Point of View

We Need a New Growth Compact

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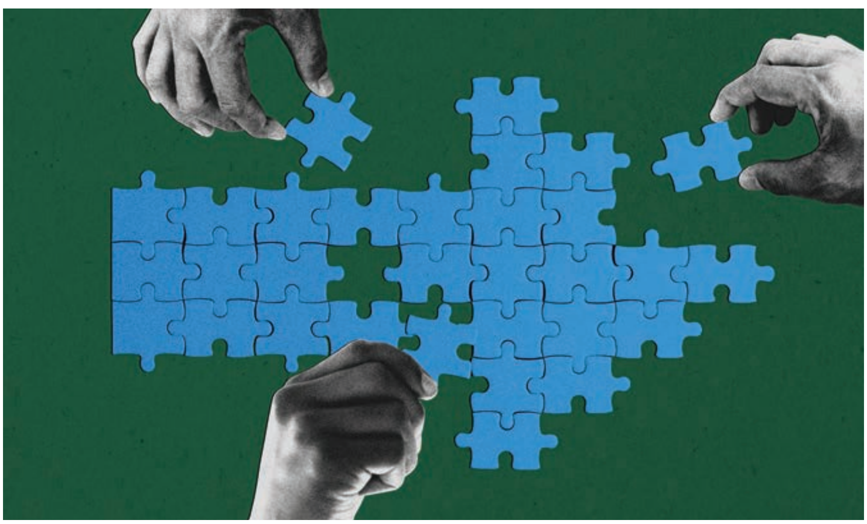
Innovation and integration can revive growth amid sweeping geopolitical change



Policymakers are grappling with how to boost growth and expand opportunities. Early in the last decade, the question was whether flagging growth was the result of years of technological stagnation. It was a different era, of course, following the global financial crisis. But now is an appropriate time to revisit that question.

Countries in the 2010s were united in addressing the aftermath of the financial crisis, and they had a common vision. Initiatives that emerged, such as prudential financial regulation, built future resilience.

Today, after the shocks of the pandemic and Russia's war in Ukraine, the geopolitical landscape is under enormous strain and consensus is more elusive. The world has avoided a severe growth crisis, but the alarming downward trend of potential growth persists. Global growth has steadily slowed, and the outlook continues to weaken.

Let's start with the diagnosis: Why is growth weakening? Economists typically decompose growth into three broad contributing factors or inputs: labor; capital (including land); and total factor productivity, a measure of how efficiently those two resources are used. Among all three, more than half of the growth lost since the crisis was driven by slowing total factor productivity growth.

The glass may seem half empty, but it's actually half full: Productivity can be raised by addressing entrenched structural constraints that hold back innovation and by exploiting recent technological breakthroughs.

Regulatory safeguards

The United States, for example, differs from most other economies in that efficiency in resource allocation has improved and contributed positively to productivity growth.

The US economy operates with sufficient flexibility that the inputs for production flow more easily to the most innovative and productive firms. In most other countries, frictions such as regulatory barriers and financing constraints reduce flexibility—and they've become more binding.

That's not to say unconditional deregulation is the answer to everything. Guardrails serve a purpose, but they must be assessed against their broader welfare cost, including stifled innovation and growth. The global financial crisis showed us the hard way that financial regulation is critical: We remove safeguards on the financial system at our peril. We saw this two years ago with the collapse of Silicon Valley Bank and a few other midsize US banks.

But some regulations protect incumbents, stifle competition, or are outdated. Argentina once strictly restricted leather exports to keep domestic prices low, a benefit to tanneries at the expense of meat-packers and ranchers. Tanneries didn't expand capacity, so meat-packers discarded hides that could have been a valuable export, helping offset chronic trade deficits. Economy-wide benefits of removing export restrictions far

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Illustration by Chantal Jahchan

outweighed the costs to the tanneries. Removing frictions the right way aids economic growth. And many countries have a lot of room to do so.

