Global Economic Prospects

HIGHLIGHTS from CHAPTER 3
BUILDING SOLID FOUNDATIONS: HOW TO PROMOTE POTENTIAL GROWTH

Key Points

- *Despite a recent acceleration of global economic activity, potential output growth is flagging. At 2.5 percent in 2013-17, post-crisis potential growth is 0.5 percentage point below its longer-term average and 0.9 percentage point below its average of a decade ago. The decline has been even steeper in emerging market and developing economies.*
- *This slowdown mainly reflects weaker capital accumulation. It is also evidence of slowing productivity growth and demographic trends that dampen labor supply growth.*
- *These forces will continue and, unless countered, will depress global potential growth further by 0.2 percentage point over the next decade. Policy options that could slow or reverse this trend include steps to lift physical and human capital, encourage labor force participation, and improve institutions.*

Weak potential growth. The global financial crisis has ushered in a period of persistently weak potential growth. During 2013-17, global potential growth (2.5 percent a year) fell 0.5 percentage point below its longer-term (1998-2017) average, and even further below its average of a decade ago (2003-07). EMDE potential growth slowed to 4.8 percent a year, 0.6 percentage point below its longer-term average. This weakness in potential growth has been broad-based, affecting almost half of EMDEs and 87 percent of advanced economies in the sample. Together, these economies represent 69 percent of global GDP (Figure 1).

Drivers of the slowdown in potential growth. Of the 0.5 percentage point shortfall in 2013-17 global potential growth below its longer-term average, about one-half can be attributed to weaker capital accumulation (0.2 percentage point) and the remainder to weaker total factor productivity (TFP) growth and slower labor supply growth (0.1 percentage point, each). TFP growth is the portion of gains in output that cannot be explained by increases in the quantity of labor or capital. Weak global capital accumulation mainly reflected investment weakness in advanced economies in the wake of financial crises in the United States and Europe and a policy-driven rebalancing away from investment in China. Unfavorable demographics and slowing TFP growth were common to both advanced economies and EMDEs.

Evolution of potential TFP growth. Global potential TFP growth—the part of TFP growth that is stripped of its wide cyclical swings—slowed from about 1.3 percent a year a decade ago to about 1 percent a year during 2013-17, but with wide heterogeneity. In advanced economies, productivity growth showed signs of flattening well before the global financial crisis. By contrast, TFP growth in EMDEs surged to 2.5 percent a year a decade ago (2003-07), reflecting productivity-enhancing investment. Reforms of policy frameworks in EMDEs in the late 1990s and early 2000s and greater

integration into global value chains provided a conducive environment for rapid productivity growth. However, TFP growth in EMDEs has slowed to 1.9 percent a year in 2013-17.

Evolution of investment growth. Global investment growth halved between 2010 and 2016. The weakening shifted from advanced economies to EMDEs over this period. Investment growth in advanced economies declined during the Euro Area crisis and, after a brief rebound, fell again after the oil price decline that disrupted energy sector investment in the United States. In EMDEs, investment growth slowed sharply following the global financial crisis, slipping from double-digit rates in the immediate wake of the crisis to a post-crisis low of 3 percent in 2016. Despite signs of bottoming out in 2017, investment growth has been well below its pre-crisis average as well as its longer-term average in more than half of the EMDEs in the sample.

Demographics. In the past five decades, economic growth was supported by rapidly growing working-age populations. Demographic trends have now turned less favorable to growth and will continue to do so over the next decade. In advanced economies, the working-age share of the population is set to decline, from 65.4 percent in 2015 to 62.3 percent by 2025. In EMDEs, the working-age share of the population peaked at 65.8 percent in 2015 and is expected to stabilize around this level for the next 10 years.

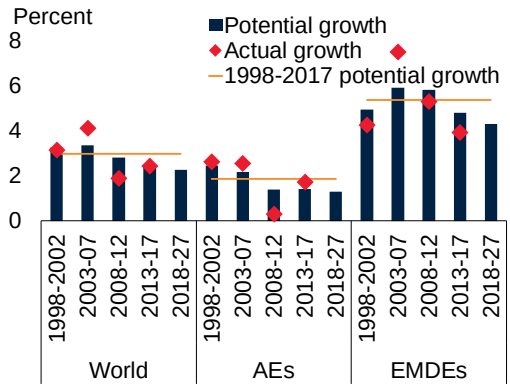
Prospects for potential growth. Factors that have weighed on potential growth over the past five years are likely to persist over the next decade. Less favorable demographic trends will weigh on potential growth even if trend improvements in human capital and female labor force participation continue. Although investment growth is expected to recover from its recent weakness, it is unlikely to return to elevated pre-crisis levels. Short of unexpected surges in productivity growth—perhaps as a result of dissipating crisis legacies or unanticipated technological breakthroughs—these trends suggest a mediocre potential growth outlook. Global potential growth may slow further by 0.2 percentage point on average over 2018-27 while EMDE potential growth could ease by 0.5 percentage point. The projected slowdown would affect EMDEs and advanced economies that account for 78 percent of global GDP.

