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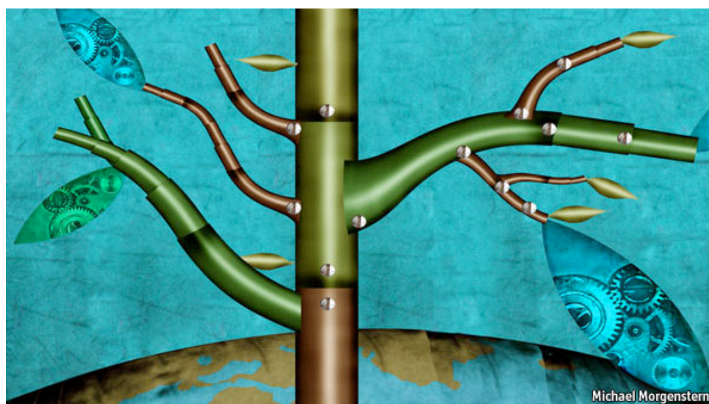
The Economist

A special report on the world economy

How to grow

Without faster growth the rich world's economies will be stuck. But what can be done to achieve it? Our economics team sets out the options

Oct 7th 2010

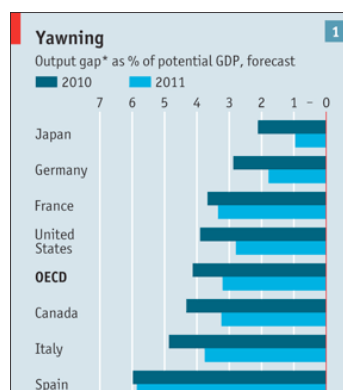

Michael Morgenstern

WHAT will tomorrow's historians see as the defining economic trend of the early 21st century? There are plenty of potential candidates, from the remaking of finance in the wake of the crash of 2008 to the explosion of sovereign debt. But the list will almost certainly be topped by the dramatic shift in global economic heft.

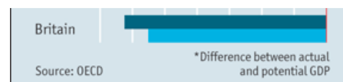
Ten years ago rich countries dominated the world economy, contributing around two-thirds of global GDP after allowing for differences in purchasing power. Since then that share has fallen to just over half. In another decade it could be down to 40%. The bulk of global output will be produced in the emerging world.

The pace of the shift testifies to these countries' success. Thanks to globalisation and good policies, virtually all developing countries are catching up with their richer peers. In 2002-08 more than 85% of developing economies grew faster than America's, compared with less than a third between 1960 and 2000, and virtually none in the century before that.

This "rise of the rest" is a remarkable achievement, bringing with it unprecedented improvements in living standards for the majority of people on the planet. But there is another, less happy, explanation for the rapid shift in the global centre of economic gravity: the lack of growth in the big rich economies of America, western Europe and Japan. That will be the focus of this special report.



The next few years could be defined as much by the stagnation of the West as by the emergence of the rest, for three main reasons. The first is the sheer scale of the recession of 2008-09 and the weakness of the subsequent recovery. For the advanced economies as a whole, the slump that followed the global financial crisis was by far the deepest since the 1930s. It has left an unprecedented degree of unemployed workers and underused factories in its wake. Although output stopped shrinking in most countries a year ago, the recovery is proving too weak to put that idle capacity back to work quickly (see chart 1). The OECD, the Paris-based organisation that tracks advanced economies, does not expect this "output gap" to close until 2015.



The second reason to worry about stagnation has to do with slowing supply. The level of demand determines whether economies run above or below their "trend" rate of growth, but that trend rate itself depends on the supply of workers and their productivity. That productivity in turn depends on the rate of capital investment and the pace of innovation. Across the rich world the supply of workers is about to slow as the number of pensioners rises. In western Europe the change will be especially marked. Over the coming decade the region's working-age population, which until now has been rising slowly, will shrink by some 0.3% a year. In Japan, where the pool of potential workers is already shrinking, the pace of decline will more than double, to around 0.7% a year. America's demography is far more favourable, but the growth in its working-age population, at some 0.3% a year over the coming two decades, will be less than a third of the post-war average.

With millions of workers unemployed, an impending slowdown in the labour supply might not seem much of a problem. But these demographic shifts set the boundaries for rich countries' medium-term future, including their ability to service their public debt. Unless more immigrants are allowed in, or a larger proportion of the working-age population joins the labour force, or people retire later, or their productivity accelerates, the ageing population will translate into permanently slower potential growth.

