Press points for Chapter 3: Where Are We Headed? Perspectives on Potential Output

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Key Points

- Potential output growth across major advanced and emerging market economies has declined in recent years. In advanced economies, this decline started as far back as the early 2000s.
- Unlike previous crises, the global financial crisis has been associated not only with a reduction in the *level* of potential output in advanced and emerging market economies, but also with a persistent reduction in its *growth rate.*
- Potential growth in advanced economies is likely to increase slightly from current rates but remain below precrisis rates in the medium term. The main reasons are aging populations and the slow increase in capital growth from current rates as output and investment recover gradually from the crisis.
- In emerging market economies, potential output growth is expected to decline further in the medium term, because of aging populations, weaker investment, and lower productivity growth as technological gaps between these economies and advanced economies get narrower.
- Reduced prospects for potential growth will raise new policy challenges such as achieving fiscal sustainability. Increasing potential output will need to be a priority in major advanced and emerging market economies.

Potential output is the level of output consistent with stable inflation (no inflationary or deflationary pressure). It is hard to estimate, and even harder to predict its future path. That is because an economy's potential output cannot be measured directly. Over the long run, the growth rate of potential output (potential growth) depends on increases in the supply and productivity, of capital and labor. Growth of the labor supply depends, in turn, on the growth of the working-age population and changes in labor force participation rates; the pace of capital-stock growth depends on investment and the initial stock of capital. The productivity of these two factors is determined by improvements in business processes and technological innovation. By looking at trends in regard to these factors, economists can make inferences about potential growth, even if it can't be measured directly.

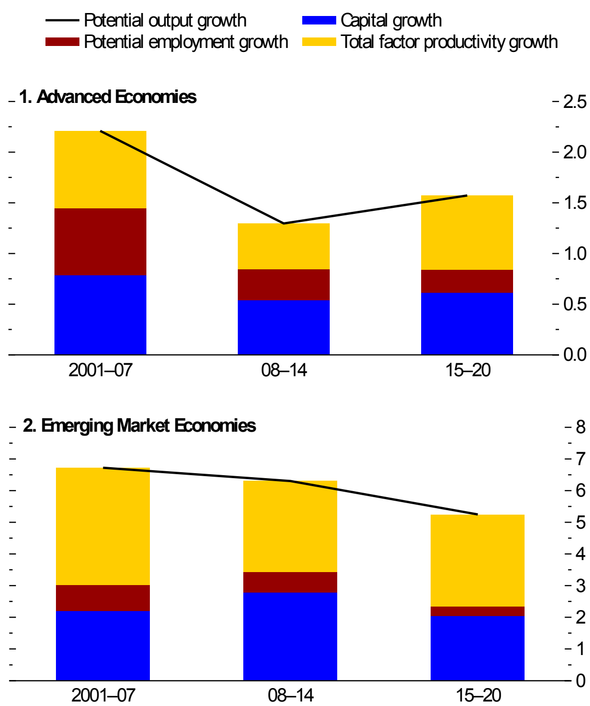
Before the crisis, potential growth began to decline in advanced economies, while it was increasing in emerging market economies. In both cases, this was due mostly to changes in productivity growth. In advanced economies, the decline reflected mainly a slowdown following a period of exceptional growth due to innovations in information technology, whereas in emerging market economies, the increase reflected mainly structural transformation and the expansion of global and regional value chains, which stimulated technology and knowledge transfers.

In the aftermath of the crisis, potential growth declined in both advanced and emerging market economies. Unlike previous financial crises, the global financial crisis has been associated not only with a reduction in the *level* of potential output, but also with a reduction in its *growth rate*. In advanced economies, potential growth declined from slightly less than 2 percent in the precrisis period (2006–07) to about 1½ percent during 2013–14, owing to reduced capital growth and adverse demographic factors not related to the crisis. In emerging market economies, potential growth declined by about 2 percentage points during this period, with lower total factor productivity growth accounting for the entire decline.

Potential growth in advanced economies is expected to increase slightly, from an average of about 1.3 percent during 2008–14 to 1.6 percent during 2015–20. This growth is well below precrisis rates (2¼ percent during 2001–07) and stems from the negative effect of demographic factors and the gradual increase in capital growth from current rates as output and investment recover from the crisis (Figure 1, panel 1).

In emerging market economies, potential growth is expected to decline further, from an average of about 6.5 percent during 2008–14 to 5.2 percent during 2015–20. The decline is the result of population aging, structural

Figure 1. Evolution of Potential Output Growth and Its Components
(Percent)



Source: IMF staff estimates.
Note: Economy groups are defined in Annex 3.1. TFP = total factor productivity.

constraints affecting capital growth, and lower total factor productivity growth as these economies get closer to the technological frontier (Figure 1, panel 2).

These reduced prospects for potential growth in the medium term, compared to those preceding the crisis, raise new policy challenges. In both advanced and emerging market economies, lower potential growth will make it more difficult to maintain fiscal sustainability. It is also likely to be associated with low equilibrium real interest rates, so that monetary policy in advanced economies may again be confronted with the problem of the zero lower bound if adverse growth shocks materialize.

Increasing potential output is a policy priority for advanced and emerging market economies. The reforms needed to achieve this objective vary across countries. In advanced economies, continued demand support is needed to offset the effects of protracted weak demand on investment and capital growth as well as on unemployment. Structural reforms and greater support for research and development are key to increasing supply and innovation. In emerging market economies, higher infrastructure spending is needed to remove critical bottlenecks, and structural reforms must be directed at improving business conditions and product markets and fostering human capital accumulation.