Analysis

Structural reforms can provide an answer to lean years in global economy

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Structural reforms are playing an increasingly important role in the recovery of long-term outlook for growth. Globally, growth has been slow since the Great Recession. Reasons for this have been sought from both supply- and demand-side factors. At least some of the problems are structural and cannot be addressed with counter-cyclical stimulus policies.

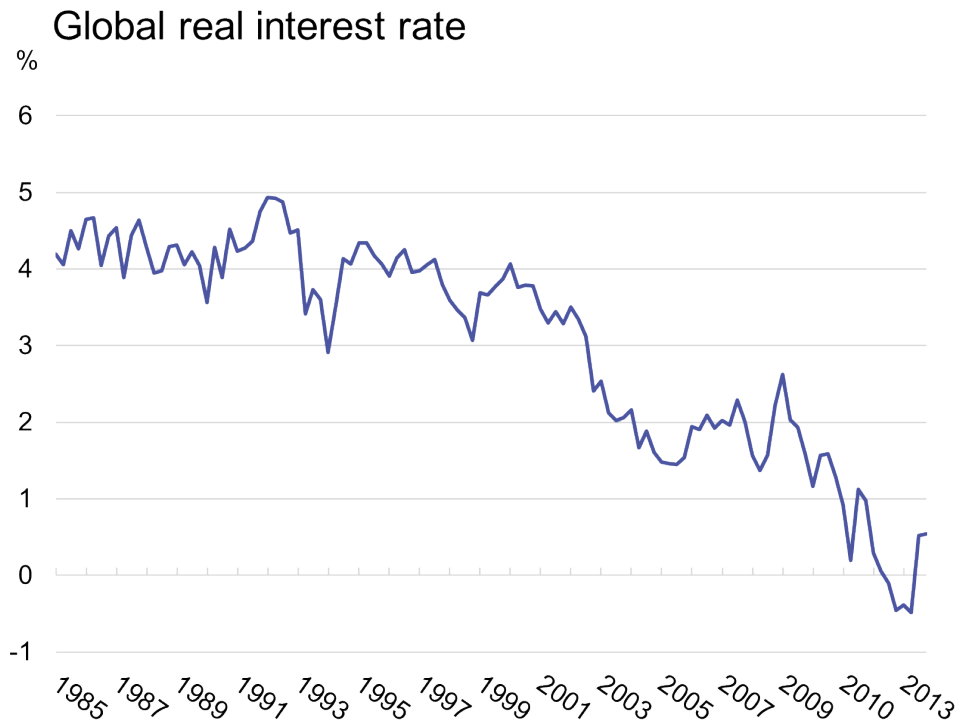


The Great Recession has already lasted seven years

The global financial crisis which escalated at the end of 2008, and the Great Recession that followed have already caused seven lean years for the global economy. The real impact of the financial crisis has hit the advanced economies hardest of all. The direct effects of the crisis spread rapidly throughout the world, and world trade declined swiftly, leading in turn to the postponement of investment plans by non-financial corporations. Despite monetary and fiscal stimulus, the decline in demand eventually resulted in lower demand for labour.

During the Great Recession, output collapsed to a level below potential output.[1] In addition, potential output decreased, i.e. the prospects for economic growth weakened, due to slower investment growth, reflected as a decline in growth of the capital stock and the exclusion of parts of the labour force from the labour market, as well as a lower labour participation rate. The decrease in potential output is a long-term phenomenon, and its restoration to a stronger level requires structural reforms.

Chart 1.