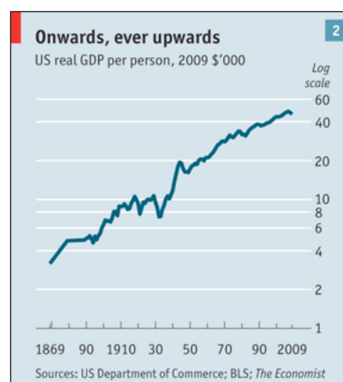
Our interactive "Global Debt Clock" calculates and compares all governments' debt

Calculations by Dale Jorgenson of Harvard University and Khuong Vu of the National University of Singapore make the point starkly. They show that the average underlying annual growth rate of the G7 group of big rich economies between 1998 and 2008 was 2.1%. On current demographic trends, and assuming that productivity improves at the same rate as in the past ten years, that potential rate of growth will come down to 1.45% a year over the next ten years, its slowest pace since the second world war.

Faster productivity growth could help to mitigate the slowdown, but it does not seem to be forthcoming. Before the financial crisis hit, the trend in productivity growth was flat or slowing in many rich countries even as it soared in the emerging world. Growth in output per worker in America, which had risen sharply in the late 1990s thanks to increased output of information technology, and again in the early part of this decade as the gains from IT spread throughout the economy, began to flag after 2004. It revived during the recession as firms slashed their labour force, but that boost may not last. Japan's productivity slumped after its bubble burst in the early 1990s. Western Europe's, overall, has also weakened since the mid-1990s.

The third reason to fret about the rich world's stagnation is that the hangover from the financial crisis and the feebleness of the recovery could themselves dent economies' potential. Long periods of high unemployment tend to reduce rather than augment the pool of potential workers. The unemployed lose their skills, and disillusioned workers drop out of the workforce. The shrinking of banks' balance-sheets that follows a financial bust makes credit more costly and harder to come by.

Optimists point to America's experience over the past century as evidence that recessions, even severe ones, need not do lasting damage. After every downturn the economy eventually bounced back so that for the period as a whole America's underlying growth rate per person remained remarkably stable (see chart 2). Despite a lack of demand, America's underlying productivity grew faster in the 1930s than in any other decade of the 20th century. Today's high unemployment may also be preparing the ground for more efficient processes.



Most economists, however, reckon that rich economies' capacity has already sustained some damage, especially in countries where much of the growth came from bubble industries like construction, as in Spain, and finance, as in Britain. The OECD now reckons that the fallout from the financial crisis will, on average, knock some 3% off rich countries' potential output. Most of that decline has already occurred.

The longer that demand remains weak, the greater the damage is likely to be. Japan's experience over the past two decades is a cautionary example, especially to fast-ageing European economies. The country's financial crash in the early 1990s contributed to a slump in productivity growth. Soon afterwards the working-age population began to shrink. A series of policy mistakes caused the hangover from the financial crisis to linger. The economy failed to recover and deflation set in. The result was a persistent combination of weak demand and slowing supply.

To avoid Japan's fate, rich countries need to foster growth in two ways, by supporting short-term demand and by boosting long-term supply. Unfortunately, today's policymakers often see these two strategies as alternatives rather than complements. Many of the Keynesian economists who fret about the lack of private demand think that concerns about economies' medium-term potential are beside the point at the moment. They include Paul Krugman, a Nobel laureate and commentator in the *New York Times*, and many of President Barack Obama's economic team.

Stimulus v austerity

European economists put more emphasis on boosting medium-term growth, favouring reforms such as making labour markets more flexible. They tend to reject further fiscal stimulus to prop up demand. Jean-Claude Trichet, the president of the European Central Bank, is a strong advocate of structural reforms in Europe. But he is also one of the most ardent champions of the idea that cutting budget deficits will itself boost growth. All this has led to a passionate but narrow debate about fiscal stimulus versus austerity.

This special report will argue that both sides are blinkered. Governments should think more coherently about how to support demand and boost supply at the same time. The exact priorities will differ from country to country, but there are several common themes. First, the Keynesians are right to observe that, for the rich world as a whole, there is a danger of overdoing the short-term budget austerity. Excessive budget-cutting poses a risk to the recovery, not least because it cannot easily be offset by looser monetary policy. Improvements to the structure of taxation and spending matter as much as the short-term deficits.

Second, there is an equally big risk of ignoring threats to economies' potential growth and of missing the opportunity for growth-enhancing microeconomic reforms. Most rich-country governments have learned one important lesson from previous financial crises: they have cleaned up their banking sectors reasonably quickly. But more competition and deregulation deserve higher billing, especially in services, which in all rich countries are likely to be the source of most future employment and productivity growth.

Instead, too many governments are determined to boost innovation by reinventing industrial policy. Making the jobless more employable should be higher on the list, especially in America, where record levels of long-term unemployment suggest that labour markets may not be as flexible as many people believe.

Faster growth is not a silver bullet. It will not eliminate the need to trim back unrealistic promises to pensioners; no rich country can simply grow its way out of looming pension and health-care commitments. Nor will it stop the relentless shift of economic gravity to the emerging world. Since developing economies are more populous than rich ones, they will inevitably come to dominate the world economy. But whether that shift takes place against a background of prosperity or stagnation depends on the pace of growth in the rich countries. For the moment, worryingly, too many of them seem to be headed for stagnation.

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