 analyze the implications of the model using classical and Keynesian closures, respectively. Section 7 contains a few concluding comments.

2. Economic growth and financial constraints in contemporary Mexico

2.1. Mexican economic performance

The structural reforms after 1982 have failed to boost economic growth. Using World Bank data we obtain that the average growth rate of per capita GDP in 1961–1981 was 3.75% while the 1982–2015 average, by contrast, is a strikingly low 0.58%.

Not surprisingly, virtually all scholars and policy makers agree that the results have been disappointing. There is also widespread agreement that although credit for consumption and housing has increased, finance for productive projects is difficult to obtain, and financial constraints have been an important reason for slow growth. According to Kehoe and Ruhl (2010, p. 2001) “[t]he most popular set of theories for Mexico’s stagnation focuses on its inefficient financial system and lack of contract enforcement”. Indeed, in 2013–2014 legal reforms involving changes in more than 30 laws with the explicit purpose of improving access to finance were carried out. Their results are still to be seen.

Fig. 1 presents the evolution of domestic credit to the private sector as a percentage of GDP for the period 1990–2015. This variable is commonly used in the literature as an indicator of financial constraints, and the figure includes data for other Latin American countries. Mexico has the lowest ratio among these countries; the average for the whole period was 21.7%. There has been some progress, and the ratio increased from 17.4% in 1990 to 32.7% in 2015. To put this rise in perspective, however, the only other Latin American OECD member, Chile, saw an increase from 45.3% in 1990 to 110.9% in 2015.

The literature suggests that the lack of credit from the banking system has been particularly important in Mexico; Márquez de Angulo (2007), Haber (2005), and Haber (2009). Fig. 2 shows the evolution of the domestic bank credit to the private sector as percentage of GDP for the years 1990–2015. Again, for comparative purposes we include the evolution of the same variable in the only other Latin American OECD member, Chile. The figure confirms the low level of bank lending in Mexico. In the early 1990s the ratio was around 30%. It then fell steadily, reaching a low of 12.1% in 2001, before recovering to 24.5% in 2015. The average for the whole period was 19%. In Chile, by contrast, the average was 61%, and the ratio went from 44.2% in 1990 to 81.7% in 2015.

The data in Figs. 1 and 2 do not distinguish between credit to firms and credit for consumption, and there is a broad consensus credit that constraints mainly affect firms rather than consumption.
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