

## **THE SHORT TERM, THE LONG TERM, AND HOW TO GET FROM HERE TO THERE. Pier Carlo Padoan, Moscow October 19, 2012**

After 5 years into the crisis and with the global economy weakening again many policy questions arise. Let me summarize them in three broad issues,

1) What can policy do in the short term? Given the (again) faltering outlook for the global economy the overarching policy imperative in the short term is to restore confidence and avoid precipitating the economy towards bad equilibria. While not all countries and regions are on the verge of such developments, dramatic events in one region, notably the euro area, may have dramatic consequences for different parts of the world.

2) What is the long term scenario? What will be the drivers of growth once the current state of weakness and fragility is left behind? How do we activate new sources of growth, while taking into account additional dimensions such as equity and sustainability?

3) Finally, how do we link the short to the long term? How do we manage the transition? How long will it take before the global economy is on a new, stronger, growth path? When will reforms result kick in? How can institution building help?

My key message is that policy at national and international level will succeed in getting beyond the crisis to the extent it links effectively the short term to the long term challenges both in policy design and in implementation.

### **The short term**

The global economy has deteriorated significantly with respect to a few months back. In this we are not facing a new pattern. Over the recent past at least twice already what seemed to be the end of a deep recession cycle turned out to be a double dip or at least a heavily bumpy ride. The risk of a new major slowdown is not negligible. Things look worse where the slowdown was already visible such as the euro area, where the risk of

countries falling into debt traps of high debt high risks and low or negative growth is still substantial. The US look clearly better but her performance remains below what was expected a few months back. A slowdown is also surfacing in the faster growing economies, most notably in the EMEs.

The causes of slowdown are several but one is especially worth pointing out: a significant drop in confidence. We should add that this takes place against a scenario of deleveraging, (which, however, was ongoing before the current weakening became apparent) and a stronger than anticipated impact of fiscal consolidation.

A fall in confidence is visible in both companies and households. In the first case this leads to holding back investment even when there is no financing constraints (at least for big companies). In the case of households high, and in some cases growing, unemployment depresses confidence and spending plans.

Lack of confidence largely reflects insufficient or ineffective policy response. This, in turn, seems to be determined not so much, or not only, by lack of understanding of the policy requirements, but rather by failure to reach consensus on the policy response itself. It is an issue of the political economy more than of the economics of policy response. The fiscal cliff and the debt ceiling in the US, and the management of the euro area crisis are two cases in kind. Policy dilemmas are present in emerging economies as well, reflecting different country specific conditions, that become more challenging as growth slows down.

Failure to take action, in addition to not restoring confidence and hence depress private spending could have significant direct consequences on activity. Hence it looks unlikely that a muddling through scenario can be sustained for a long period of time.

Rather, different scenarios are likely to materialize. If the fiscal cliff is not taken care of, a large negative shock could bring the US economy into recession with heavy consequences for the rest of the world. In the euro area, while progress in strengthening institutions has

been significant over the past few months, the risk of events precipitating in one or more economies under pressure could lead to a negative spiral, a debt trap and a break-up of the system.

The likelihood of such a scenario appears more clearly if one thinks of the three negative feed back loops in the euro area that could amplify and interact negatively.

Solvency fears for banks and their sovereigns are feeding on each other due to government guarantees for banks and bank holdings of government bonds. The possibility of exit from the euro area pushes up yields, which in turn reinforce break-up fears. Worries about government debt are driving up yields, which further weigh on debt dynamics.

The euro area crisis requires **now** a collective response by all actors involved: surplus and deficit countries, the Euro area institutions, the ESM, the ECB. The instruments have been significantly strengthened but it is not difficult to imagine a situation in which, the policy response needed by one or several of the actors involved is not delivered: i.e. deficit countries in the south not delivering in their reform programs,) surplus countries not contributing to making the adjustment more symmetric, european institutions not providing support in a timely and adequate fashion and size. This would precipitate market confidence and push countries undertaking painful adjustment in a debt trap where declining growth, tighter fiscal consolidation high debt and risk chase themselves down a deflationary path. Increasing unemployment would trigger reforms fatigue and social resistance. The euro area, which is already witnessing significant fragmentation pressures, could be in danger.

