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As countries struggle to reach their economic potential, could infrastructure be the key to boost growth?

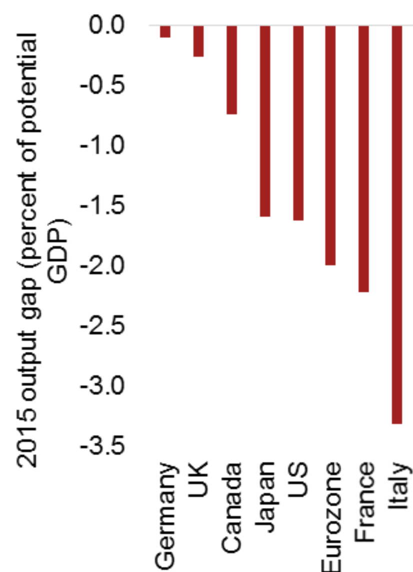
Eight years after the financial crisis, many large economies continue to have sizeable negative output gaps, say PwC economists. This gap indicates the amount of spare capacity in an economy by estimating how close it is to operating at its potential level of output.

Of the G7, Italy is furthest adrift with France and Japan still running behind the GDP-weighted average for the group. Only Germany and the UK are near to closing the gap. *(See Figure 1).*

Says Richard Boxshall, Senior Economist, PwC:

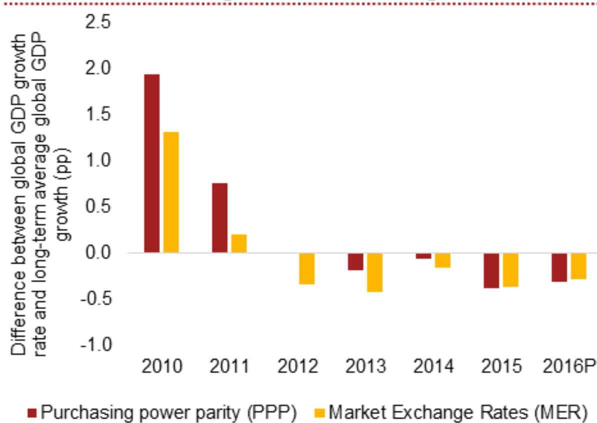
> "We don't expect this to change soon, since our main scenario sees global growth of around 2.5-3% this year, the fifth year of below trend growth measured in market exchange rate terms." *(See Figure 2 below).*

Figure 1: Of the G7, Germany's economy is operating closest to its potential



Source: PwC analysis, IMF

Figure 2: Global GDP growth is expected to be below its long-term trend again in 2016



Note: Long-term average defined as 1980-2015
Sources: PwC analysis, IMF

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At the country level, the recent data has been mixed. The Eurozone grew at an encouraging rate of 0.6% quarter-on-quarter in the first quarter of the year – higher than expected and slightly above trend.

In contrast, the US grew at a lethargic rate of 0.1% quarter-on-quarter; and the UK also saw growth slow to a slightly-below-trend rate of 0.4% in the first quarter.

So what could help boost growth rates? One potentially attractive approach is to invest more in infrastructure. Doing this effectively is a necessary condition to going beyond boosting short-term demand and to ensure the supply-side of the economy grows more strongly in the long term.

Based on their infrastructure project experience, PwC's economists have set out four principles for policymakers to keep front-of-mind when considering where to target investment:

- ***Ensure it meets a need:*** identify current and future needs, supplementing the base case analysis with a range of scenarios including optimistic and pessimistic cases.
- ***Ensure consistency with other objectives:*** infrastructure projects should fit with the government's broader policy agenda, including social and environmental as well as economic goals.
- ***Ensure the numbers add up:*** for governments with a relatively low net debt position and healthy public finances (e.g. Germany and Canada), embarking on an infrastructure-led programme seems like a sensible way to boost aggregate demand and long-term supply capacity. But even where budget deficits remain relatively high – as in the UK – there could be a case for prioritising infrastructure investment over current spending.
- ***Ensure it will benefit the wider economy:*** assessment of the potential impact should factor in both the long-term effects as well as the direct and indirect impacts relative to a scenario where the project does not go ahead.

Concludes Richard Boxshall:

> "In response to the Great Depression in the 1930s, the US enacted the Public Works Administration, investing $6 billion in infrastructure over a number of years (equivalent to around 11% of US GDP in 1933, the year the PWA was established) to kick start growth and productivity. This type of investment is once again being touted as the key to unlock our low growth environment – but the effectiveness of this policy will ultimately depend on how many shovel-ready projects in different economies meet the principles we've outlined."

For more details, please see this month's Global Economy Watch at www.pwc.com/GEW.

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