Economic growth

Economic growth is arguably the most important target for economic policy, as it increases the opportunities for improving the wellbeing of members of society. Here **Peter Smith** highlights its key aspects

1 What is economic growth?

Potential economic growth is an expansion of the productive capacity of an economy. This can be depicted either as a shift in an economy's production possibility frontier (*PPF*, as in Figure 1), or as a shift in the aggregate supply curve (Figure 2).

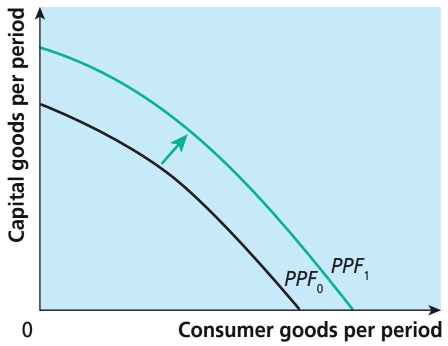


Figure 1 Economic growth

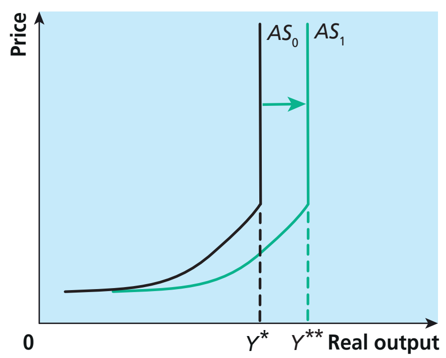


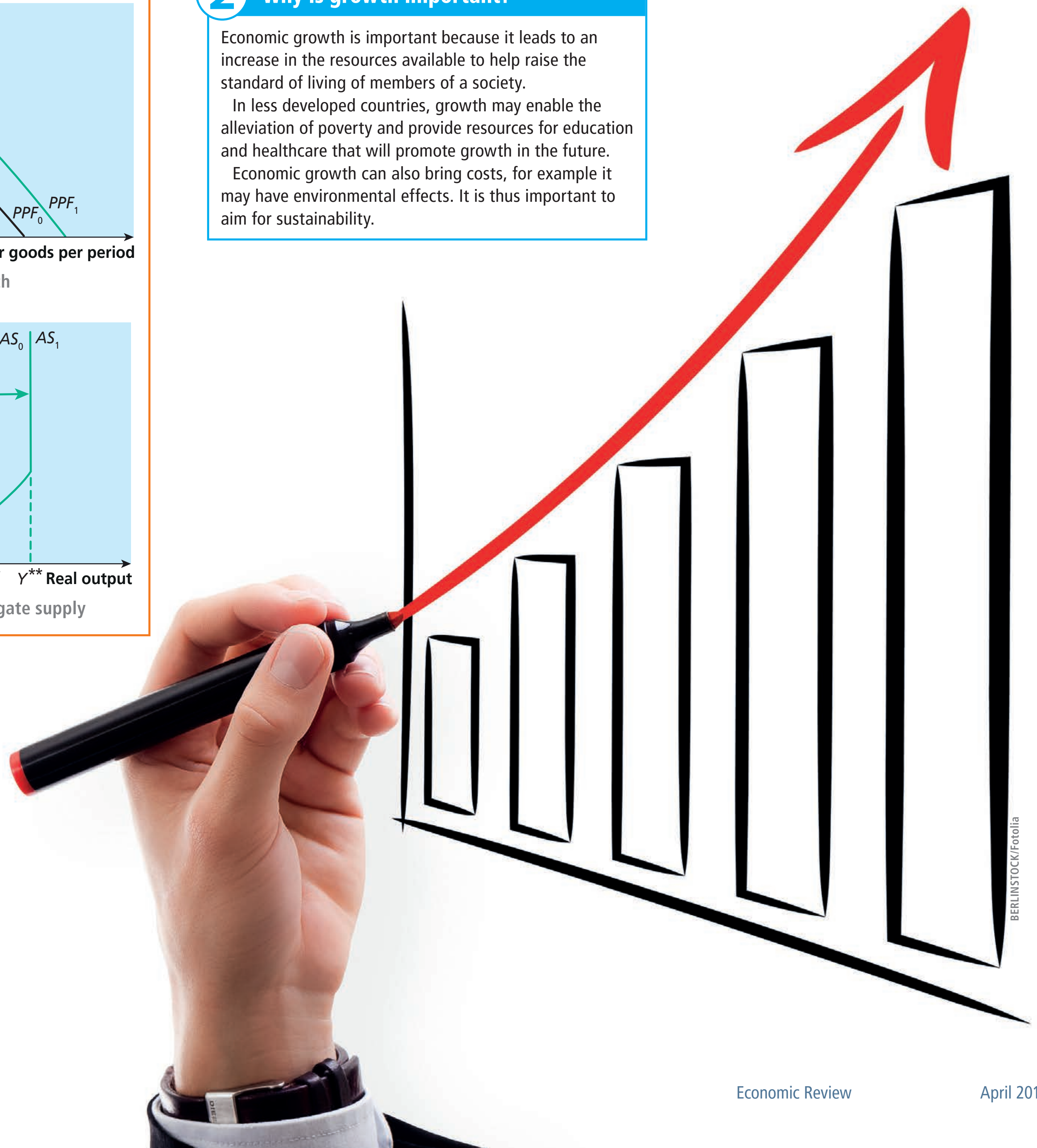
Figure 2 A shift in aggregate supply

2 Why is growth important?

Economic growth is important because it leads to an increase in the resources available to help raise the standard of living of members of a society.