This however need not happen, and euro area member states and institutions are indeed engaged in a tremendous effort for a different outcome. An upside scenario may materialize which would lead to more confidence, a positive market response both in terms of risk assessment and investment and spending decisions.

The emerging markets face challenges too. In the short term they have to use their policy space to prevent growth from falling below critical levels. However they have to do so while avoiding unleashing unsustainable credit booms

In sum in the US and, more so, in the euro area and at the global level a classical collective action problem is at work. At a global level a weakening activity outlooks suggest that collective response is needed mobilizing all available policy space , not only because a collective response support has more impact on activity, but even more importantly as a way to boost market confidence that policy makers are willing and able to take appropriate action, much in the spirit of the early response of the G20 at the break out of the global financial crisis.

In Los Cabos countries agreed on language that pointed exactly in this direction. They should follow up with action. If confidence in crisis management is restored confidence in general will improve and private sector will likely give up its wait-and-see mode and contribute to lifting activity

### **The long term**

The global crisis has taken its toll on potential output in several G20 countries. Even as economies eventually recover, the crisis could well reduce medium-term potential output. Most of the drop in potential output is expected to have been due to foregone investment and lower productivity, followed by higher unemployment. To the extent that higher cyclical unemployment translates into higher structural unemployment, as workers lose attachment to the labour force and their skills deteriorate during lengthy spells of inactivity. The size of this latter effect depends on the functioning of labour markets, which varies significantly across countries and has been somewhat different in the current crisis relative to previous ones.

As the global economy moves out of the acute phase of the crisis policy priorities will have to be directed to longer term growth. It cannot, however, be a return to a business-as-

usual long term growth scenario. Indeed the question is where will growth come from? What are the policies for strong sustainable and balanced growth that need to be put in place?

To answer this it is useful to distinguish between growth resulting from catching up to the technology frontier, which is the case of emerging and some advanced countries, and growth for countries on the frontier.

There is large evidence structural reforms, in labour and product markets, in fostering human capital and knowledge capital accumulation, and taxation are key both to achieving rapid catch up and pushing the frontier forward. Such measures support growth including through more efficient reallocation of resources towards more profitable and more dynamic sectors and companies.

This is relevant for both advanced and emerging economies. In a soon to be released long term scenario exercise the OECD sees MFP and human capital are main drivers of long term growth and convergence towards the frontier over the next few decades. (Indeed human capital is by far the factor that has the largest impact on per capita gdp growth, but it is also the one that takes the longest time lag to exert its full effects)

EMEs will catch up to MFP levels of the frontier countries but not completely. For these countries to make the most out of catching up policy measures will have to concentrate in the improvement of mechanism that impact on factor allocation, such as product market reforms and the rule of law, as well as mechanisms that drive human capital accumulation

Even if catching up improves, with benefits for global growth, a main challenge remains: what will drive growth at the frontier? What are the new sources of growth of total factor productivity and per capita gdp? A recent paper by Robert Gordon suggests that spells of significant productivity growth are associated to “heroic” innovation cycles that have happened very few times in the past and it is very unlikely that they will repeat themselves. Let me be a bit more optimistic and point out at two areas of innovation that

could bring significant contributions to productivity growth: intangible assets and green growth.

Investment in intangibles such as employee skills, organisational know-how and various forms of intellectual property, are an important driver of productivity growth. Evidence shows that they are responsible for the largest increase in productivity (which could be as high as two thirds of total productivity growth) in the most advanced economies.

Unlocking, for example, a large source of financing of intangibles thus would seem to be crucial. However, the growing importance of intangibles as a source of growth raises various policy issues. A key challenge is to overcome problems of information asymmetry and market incompleteness associated with intangibles. Here policy can help to mobilise seed capital and by the development of standards to facilitate the use of intangibles as collateral.

Another key challenge is to improve private incentives to invest in intangibles while preserving the social returns to knowledge and avoiding rent-seeking behaviour. Specifically, while there is a need for private investors to recoup investment in intangibles through intellectual property rights protection, anti-competitive behaviour must be prevented. Moreover, policies in the areas of public procurement, public funded research and the creation of regional clusters can play an important role.

The frontier could be shifted upwards also by moving towards greener growth, *i.e.* fostering economic growth and development while ensuring that natural assets continue to provide the resources and environmental services on which the economy relies. Green growth policy has the potential to address economic and environmental challenges and open up new sources of growth through several channels:

- [Incentives for greater efficiency in the use of resources and natural assets, reducing waste and energy consumption and making resources available to highest value.