Policy options to lift potential growth. A combination of additional investment, better educational and health outcomes, labor market or business climate and governance reforms could stem or even reverse the expected decline in potential growth over the next decade. Stylized scenarios suggest that a repeat of past reform efforts in boosting human and physical capital and labor market participation could lift potential growth in EMDEs by 0.7 percentage point, more than offsetting the 0.5 percentage point slowdown in EMDE potential growth expected under the baseline scenario. In addition, business climate reforms and governance reforms have historically been associated with sizeable increases in investment and productivity growth.

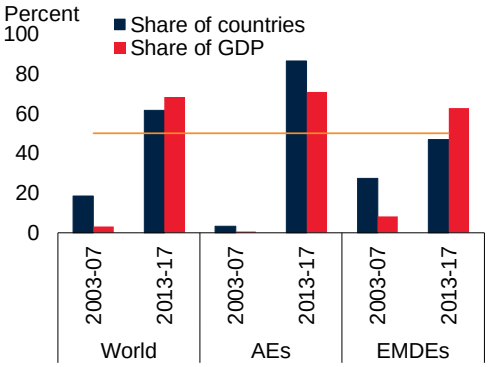
Figure 1. Weak potential growth: sources and remedies

Global potential growth slowed in 2013-17 below its longer-term average rates. This mainly reflected slowing capital accumulation, but also easing labor supply growth and total factor productivity (TFP) growth. Over the next decade, trends in fundamental drivers of potential growth suggest a further slowdown. Initiatives to lift physical and human capital, encourage labor force participation, and improve institutions could help reverse the decline.

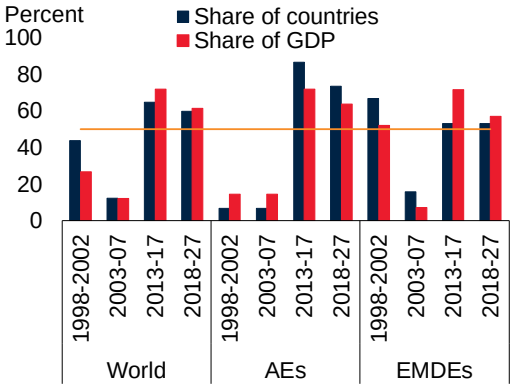
A. Potential growth



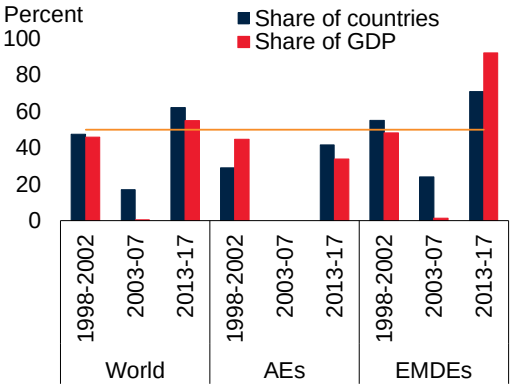
B. Share of economies and GDP with potential growth below longer-term average



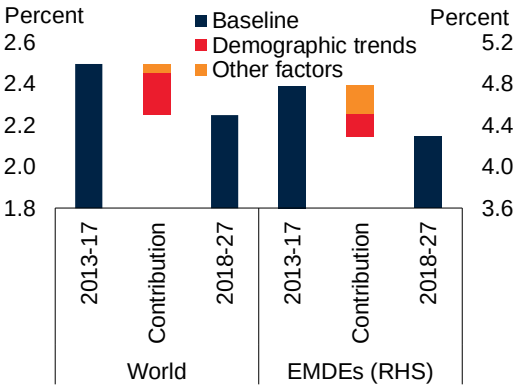
B. Share of economies and GDP with TFP growth below longer-term average



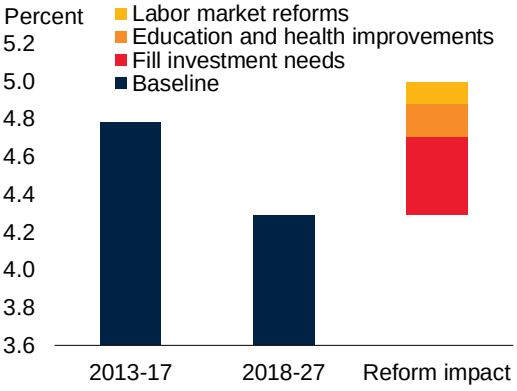
C. Share of economies and GDP with investment growth below longer-term average



E. Potential growth



F. EMDE potential growth under reform scenarios



Sources: World Bank estimates; Haver Analytics; Penn World Tables; World Development Indicators, World Bank.
Notes: A. Based on production function approach, GDP-weighted averages for a sample of 30 advanced economies and 50 EMDEs.
B. C. Number of economies and their share of GDP among 30 advanced economies and 50 EMDEs in which potential growth is lower than its longer-term average (1998-2017).
C. Number of economies and their share of GDP among 30 advanced economies and 50 EMDEs in which potential total factor productivity growth is lower than its longer-term average (1998-2017).
D. Number of economies and their share of GDP among 139 countries in which investment growth is below the longer-term average (1998-2017).
E. GDP weighted averages. Derived using the production function-based potential growth as described in GEP Methodological Annex 3.1. "Other factors" reflects declining population growth, convergence-related productivity growth, policy changes, cohort effects, and a slowdown in investment growth relative to output growth. "Contribution" denotes contribution to change in potential growth between 2013-17 and 2018-27.
F. GDP weighted averages. Derived using the methodology described in GEP Annex 3.1.