The economics of slow growth

Long Abstract

We document two stylized facts. First, most periods in history have been characterized by per capita GDP growth that was an order of magnitude slower than modern growth in the "old world". Second, most countries with capitalists institutions have grown steadily and relatively fast. This presents us with a puzzle: does the recent growth slowdown in the capitalist old world mean that the second stylized fact was an historical exception, or is the current phase of low growth just a temporary phenomenon?

We use historical evidence from several sources. The traditional picture is that up to 1750 – the mythical year of the British industrial revolution – growth was absent and after 1750 growth was rapid in countries that adopted the ideas of the industrial revolution, with England being the first one. Recent research in economic history has revised this picture: growth was not completely absent in pre-industrial societies, while it took industrializing societies a long period to initiate fast growth. We also consider evidence on the link between resource use and economic growth and focus on frontier economies that tend to grow fast by exploiting new sources of resources.

The next step in our analysis is to check whether modern growth theories can explain the current growth slowdown. Neoclassical growth theory explains growth slow-downs in institutionally stable economies from either the exhaustion of catch-up potential, or the slowing down of innovation possibilities. We dismiss both as plausible explanations for the current growth slowdown and as a basis to expect low growth in the near future. European economies could grow fast in the postwar period because they could easily close (part of) the technology gap and

income gap relative to the leading economy in the world, the USA. Since the 1980s, the gaps have been substantially reduced and the structural differences between USA and European economies prevent further catch up. In the recent years, if anything the gaps have widened which would – according to neoclassical growth theory – implies new possibilities for faster growth. Of course we have observed the opposite, which leads us to conclude that catch-up is not the proper framework to explain growth slowdown. An alternative possible explanation suggested by neoclassical growth theory is the exhaustion of innovation possibilities. Long-run growth is driven by sustained innovation in cheaper production technologies and new products. Limits to innovation would imply growth slowdowns. There are serious theories about such limits, but also about the opposite, viz. the increasing potential to realize technical changes in future. Empirical observations, however, make it difficult to argue that we have hit the limits in recent years, which makes it difficult to see how traditional growth theory can see growth as an episode.

The final step in our analysis is to present two alternative growth models: one based on speculative investments and inefficient financialization and the other based income inequality and monopolization of investment opportunities. We show how the introduction of these new elements in growth theory can both explain why fast growth occurs as an episode and why the recent developments in the world economy have triggered the collapse of growth, not just as a temporary phenomenon, but potentially as a structural phenomenon. Many firms have witnessed a process of financialization that implies excessive focus on short-run financial rewards, either enforced by shareholders or financial institutions, potentially at the cost of jobs and long-run investments. The process creates inflated sales in the short run, but erodes long-term investments as a basis for sustained growth. What appears a short-run financial crisis may be a structural phenomenon. Smaller firms have been initially less affected by this process, but through the liquidity problems of banks since the recession, financialization spreads to small firms that rely on bank credits. The second new element to be introduced is inequality in access to investment and success of innovation. Income inequality both erodes the market for useful innovations and concentrates decision power with respect to investment decisions in fewer hands. The result is a big divide in society in which inequality only grows and economic growth becomes less and less inclusive.

We review some evidence on financialization and income inequality and build a small model to analyze how they affect long-term economic growth in the future.