Five reasons for slow growth

By Michael Spence
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A remarkable pattern has emerged since the 2008 global financial crisis: Governments, central banks, and international financial institutions have consistently had to revise their growth forecasts downward. With very few exceptions, this has been true of projections for the global economy and individual countries alike.

It is a pattern that has caused real damage, because overoptimistic forecasts delay measures that are needed to boost growth, and thus impede full economic recovery. Forecasters need to come to terms with what has gone wrong; fortunately, as the post-crisis experience lengthens, some of the missing pieces are coming into clear focus. I have identified five.

First, the capacity for fiscal intervention – at least among developed economies – has been underutilized. As former United States Deputy Secretary of the Treasury Frank Newman argued in a recent book, *Freedom from National Debt*, a country's capacity for fiscal intervention is better assessed by examining its aggregate balance sheet than by the traditional method of comparing its debt (a liability) to its GDP (a flow).

Reliance on the traditional method has resulted in missed opportunities, particularly given that productive public-sector investment can more than pay for itself. Investments in infrastructure, education, and technology help drive long-term growth. They increase competitiveness, facilitate innovation, and boost private-sector returns, generating growth and employment. It does not take a lot of growth to offset even substantial investment – especially given current low borrowing costs.

Research by the International Monetary Fund has indicated that these fiscal multipliers – the second factor overlooked by forecasters – vary with underlying economic conditions. In economies with excess capacity (including human capital) and a high degree of structural flexibility, the multipliers are greater than once thought.

In the US, for instance, structural flexibility contributed to economic recovery and helped the country adapt to long-term technological changes and global market forces. In Europe, by contrast, structural change faces resistance. Fiscal stimulus in Europe may still be justified, but structural rigidity will lower its impact on long-term growth. Europe's fiscal interventions would be easier to justify if they were accompanied by microeconomic reforms targeted at increasing flexibility.

A third piece of the forecast puzzle is the disparity between the behavior of financial markets and that of the real economy. Judged only by asset prices, one would have to conclude that growth is booming. Obviously, it is not.

A major contributor to this divergence has been ultra-loose monetary policy, which, by flooding financial markets with liquidity, was supposed to boost growth. But it remains unclear whether elevated asset prices are supporting aggregate demand or mainly shifting the distribution of wealth. It is equally unclear what will happen to asset prices when monetary assistance is withdrawn.

A fourth factor is the quality of government. In recent years, there has been no shortage of examples of governments abusing their powers to favor the ruling elite, their supporters, and a variety of special interests, with detrimental effects on regulation, public investment, the delivery of services, and growth. It is critically important that public services, public

investment, and public policy are well managed. Countries that attract and motivate skilled public managers outperform their peers.

Finally, and most important, the magnitude and duration of the drop in aggregate demand has been greater than expected, partly because employment and median incomes have been lagging behind growth. This phenomenon preceded the crisis, and high levels of household debt have exacerbated its impact in the aftermath. The stagnation of incomes in the bottom 75% of the distribution presents an especially large challenge, because it depresses consumption, undermines social cohesion (and thus political stability and effectiveness), and decreases intergenerational mobility – especially where public education is poor.

Sometimes change occurs at a pace that outstrips the capacity of individuals and systems to respond. This appears to be one of those times. Labor markets have been knocked out of equilibrium as new technology and shifting global supply chains have caused demand in the labor market to change faster than supply can adjust.

This is not a permanent condition, but the transition will be long and complex. The same forces that are dramatically increasing the world economy's productive potential are largely responsible for the adverse trends in income distribution. Digital technology and capital have eliminated middle-income jobs or moved them offshore, generating an excess supply of labor that has contributed to income stagnation precisely in that range.

A more muscular response will require an awareness of the nature of the challenge and a willingness to meet it by investing heavily in key areas – particularly education, health care, and infrastructure. It must be recognized that this is a difficult moment and countries must mobilize their resources to help their people with the transition.

That will mean redistributing income and ensuring access to essential basic services. If countering inequality and promoting intergenerational opportunity introduces some marginal inefficiencies and blunts some incentives, it is more than worth the price. Public provision of critical basic services like education or health care may never be as efficient as private-sector alternatives; but where efficiency entails exclusion and inequality of opportunity, public provision is not a mistake.

One hopes that a growing awareness of the significance of these and other factors will have a positive effect on policy agendas in the coming year.

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