Another reason for optimism is the artificial intelligence revolution, which could transform work. AI's boost to labor productivity is uncertain, but potentially substantial, depending on how, and how much, workers use it. And much lower development costs of some newer models, including DeepSeek and Mistral, signal that the full story is far from written. Many countries can still shape the plot.

The pace of innovation is staggering, with the cost of generative AI dropping by a factor of 10 each year, according to some estimates. This could bring about substantial growth, but we must also manage the societal transformations it might induce.

So there's hope. Various policies—from reforms aiding labor and capital allocation across firms to technological breakthroughs—could rekindle medium-term growth.

Global integration

But we must also recognize the shifting geopolitical landscape. This has important implications for economic growth given its implications for global integration.

World trade has increased fivefold in real terms since 1980, and its share of global output has expanded to 60 percent from 36 percent. This was supported by important reductions in trade costs that helped expand global value chains, a strong driver of productivity gains and goods exports since the early 1990s.

Increased trade integration helped fuel a spectacular rise in global living standards. Lower trade costs increased global GDP by 6.8 percent in real terms between 1995 and 2020. Low-income countries saw an even greater rise, of 33 percent.

Over the past 15 years, however, threats to the free flow of capital, goods, and people have intensified as geopolitical risks have grown. Conflicts are proliferating, alliances are changing, and countries are raising trade and migration barriers.

Despite such headwinds, global trade has proved remarkably adaptable. It has remained constant in relation to economic output, which means the impact of geopolitical shifts has been muted at the global level. The composition of trade is changing rapidly, however, as an important realignment takes place.

Multinational firms responded to trade restrictions on their exports by moving production to connector countries—notably Mexico, Morocco, and Vietnam—that belong to neither Western nor China-led blocs and trade freely with both. This is an important difference from past episodes of geopolitical fragmentation, like the Cold War, when trade diversion via connector countries was much more limited. One reason for that difference is precisely that the connector countries have already moved up the value chain, benefiting from earlier trade integration.

Emerging markets are also critical. With larger economies and greater global stature, thanks to deeper integration and arduous reforms, they're permanent fixtures on the global economic stage. As advanced economies turn increasingly inward, emerging markets have an important stake in fending off global economic fragmentation.

However, while connector countries support global trade and investment and attenuate the costs of fragmentation, there's still a price to pay. Stretched supply chains can be more inefficient and vulnerable. And more opacity in trade and financial flows makes spotting risks harder. Ultimately, too much trade disruption will diminish global growth and prosperity.

Fostering trade growth

While trade and financial integration helped lift growth momentum, not everyone benefited equally, especially in advanced economies.

Although there's broad agreement that trade integration can hurt some categories of workers and communities disproportionately, our analysis shows a more nuanced story. Globalization had a much smaller impact than technological progress on rising inequalities within countries.

Still, trade shocks can hurt, and perceptions of lost jobs also come into play. What may matter more is the speed of economic transformation, leaving little time for economic systems and safety nets to adapt. And this brings me back to AI and the blazing pace of change. Unattended, this may cause major dislocations—and the associated political blowback.

We are left searching for ways to reinvigorate growth amid rising geopolitical strains and heightened uncertainty around the future of global integration and technology.

Policy can play a central role, especially structural reforms. Easing worker mobility across employers, industries, and regions minimizes trade adjustment costs and promotes employment. Compensatory measures, especially for the most vulnerable, and helping workers adapt and sharpen skills are also useful—and even boost public support for government policies, as our research shows.

This brings me to the shared vision at the core of our institution. The IMF was born into a world at war when delegates in Bretton Woods, New Hampshire, agreed to an unprecedented framework for global economic cooperation in which countries helped themselves by helping each other. We were charged with three critical missions, one of which was to facilitate the balanced growth of international trade and thereby contribute to high levels of employment and real income as primary objectives of economic policy.

This is a delicate balancing act, which we have striven to achieve for the past eight decades through our surveillance and crisis-fighting mandates. Trade integration and expansion are by no means ends in themselves; they are important to the extent that they support employment and improved living standards. Carefully calibrated policy can help attain these goals. F&D

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