Economics MASTERCLASS

Economic Growth: What Macroeconomic Factors Lead to Economic Growth?

Dr. Stephan Pfeffenzeller, economics lecturer at the University of Liverpool, discusses the macroeconomic factors that affect economic growth

When economists discuss growth, the factor that they are interested in is the annual growth rate of real income. Real income growth simply adjusts economic growth for inflation, to obtain a true measure of growth.

So, what drives economic growth? It is tempting to assume that growth is driven solely by investment and, therefore, ultimately by savings. But experience tells us that the quantity of investment will not determine economic growth in the long run. This is because production becomes increasingly capital intensive and adding even more capital often leads to less overall output. This will translate into low growth figures over time.

The long-term outlook for economic growth in any economy is dependent, to a degree, on technological progress. When advances in technology are linked to investment, it is the quality of such an investment that drives growth. This idea can be seen when comparing recent growth figures in mature and emerging markets.

Mature economies, which are already well equipped with productive capital, have experienced growth rates of between 2–3% per capita over the past decade. UK economic growth averaged 2.7% of GDP over the period from 1995–2005, compared to 2% in France and 3% for the USA.

Among emerging markets, China grew at an average 9.2%, India at 6.2% and Ireland at 7.2% per annum over the same periods. High rates of growth can be supported by increases in the quantity of capital as an economy builds up the amount of capital it uses. Eventually the capital intensity of production in emerging markets will become similar to that of existing industrialised economies. From this point onward, growth can be expected to slow to a level more similar to that of mature economies.

The macroeconomic environment

Macroeconomics is the movement and trends in the economy as a whole, which is influenced and in turn influences the microeconomic factors found at business and individual levels. The overall macroeconomic framework plays a role in determining the conditions under which these microlevel decisions are made. Broadly speaking, the macroeconomic conditions are:

Inflationary stability

Economic decision-making benefits from a stable general economic environment. This means that a stable inflationary environment is incredibly important. Low rates of predictable inflation are easily managed, whereas a substantial change in the rate of inflation will be more problematic, not least because inflation is difficult to forecast in such a situation.

In a modern, complex economy, relative prices will act as a guide to production and investment decisions. Price signals like this are useful if they reflect the scarcity of goods or demand pressures in product markets. However, if relative price shifts come about because price signals are distorted due to inflationary pressures, they become unreliable as a guide for production and investment decisions. Investment may then be directed into less profitable activities. Over time these misallocations of resources will lead to a reduction in growth when compared to what may have been achieved under an efficient resource allocation.

Openness to trade and investment

Openness to international trade and investment is also important to promote economic growth. It has also long been recognised that specialisation of labour makes for increased productivity. Since a larger market allows for more specialisation, productivity gains should be expected from international trade as well.

Some economists have moved beyond this basic principle and argue that an economy's most innovative and most productive sectors are also those which perform best in export markets. To the extent that economic growth is driven by productivity gains, a higher export share in GDP should then correspond to a better growth performance. This can be seen in the recent resurgence of Germany's economic growth. Germany is the largest exporter of goods in the world. The current driver of foreign trade is essentially its industrial sector, which accounts for the majority of German exports, and includes car brands such as Porsche, Mercedes, BMW and VW, and machine construction and environmental technologies.

Openness to trade, increased competition and growth performance are all related to another aspect, Foreign Direct Investment (FDI). FDI can contribute to growth by introducing efficient practices inherent to a particular firm to the recipient economy. FDI, then, is one mechanism by which the qualitative characteristics of investment can promote economic growth.

Good governance

A stable, well-regulated macroeconomic environment depends on the quality of governance. An appropriate degree of regulation will aim to ensure fairness, and protects the economic system from potentially reckless business practices. This will enable the smooth running of business transactions and thereby contribute to growth.

There is a need for a balanced approach, as excess government interference can in fact be detrimental to economic growth: excessive regulation tends to impose unnecessary costs on businesses, and in the UK this amounted to £55.6 billion by 2007. It also has the potential to introduce rigidities into the market. Where excessive regulation prevents the market from using all productive resources effectively, unemployment may persist over longer periods.

Unemployment

Some unemployment is likely to occur in any economy in the course of short-term fluctuations around the long run growth trend. Where unemployment persists for long periods, not all available productive resources are being used. Growth will therefore be slower than it could have been.

The housing market

Many of the above macroeconomic factors affect the housing market, although most often in an indirect manner. The basic economic principles still hold true. House prices are likely to rise in a rapidly growing economy. If the supply of new housing does not keep up with rising demand, this trend will be particularly strong, as it has been in the UK where the supply of housing is strongly limited by planning restrictions.

The rise in house prices has, however, coincided with a decline in personal savings to a point where household net savings rates are close to 0% of GDP. Personal debt, by contrast, has increased in line with higher mortgages. There are indications that much of the UK's recent growth has been driven by the house price boom, in combination with an increase in public debt. This and the shortfall in personal savings imply that a future slowdown in growth may be accompanied by a strong cyclical downturn, as there is little in terms of private savings to stabilise demand.

For the average UK homeowner the last interest rate cut of 0.25% to 5.5% by the Bank of England means that the cost of borrowing has been reduced slightly, although it remains to be seen how much saving will be passed on to borrowers as financial markets remain jittery. As always, if you have no need to move house, in the shorter term any downturn in house prices may not affect you. Likewise, for the investor who has adopted a 'cash flow positive' strategy where the income from the investment property more than covers its costs, price fluctuations can be ridden out in the longer term (again provided there is no need to sell). For the investor, however, there are obvious implications for investments involving equity release, but the cost of borrowing remains low for the time being.

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