Return from the dead?

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Old ways of thinking won't bring developed countries back to economic life. Weighed down by the legacy of the crisis, they also face deep challenges like a faltering labour supply and slowing innovation. And growth itself won't be enough–it must also be stable, inclusive and green. The need for structural reforms has never been greater, but they will require difficult trade-offs. In short, policymakers in the OECD area, and the OECD itself, face daunting challenges.

Parents in OECD countries have long had confidence that their children will enjoy a higher standard of material well-being than they did. Sadly, that confidence is no longer there. Why?

Clearly, our starting point is not a good one. OECD estimates indicate that the average member country has seen its level of potential output drop by three percentage points since the beginning of the economic and financial crisis in 2007. Moreover, the recovery to date has been slow and halting under the influence of a debt overhang that has severely affected both borrowers and the banks that lent to them. The traditional quick fix of macroeconomic stimulus also seems to be both increasingly ineffective and encumbered by dangerous side effects. Studies of previous credit-driven "boom-bust" cycles indicate that what we are witnessing now is typical. The sluggishness and associated ennui could well continue for an uncomfortably long time.

There are deeper issues, too. Robert Gordon, one of the world's best-known academic authorities on growth issues, suggests that future growth in US consumption per capita (for all but the top 1%) could fall "below 0.5% per year for an extended period of decades". This conclusion should raise serious concerns for OECD countries, many of which face common challenges.

Another problem is the faltering supply of labour. This reflects not just slower population growth in most OECD countries, but also slower rates of increase in labour force participation and, often, a growing antipathy to immigration. Moreover, under the influence of technological change and globalisation, employers in OECD countries need workers with both highly specialised production skills and generalised problem-solving capacities. Many workers, including high school and even university graduates, don't have those skills and are therefore being left behind. This hurts both growth and inclusiveness.

We are also likely to see low rates of saving and, thus, a slow rate of growth of the capital stock. The ratio of private investment to GDP has been trending down for decades, and there is no obvious reason to expect a reversal. Indeed,

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a recent report from the Group of Thirty, a nonprofit grouping of senior figures from the public and private sectors and academia, suggests particular concern for the future availability of finance for longer-term investments. As for public sector investment, it seems increasingly likely that it will suffer given the broad trend towards reining in sovereign debt levels and the need for deficit reduction.

Longer-term issues also need to be confronted. One of these has to do with the environment. Even though commodity prices are declining, doubts about the sustainability of today's economic model are increasing. Is the recent, much accelerated, pace of depletion of natural resources sustainable? What might be the implications for future living standards, particularly for the poor, of rising prices for food and energy? In addition, current production processes have massive externalities that threaten the environment and well-being in other ways, not least via climate change. Is this sustainable for much longer?

The apparent slowing pace of innovation is also a concern. Most studies of the determinants of growth give pride of place to increases in "total factor productivity", which is ultimately driven by innovation. Can we count on more innovation to power future growth in living standards?

Rising to these formidable new challenges will not be easy, but it can be done. In particular, we must resist the temptation to retreat into old belief systems. First, we must face up more courageously to the immediate problems confronting us. Overindebtedness implies the need for explicit debt reduction and plans to recapitalise or wind down imprudent lenders–the Nordic model rather than the Japanese model. We must also resist the belief that demand stimulus alone can restore "strong, sustainable and balanced growth". Clearly, demand stimulus has its place during the recovery from the global economic and financial crisis. But sustained growth will depend not on demand stimulus, but instead on structural reforms. Second, relying on increasingly impotent macroeconomic policies, and refusing to consider policies that might work, is surely not the way forward.

New beliefs must be based on both sound theory and factual evidence

If there is still much to learn about making structural reforms effective, particularly given multiple objectives, some points would seem pretty obvious. Smarter regulation of product markets and increased competition would increase efficiency and lower living costs, and could have significant effects on international imbalances. In many cases, it would seem that such reforms can have quite rapid payoffs. Making labour markets less rigid, particularly with respect to employment protection, would encourage more hiring and probably more training. Raising the participation rate of women in the workforce, notably through the provision of better education and care in early childhood, but also other measures, would provide multiple benefits. So too would raising the effective retirement age. An education system better tuned to future employment opportunities, and with resources more focused on the disadvantaged, would provide more and better workers, aid inclusiveness, and encourage innovation. Public sector investment, if carefully evaluated and undertaken, can provide higher-yielding state assets to service higher liabilities. Many more recommendations of a similar nature are routinely made by the Economic Development and Review Committee in its Economic Surveys and Going for Growth project, drawing on the vast base of knowledge developed over the years by the OECD.

None of this is to deny that reforms can have downsides. For example, lowering employment protection in downturns might lead initially to more job losses than gains, and more and better education raises the issue of financing. These downsides must also be recognised and addressed. Nor is it possible to state that we know everything we need to know to pursue good public policies. Indeed, it was the recognition of our analytical shortcomings that recently led the Council of the OECD to initiate the New Approaches to Economic Challenges (NAEC) project. Evidently, throwing off old belief systems requires creating new ones, and new beliefs must be based as much as possible on both sound theory and factual evidence about what actually works. In many ways, we are just beginning the task of laying the analytical groundwork for such new approaches.

Of course, knowing what to do or to recommend is only one part of public policy. Actually implementing what needs to be done to provide "strong, sustainable and balanced growth" will be still more difficult. In the globalised world in which we live, many desirable initiatives will require a degree of international co-operation, in effect ceding some sovereignty, that might prove hard to achieve. At the domestic level, those profiting from current practices will resist change fiercely. Moreover, structural change is, by definition, destabilising and could have unforeseen social and political ramifications. Yet without change in our public policies, the objectives we seek will not be met. And if we fail, we risk being left with a bleak economic future that would surely be even more prone to turmoil.

John Kenneth Galbraith summed it up well when he wrote: "Politics is not the art of the possible. It consists in choosing between the unpalatable and the disastrous." We must now get on with the more appetising of these unappetising options.

Recommended links

www.oecd.org/eco/growth

www.williamwhite.ca

Group of Thirty (2013), *Long-Term Finance and Economic Growth*, available at www.group30.org