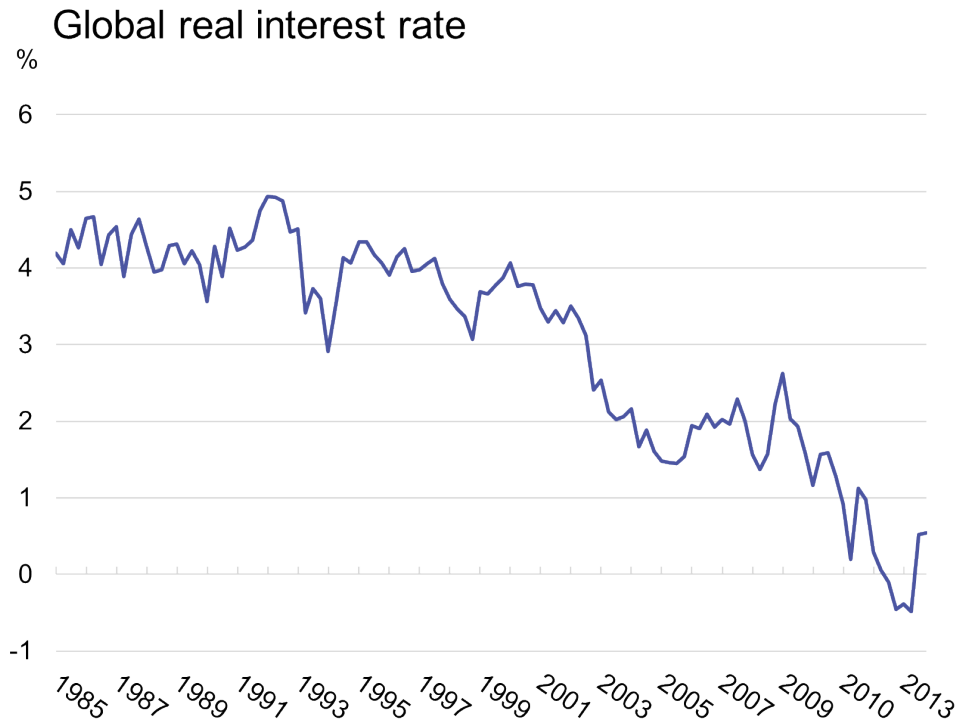
Source: King and Low (2014) Measuring the 'World' Real Interest Rate, NBER Working Paper No. 19887.
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The real interest rate also declined sharply. This decline is, however, a longer-term phenomenon. The real interest rate, defined on the financial markets (credit markets), may in the short term deviate from the long-term equilibrium real interest rate of supply and demand. The equilibrium real interest rate harmonises the marginal return and compensation that savers require to postpone consumption. The output achieved with this equilibrium real interest rate is at the level of potential output and the economy exhibits equilibrium employment.

In the short term, monetary policy can also be used to influence the real interest rate when the central bank changes the nominal interest rate with the aim of maintaining price stability and

bringing output close to potential. The level of real interest rates, which is defined on the markets, depends not only on savings and investment but also on the risks attaching to financial assets. A long-term decline in the real interest rate can be an indication that the economy has entered a period of slower growth.

Chart 2.



Source: King and Low (2014) Measuring the 'World' Real Interest Rate, NBER Working Paper No. 19887.
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Growth has weakened permanently

Lawrence Summers[2]. has proposed that the growth prospects of the global economy have probably weakened permanently. This view is based on the impact of the disruptions caused by the Great Recession and on estimates on the long-term factors of economic growth. One possible interpretation [3] of this hypothesis of secular stagnation is that investment growth will slow if companies see that slow future population growth and subdued innovation will diminish the return on investment. The real interest rate – that normally balances investment and savings – cannot decline sufficiently in this situation. The zero bound on the nominal interest rate, in particular, constrains the decline of real interest rates into negative territory, especially if this is coupled with very slow inflation rates in nearly all the advanced economies. Summers notes that, in future, the zero bound on the nominal interest rate and a permanent weakening of growth

prospects will create a pressure to maintain the real interest rate at a very low level so that emerging economies can reach full employment. This may cause instability on the financial markets.

According to Summers, a collapse in demand alone does not explain the more permanent decline in potential output. As an explanation, he provides the hysteresis effect in which a decline in current output levels will also weaken future output. Even though the hysteresis effect may be a good explanation of a collapse in potential output, the detailed channels of this effect remain unclear.