In less developed countries, growth may enable the alleviation of poverty and provide resources for education and healthcare that will promote growth in the future.

Economic growth can also bring costs, for example it may have environmental effects. It is thus important to aim for sustainability.



3 Measuring economic growth

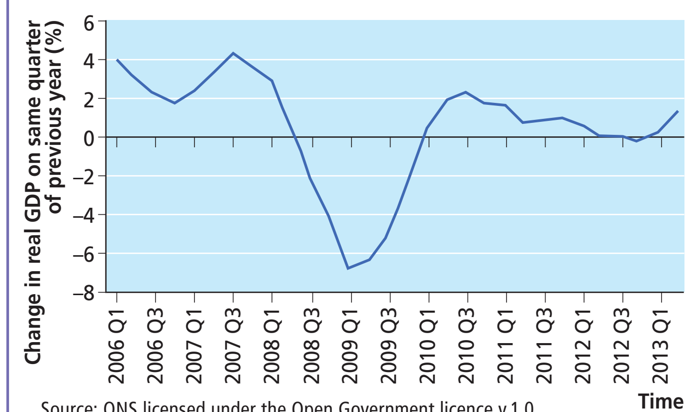
Actual economic growth is measured by the percentage increase in the economy's gross domestic product (GDP) over a period of time.

Actual economic growth may reflect the movement of an economy towards its *PPF*, for example during the recovery after a period of recession. Potential economic growth is represented by the underlying long-run trend rate of growth of GDP.

4 The UK's recent performance

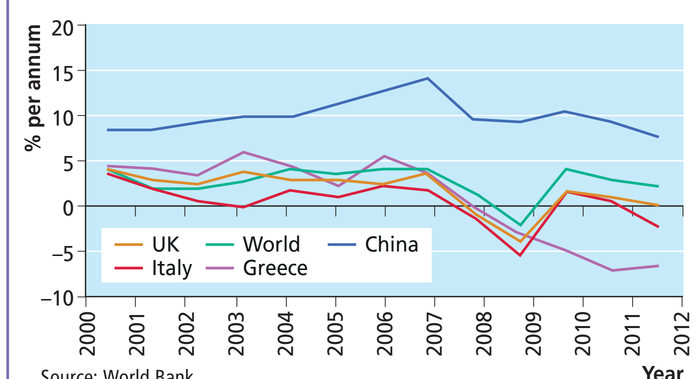
Figure 3 shows the recent performance of the UK economy. The recession of 2008/09 is clearly seen. The initial recovery was followed by a second slowing of economic growth, with the first half of 2013 showing some improvement.

Figure 4 puts the UK experience into an international context, emphasising that the UK was not alone in suffering a recession in 2008/09. The failure of the Greek economy to recover is very clear — as is the way that China has been able to maintain a relatively rapid rate of growth throughout.



Source: ONS licensed under the Open Government licence v.1.0.

Figure 3 Economic growth in the UK since 2006



Source: World Bank

Figure 4 Growth of GDP in selected countries

5 Factors that favour growth

Economic growth occurs when there is an expansion in the availability of **factors of production** (especially capital and labour), or where there is an improvement in the productivity of those factors. Key influences include:

- technological advance
- improvements in human capital (education and healthcare)
- stability in the macroeconomic environment (which encourages firms to invest)
- efficient and flexible markets (which ensure good allocation of resources)

6 Obstacles to growth

The impediments to economic growth largely mirror the factors that favour growth. Slow technological change (or problems in accessing it), weak human capital and an unstable macroeconomic environment are all expected to slow the rate of economic growth.

For less developed countries, lack of access to physical capital and technology and inadequate education and healthcare can hinder growth, as can the absence of well-functioning markets. In more developed countries, periods of inflation may damage firms' expectations and lead to a reduction in investment. The onset of recession and a fall in aggregate demand may have similar effects.

7 Policy options to encourage growth

Supply-side policies can lead to a shift in aggregate supply, for example:

- education and training
- promoting research and development
- improving the flexibility of markets
- competition policy
- providing good incentives

Monetary and **fiscal policy** can also promote growth by ensuring there is a stable macroeconomic environment. This may improve the expectations of firms about the future prospects for their products, and thus encourage investment.

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