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The New Growth Debate

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The developed economies of Europe and the United States are slowly recovering from the worldwide financial crisis and the debt crisis in the euro area. How will the economic situation of these countries evolve in the future? Will the developed economies experience high rates of productivity and economic growth or will they have to face stagnation for a long period of time? Various famous economists have started a debate about these issues.

It is neither surprising nor new that some economic outlooks following a severe economic crisis are pessimistic. This was the case at the end of the 1930's when the Great Depression came to an end. At that time, it was Alvin Hansen who mentioned the possibility of "secular stagnation" – thus a long period of economic stagnation. Economists who nowadays predict low growth rates for the future, such as Robert Gordon and Tyler Cowen, emphasize that they do not want to fall into the trap of being too pessimistic after a crisis. They emphasize that stagnation already announced itself in the years before the financial crisis and could even be seen as a reason for the emergence of the bubble before 2007. While Robert Gordon and others see faltering innovation as the main reason for potentially low economic growth rates, other economists such as Larry Summers or Paul Krugman put the emphasis on factors that dampen aggregate demand.

Economic stagnation due to faltering innovation…

The productivity growth skeptics do not only belong to the scientific community, but also include the entrepreneur Peter Thiel, chess champion Garry Kasparov and IT-specialist Max Levchin. What do they offer as their main hypotheses? According to Robert Gordon, innovation, technological progress and economic growth do not evolve constantly over time. It was only in the 18th century that stable rates of economic growth and technological progress could be observed for the first time in the high income economies of today. Gordon argues that the early industrial revolutions, the first (about 1750 – 1830) – characterized by the invention of the steam engine and railway – and the second (about 1870 – 1970) – driven by electricity, flowing water, chemistry and raw oil – have had a much stronger and more sustainable influence on productivity and economic development than the third so-called digital revolution that has been in place since the 1960's.

Following Gordon's argument, the third industrial revolution only had a temporary effect on productivity – mainly during the 1990s – and only modest effects on productivity during the 2000's. Since then, the digital revolution has consisted mostly of producing new consumer goods. According to Gordon, this may have facilitated the life of many people, but has only had a minor impact on productivity. Indeed, economic growth rates show a downward trend. Robert Gordon identifies six "headwinds" that are considerably slowing down innovation and growth these days: demography, education, inequality, globalization, energy and the environment and the high levels of sovereign and private debt.

Several economists have criticized the skeptics' hypotheses and do not share the view that productivity growth will slow down in the future. Business economists such as Erik Brynjolfsson and Andrew McAfee or the economic historian Joel Mokyr are among the "growth optimists". They emphasize the unpredictability of innovations and that growth skeptics have in the past been wrong most of the time. Erik Brynjolfsson argues that the most productivity enhancing effects of the "digital revolution" will still come. They propose a theory, according to which growth opportunities do not die out but increase with technological progress. Inventions emerge from the accumulated stock of knowledge, which allows for ever new inventions and growth opportunities. However, the growth optimists partly agree with Robert Gordon on the considerable challenges that high income economies face related – among others - to education.

…or weak aggregate demand

Many economists have taken the position that a long phase of stagnation is a real possibility, but at the same time, they argue that it can be prevented by political measures that enhance consumption and investment. The most prominent advocates of this view are Paul Krugman and Larry Summers. Both use Hansen's terminology of "secular stagnation" which describes a long period of economic stagnation. They both emphasize the slow recovery in the aftermath of the financial crisis and argue that economic growth in the high income economies in the years before 2008 was only moderate despite the emergence of bubbles. Unlike Robert Gordon, Paul Krugman and Larry Summers do not see low rates of innovations as the main reason for meagre economic growth, but focus on aggregate demand that needs to be stimulated. They argue that the "natural interest rate" – that is the interest rate consistent with full employment – is considerably below zero. According to this view, the currently low interest rates may still be too high to enhance higher levels of investment and consumption. According to this view, developed economies may find themselves in a Keynesian "liquidity trap" as described by Paul Krugman. In such a situation, fiscal policy may be more effective than monetary policy in stimulating aggregate demand.

Other economists such as John Taylor and Steven Williamson reject this view. They argue that "secular stagnation" and a negative rate of interest could only arise if prices and wages cannot adjust downwards and that such a situation is very unlikely at least in the medium and long run. According to Taylor, the current low level of investment is due to heavy regulatory burdens and political uncertainty about further political interventions.

By contrast, Summers and Krugman mention the high level of social and economic inequality as an important cause for the lack of aggregate demand and the possibility of a “secular stagnation”. High inequality may dampen consumption, since individuals with a higher income have a higher propensity to save than middle and lower class individuals, which tends to weaken aggregate demand. Also, they argue that rising inequality lowers the chance of “rags to riches,” which leads to a situation where large portions of society will no longer be able to develop their potential. Summers and Krugman emphasize the importance of productive government spending (such as infrastructure, education or research and development) to enhance aggregate demand and productivity at the same and thereby contribute to avoiding secular stagnation.

Conclusion

Both, growth skeptics and optimists, provide good arguments for either position. Skeptics point out that productivity growth has been rather low in the last thirty years and that this could continue in the future. But, as the optimists point out, growth skepticism has often proved to be wrong in the past and there are reasons to believe that the digital revolution will lead to a new wave of path-breaking innovations. Several economists emphasize that weak aggregate demand may lead to economic stagnation. However, after a crisis, it is difficult to assess whether weak aggregate demand is a temporary phenomenon or is due to structural factors. Despite these disagreements, many of the growth skeptics and optimists seem to agree on one point: The developed economies are facing demanding challenges related – among others - to the quality of their infrastructure and their distributional, educational and energy policies.

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