According to Robert Gordon [4], the weaker growth prospects of the global economy, and particularly the US economy, do not reflect only inadequate demand. Gordon states that the slow pace of GDP growth is mainly due to supply-side factors. For example, technological change has slowed to a trajectory of weaker long-term growth. The other headwinds of the economy are unfavourable demographics (slow population growth and population ageing), the decrease in the benefits achieved from education (the general level of education is already high), the increase in inequality and high government debt. Gordon estimates that longer-term productivity growth adjusted for technological slowdown and educational stagnation will be around a good ½ a percentage point per annum in the United States. He also estimates that supply-side factors will reduce average growth in real US GDP to 0.9% per annum over the period 2007–2032.

In the other advanced economies, these factors will have a similar effect as in the United States, although the differences across countries will be substantial.

Regional differences in the sources of growth

The sources of economic growth can be classified roughly as employment growth, increase in capital intensity and higher productivity.

According to population prospects by the United Nations (Table 1), the population of the United States will grow by approximately 0.5 percentage points per annum in the next 50 years. In Europe, there are considerable differences across countries: population will increase in some countries and decrease in others. For Europe as a whole, population growth is estimated to stagnate for the next 50 years, and therefore population developments will not have a significant impact on growth. In Asian countries, too, developments will be mixed. Of the high-population countries, China's population growth is slowing. In India, population will continue to grow at a rapid pace, pushing total population growth in Asia and increasing the supply of labour. The high rate of population growth in Africa is projected to maintain the rapid pace of increase in world population.

Table 1.

Average population growth 2015–2065, %	
United States	0.5
Germany	–0.3
United Kingdom	0.4
France	0.2
Italy	–0.2
China	–0.2
India	0.6
Africa	1.9
World	0.7

Source: United Nations (2015). World Population Prospects.

Of supply-side factors, in addition to population growth, employment dynamics also reflect developments in the labour force participation rate. The OECD's long-term projections on the evolution of the labour force participation rate are moderate, and therefore population growth can be considered a rough estimate of labour input in the long term. The potential labour force relative to population will decrease in the United States, the euro area and China in 2014–2030.

Even though China will probably rebalance the structure of its economy towards domestic consumption, the investment ratio will long remain much higher than in the advanced economies. This will increase the amount of capital in the economy more in emerging economies than in advanced economies. Capital intensity can be assumed to continue to rise in the emerging economies of Asia, despite the abundant supply of labour. In the OECD long-term projections, capital stock relative to output will increase in Asia particularly in 2014–2030.

Assessments of productivity are considerably hampered by the uncertainty surrounding future technical innovations. In emerging economies, general productivity growth is expected to follow at the maximum the trend productivity growth of past decades. The US economy has at least in the past been more dynamic than European economies. The largest benefits from the expansion of cutting-edge technology may in the future, too, be found in the United States. Emerging

economies – including China and particularly India – are, however, approaching the technological frontline, which will enable the utilisation of existing technical advances. This catch-up in technology will in the future, too, generate rapid growth in the emerging economies of Asia. In the OECD's long-term projections, improvements in labour productivity in the euro area slightly exceed the rate of productivity growth in the United States, but both economies lag behind labour productivity growth in the high-population countries of Asia.

Structural reforms will boost the economy

From the perspective of economic policy, it is essential to know to what extent the weaker growth prospects are due to problems on the demand side and to what extent they are the result of supply-side problems. The Great Recession has been alleviated by relaxing monetary and fiscal policy stances. The protracted recession has, however, shaped our understanding of the nature of the problems that the economy is facing. It is increasingly clear that some of the problems are of a permanent nature and cannot be affected by monetary or fiscal policies that are aimed at stimulating demand; they will instead have to be solved by structural reforms.

According to Summers, in an environment of zero interest rates, the real interest rate can be reduced by changing the inflation rate target. This does, however, involve risks and may weaken the credibility of monetary policy. In addition, the experiences of Japan are not encouraging: setting an inflation target and the subsequent raising of this target have thus far not resulted in a significant decline in the real interest rate in Japan. The real interest rate can also be reduced by conducting a policy of quantitative easing, in which the central bank aims to reduce long-term bond yields. The latter method has been used extensively in the advanced economies.