- Creation of new markets by stimulating demand for green technologies, goods, and services; creating potential for new job opportunities.
- Boosting investor confidence through greater predictability and stability around how governments are going to deal with major environmental issues.
- More balanced macroeconomic conditions, reduced resource price volatility and supporting fiscal consolidation through, for instance, reviewing the composition and efficiency of public spending and increasing revenues through the pricing of pollution.
- Last but not least, innovation spurred by policies and framework conditions that allow for new ways of addressing environmental problems.

However, green innovation is subject to the same obstacles as intangibles at large. The market for green innovation is affected also by specific barriers, notably the prevalence of dominant designs, technologies and systems in energy and transport markets, which can “lock in “ into “brown “technologies, and generate entry barriers for new technologies and competitors due to, for example, the high sunk costs of developing new infrastructures. Policy should reduce or eliminate such barriers.

Long term growth will not come without imbalances. Current account imbalances are set to widen again as savings will rise above investment in emerging economies. Structural reforms that improve social security systems will help address imbalances by lowering saving in emerging surplus economies and could increase investment through product market liberalisation (especially services) in surplus advanced economies

Imbalances should not be fully eliminated, as they also reflect reallocation of savings which support growth. This however has to take place without adding to instability and while international financial integration is commonly seen as increasing economic efficiency and growth, it can also increase the risk of financial contagion and instability. New empirical analysis by the OECD, covering both advanced and emerging economies, shows that a bias in gross external liabilities towards debt, in particular bank debt, substantially increases the risk of financial crises. Currency mismatch of assets and liabilities and shorter banking debt maturities add to this increased crisis risk, the latter

mainly by increasing financial contagion. By contrast, financial integration through foreign direct investment (FDI) is found to have little adverse impact on financial vulnerabilities.

Structural policies can help reduce financial fragility, typically through their impact on the financial account structure. Specifically, reducing regulatory burdens on foreign direct investment and relaxing product market regulation shift external liabilities away from bank debt to FDI. Similarly, reforming tax systems away from a favourable treatment of debt finance over equity finance reduce the share of debt, including external debt, in corporate financing. Opening cross-border flows to FDI and equity can influence the structure of external liabilities as well and therefore financial stability. Stricter financial regulation and oversight reduces financial fragility as well, as do stricter macro-prudential regulations that protect against excessive credit growth and housing policies that prevent housing bubbles.

Last but not least long term growth especially, but not only, in advanced economies will face the challenge of very high and still rising debt. Debt levels in many OECD countries are already higher than the levels beyond which evidence shows they impose a negative toll on growth. Low growth, in turn, will make debt reduction much more difficult to achieve. Contrary to fast debt reduction episodes in the past, which have been achieved mainly through rapid growth, OECD long term projections show that the interest rate growth rate differential will remain positive over the long term, which means that fiscal consolidation through higher primary surpluses will have to be a permanent feature of the long term scenario of many advanced countries.

However budget consolidation can be made more growth friendly, especially by linking it to structural reforms. Deeper and more rapid reforms increase competitive pressures in product markets, ensuring that productivity gaps between countries close faster, while deep labour market reforms would boost participation. [These structural reforms could facilitate faster fiscal consolidation in the advanced economies and while deeper welfare and financial market reforms, as well measures to reduce informal employment would have a similar impact in the emerging economies. This combination of policies would



contribute to absorbing global imbalances and reducing risk premia, with positive influences on growth.

Budget consolidation in turn can also play an essential support to growth for instance by securing the fiscal space necessary for long-term investment including infrastructure. This implies that the composition of consolidation is obviously crucial. For most countries, present consolidation plans envisage some mix of spending restraint and revenue-raising measures. Each consolidation instrument has its advantages and disadvantages, but the possible trade-offs may be less stark when considering a broad package of different measures that contribute to both raise potential output and consolidate budgets.

On the expenditure side, reforms of disability, sickness and unemployment benefit schemes, along with old-age pension systems and de facto early retirement schemes, could contribute to immediately improve fiscal balances while boosting employment and thereby raising growth and tax revenues in the longer term.

