Simon Johnson: One Page Summary

15.015, class #2: Determinants of Long-term Growth

Most of this course is focused on relatively short-run macroeconomic management issues. One key building block is known as "aggregate demand". The basic demand equation is:

(1) $C + I + G + (X - M) = Y$.

This can be rewritten to focus on savings (to see this, look at the HBS note in the reading pack):

(2) Domestic savings + foreign savings inflow = investment + government deficit

This class is about longer run growth issues, because this should be the context for thinking about whether short-run macro policies are on the right track.

Output per capita is a function of capital stock, labor (quantity and quality), and a rather vague residual known as "total factor productivity".

The basic idea behind modern economic growth – which started around 1750-1800 – is that it involves accumulating physical capital (buildings, machines, infrastructure), increasing education, and combining "factors of production" in a way that increases productivity.

For example, bringing people into urban areas and employing them in factories is almost always associated with big increases in productivity – and thus in per capita income (although the effects on wages may be more mixed and income distribution could become more unequal.)

The prevailing development idea in the 1960s was to focus on increasing domestic savings and on arranging sustainable capital flows into poorer countries. This rising pool of savings would increase investment (assuming the government deficit was kept under control; see equation 2.)

While increasing savings and investing them productively is necessary for economic development, it has proved far from sufficient. Many countries that were forecast to grow fast after 1960 have had disappointing experiences. "Catching up" has proved hard.

As the world economy grows, per capita income tends to drift upwards almost everywhere – unless there is a dramatic breakdown in political order and social cohesion (e.g., civil war).

Across the broad sweep of economic history, institutions have played a key role in facilitating sustained economic development. Stronger economic institutions mean more protection for property rights and respect for the rule of law. Rulers are tempted to be opportunistic and need to be constrained.

Institutions are endogenous – meaning they are the outcome of a deeper political process, itself driven by conflicts of interest among different groups.

Some people like to put weight on geography and culture in explaining differences in per capita income, but it is hard to find robust relationships.

The big positive growth surprises in the past 50 years have almost all been in Asian countries that focused on exporting manufactured goods and that found a way to climb the "value chain". Japan might be considered the first non-European country to have used this development path; Korea, Singapore, Hong Kong and others have followed. China's development is often considered to follow similar lines (although this is a much larger country, so internal demand naturally plays a bigger role). Stronger institutions can sometimes be created as an outcome of economic growth, at least when the benefits are widely shared.

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