Table 2.

Breakdown of potential GDP for 2014–2030 (2031–2060)

	Potential GDP	Potential GDP per capita	Trend productivity excl. capital	Capital/ output	Potential employment ratio
USA	2.4 (1.7)	1.6 (1.2)	1.7 (1.2)	0.2 (0)	–0.3 (0.1)
Euro area	1.7 (1.5)	1.5 (1.5)	1.5 (1.7)	0 (–0.1)	–0.1 (0)
China	5.0 (2.4)	4.7 (2.8)	4.4 (3.2)	0.7 (0)	–0.4 (–0.5)

Source: OECD Economic Outlook (May 2014).

Breakdown of potential GDP for 2014–2030 (2031–2060)					
India	5.8 (4.3)	4.8 (3.9)	3.4 (3.8)	0.5 (0)	0.8 (0.1)

Source: OECD Economic Outlook (May 2014).

In the advanced economies, fiscal policies have rapidly faced problems concerning the sustainability of government debt, leading to a need for fiscal tightening.

In advanced economies, fiscal and monetary policy measures are currently considered as having limited possibilities of providing an additional stimulus to aggregate demand. Therefore, the only viable economic policy tools available are structural reforms. Structural reforms are considered beneficial irrespective of whether the recession is due to supply or demand factors. Implementation of the reforms is, however, hampered by a number of factors. The appropriate structural reforms differ across countries. Moreover, their implementation is often painful, particularly during a downturn, when old structures have to be broken down and new ones created. On the other hand, if structural reforms are implemented worldwide, everyone benefits more, i.e. the reforms generate synergies.

Structural reforms may, in the longer term, significantly accelerate the pace of economic growth. Structural reforms can be divided roughly into labour and product market reforms. Among other approaches, the operation and incentives of markets can be improved by changes in taxation, e.g. by shifting the focus from input taxes to consumption taxes.

The European Commission has assessed the impact of EU-wide structural reforms in selected EU countries (Table 3). The assessments are based on a wide range of structural reforms that differ across countries. The structural reforms are implemented immediately, and possible institutional delays have not been taken into consideration. The calculations can therefore be said to represent the upper limit of the possible benefits of structural reforms.

Table 3.

The GDP effects of structural reforms, %				
	5 years	10 years	20 years	50 years
Germany	3.2	5.5	8.7	12.1

Source: Varga and in't Veld (2014), The potential growth impact of structural reforms in the EU: A benchmarking exercise, European Commission, Economic Papers, 541.

The GDP effects of structural reforms, %				
France	4.2	7.7	13.3	17.8
Italy	3.9	8.5	16.1	23.4
Finland	5.2	9.6	15.8	19.4
United Kingdom	2.1	4.3	7	10.7

Source: Varga and in't Veld (2014), The potential growth impact of structural reforms in the EU: A benchmarking exercise, European Commission, Economic Papers, 541.

The figures presented (Table 3) are slightly smaller than in the OECD assessment[5] in which the full implementation of extensive reform packages can in the period of ten years add up to 10% to the GDP of an average OECD country. The various empirical and imputed estimates on the effects of structural reforms are naturally very uncertain, but they are nevertheless believed to be capable of providing a significant boost to annual economic growth.

Notes

1. Potential output is often defined as the level of GDP that the economy can attain without inflationary pressures. ↑
2. IMF Fourteenth Annual Research Conference in Honor of Stanley Fisher (2013) and VoxEU eBook (2014) Secular Stagnation: Facts, Causes and Cures, see http://www.voxeu.org/content/secular-stagnation-facts-causes-and-cures. ↑
3. See http://www.brookings.edu/blogs/ben-bernanke/posts/2015/03/31-why-interest-rates-low-secular-stagnation. ↑
4. Bouis and Duval (2011) Raising potential growth after the crises: A quantitative assessment of the potential gains from various structural reforms in the OECD area and beyond. OECD Economics Department Working Papers, No. 835. ↑

Keywords

economic growth, economic policy, employment, investment, productivity