Public spending efficiency is another key policy area where reforms could allow for reduced expenditure, while maintaining or even increasing outputs. Recent OECD analysis suggests that substantial fiscal resources could be saved in underperforming countries through the gradual adoption of best practices in primary and secondary education. Improving health care sector efficiency could deliver even larger fiscal gains, as does the reduction public subsidies, when not addressing market failures, which distort resource allocation and hurt productivity

In several countries, broadening tax bases by reducing tax expenditures would enhance the efficiency of the tax system by enabling a reduction in tax rates and by cutting economic distortions and administrative compliance. Improving the effectiveness of tax administrations in tax collection and the fight against tax evasion is an important way to both enhance tax efficiency and reduce fiscal deficits, and the amounts of tax revenues involved can be significant. Moreover, changes in the tax mix involving lower personal and corporate income taxes offset by higher consumption and property taxes can make some indirect contribution to fiscal consolidation through their medium-term effects on income, productivity and tax receipts. As well, policies to tax public 'bads' such as

pollution, could enhance welfare while assisting fiscal consolidation. Opportunities to raise additional receipts emerge also from the existence of disparities in environmental-related tax rates within countries to the extent they do not generally reflect differences in the magnitude of negative externalities.

In sum, in the long run fiscal policy in advanced economies will be largely geared towards fiscal consolidation and debt reduction, this will leave most of the burden to support growth and make it more balanced to structural reforms, Reforms however, play a role already now, in the transition towards a new long term scenario

To conclude this section let me remind that the long term is not only about finding new sources of growth and making them more sustainable and robust. It is also about other dimensions, such as equity and sustainability. OECD research is increasingly looking at the existence of possible trade-offs between, growth and stability, growth and equity, growth and green sustainability, innovation and equity. The key point is to recognize that structural policies that impact on one variable notably growth, can have unintended consequences on other variables, such as equity, that need to be taken into account. Likewise, an important dimension of budget consolidation, not least for its political feasibility, is the extent to which it distributes the burden fairly across tax payers and benefit recipients. Such trade-offs will have to be taken into more consideration in the definition of long term policy strategies

### **The transition**

If immediate policy action is successful in avoiding a bad equilibrium the global economy can move forward towards a new long term growth path. In a world of multiple equilibria linking the short term to the long term implies jumping on a path which leads to a good equilibrium. The policy challenge is to take the short term action which allows to make such a jump. Such a policy will typically require the joint activation of fiscal, structural and financial policies. This challenge, in addition, may not be just a one-time choice. The possibility of stumbling into new bifurcation points will not go away and the risk of falling towards new bad equilibria will remain a real and present danger for some time to come .

If uncertainty is a major cause of current disappointing performance (through its negative impact on confidence) a way of looking at the transition is to ask how to rebuild confidence that policy is choosing the right path. Confidence building however will also require that policy action breeds visible results, as lack of visibility will undermine support to the painful adjustment process.

The process is going to be slow, however, as positive forces and headwinds will continue to coexist for some time. In the advanced economies headwinds will include the stance of fiscal consolidation, which, as mentioned, will have to continue for some time if debt has to be brought on a declining path, and deleveraging, which, however, could come to an end relatively soon in the US while it could take more time in Europe. In the euro area substantial intra zone adjustment will be needed to restore current account balance and sustainable growth and this could also take some time especially if adjustment falls uniquely or largely on deficit countries without symmetric contribution from surplus countries.

Persistent or still rising unemployment, also has a very negative impact on the transition, and for a number of reasons: it lowers growth directly, it lowers household income and spending, it lowers confidence and increases reform fatigue and weakens support for reform, especially if it is associated with the perception that adjustment may lead to more and not less inequality. There appears to be a strong correlation between progress in the current account adjustment in euro deficit countries and rising unemployment. The simultaneous occurrence of high and rising unemployment and strong adjustment efforts in several countries of the euro area could spark political contagion and intolerance for euro area constraints thus increasing the probability of bad equilibria as reforms efforts are weakened or interrupted and exit options become more attractive.

Positive forces will come from monetary policy, as long as QE is in place and its benefits outweigh possible costs, and from structural reforms, which, let's not forget, have already started to be introduced in many countries, both advanced and emerging, and should begin to bear visible fruits over the next few years.

OECD evidence shows that, if fully implemented, a “best practice” package of structural reforms, would raise the growth rate of potential output growth by as much as 0.5 percent even over the first five years in southern euro area countries. Evidence also shows that short term costs of structural reforms, in terms of, say, employment losses, could be very limited if at all, and that in some cases there could be short term gains in activity deriving from enhanced confidence. However, the overall benefits of structural reforms will be less pronounced the weaker is the phase of the macroeconomic cycle

Stronger confidence and lower uncertainty will be enhanced by the credibility of policy commitments. In part this should come as a consequence of successful policy action in avoiding the bad equilibrium. But, once the immediate crisis management phase is resolved credibility will come from long term commitments to continue the adjustment process in both fiscal and structural policies. In such a case strong institutions, such as independent fiscal councils or credible fiscal rules, could provide an additional element of support.

Indeed the ongoing sovereign debt crisis suggests that countries with strong institutions, including an effective and independent monetary policy, can enjoy market confidence beyond what would be warranted by their fiscal policy performance. On the other hand, in some cases the safe haven effect may have negative consequences to the extent that it slows down or postpones the commitment to embark in a long term consolidation process, such as in the case of the US.

Institution building is of course very relevant in the euro area. In this case, while the speed of progress has been remarkable over the past two years, it has inevitably lagged behind market impatience. However it is important to distinguish two factors affecting the speed of institutional change: the speed of the process that is needed to materially set up and implement the new institutions (A banking union does not happen overnight) from the speed reflecting a collective action failure, the difficulty of finding agreement. While the

first process, if credible, has a finite time horizon, the second is highly uncertain. In this case what we do not know is not when the process will be completed, but if it will.

Recent progress in the establishment of a crisis management mechanism in the euro area, involving different institutions, not only buys time, but more importantly shows the resolve to address major institutional weaknesses of monetary union. Its effectiveness however will have to be tested against the progress in reform implementation in countries that will require assistance, as well as the willingness of creditor countries to agree on the use of common resources. Again what is key is that all actors involved do their share. Free riding will destroy institutions even before they start.

In the emerging economies transition will be associated with catching up to a slower moving frontier, but it should also involve a rebalancing of domestic demand, while avoiding credit booms and asset bubbles. While in different domains and with different priorities the reform needs for emerging economies are just as challenging as those of the advanced economies. The macroeconomic policy space in many cases is larger than the one available to advanced economies and it should be used to contribute to avoiding a bad equilibrium in the global economy because of lack of aggregate demand.

This leads me to the last element required to generate confidence at the global level. The need to take into account international spillovers of domestic policy action. Indeed this has been and is at the heart of the G20 policy debate when looking at the issue of imbalances and, more recently, at the impact of monetary policies on capital flows and exchange rates.

While the pressure to cope with such issues may vary with the cycle it does point to the need of taking interdependence and channels of transmission more into consideration and therefore shape the policy response accordingly

### **Implications for the G20**

One of the often made claims about the G20 process is that while it performs a useful and effective role in crisis management the group is less effective when dealing with longer term issues, especially given the tendency to expand the agenda as new chairs set in. This translates into a weaker capacity to implement the policy agenda and, therefore, to contribute to confidence building

I would argue that the issue is not so much the multiplication of agenda items but, often, the lack of a clear connection between the different agenda items and especially the difficulty in making a link between the short term, which includes crisis management, and the long term.

The G20 have a powerful instrument to deal with this issue: the Framework for strong sustainable and balanced growth. It is a tool for analysis of the policy issues as it helps highlighting connections and complementarities between policy domains and countries. It is a tool for policy design and assessment as it allows to identify “superior” policy scenarios and to assess implementation and impact. It provides a link between the short term and the long term. It helps manage the transition

Of course its policy effectiveness is directly related to the effectiveness of policy commitments of member countries. But it also provides the possibility of exercising peer pressure. In this way it helps build credibility on a coherent policy response. Also for this reason costs of inaction can be very high. Markets are particularly disappointed when they see that superior solutions are feasible, yet they are not implemented. And they can derail the transition towards a sustainable long term path.

A successful management of the transition from here to there is key to avoid the global economy to be stuck in a sequence of short term episodes. It is up to the G20 to lead the transition agenda as all the G20 members, and many more, have an interest in its success.