

Sustaining Economic Growth: Outlook and Challenges

Presentation at the Bank of Greece
Athens
June 2006

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Introduction and roadmap

It is a great pleasure to speak here in Athens, and to share some of the latest OECD insights on the world economy. It is also fitting to talk about how to achieve and sustain rapid growth in living standards in this most dynamic part of Europe.

I will first set the scene by outlining the global macroeconomic prospects including some of the risks that lurk in the background of a seemingly reassuring outlook.¹ Next, I will zoom in on Europe. I will then turn to the structural reforms that are under way or that are required to deliver faster growth and convergence. In the process, I will address some of the key challenges facing Greece.

¹ See *OECD Economic Outlook No. 79*, Paris, May 2006.

The global outlook

A broadening expansion

Notwithstanding high and volatile energy prices, the global expansion is projected to continue and broaden this year and next, helped by still supportive financial market conditions – despite recent “corrections” – and in a context of contained inflation.

The US locomotive should decelerate somewhat, with growth settling around its 3% + potential rate – a baseline scenario best described as one of soft landing. The projected moderation reflects a lagged response to \$70 per barrel oil, rising interest rates and some cooling housing market exuberance.

In Europe, where the cycle is less advanced, the pace of activity is gradually picking up. However, following a series of fits and starts, the strength of the high-frequency survey data (on orders and business confidence) has yet to be corroborated by the less timely, lower-frequency national accounts data.

In the case of Greece, we see growth at around 3¾ per cent this year and next, helped by some rebound in investment following the post-Olympics slowdown. Greece is thus set to outpace the euro area average by a substantial margin. Inflation

should diminish to around 3% by next year, remaining above the euro area average and therefore still a source of competitiveness erosion.

The world's other, Asian, locomotives – China, India and Japan – are also set to decelerate a little, but should continue to expand vigorously. Growth in China and India in particular is expected to be in the high single digits.

Risks

A number of risks and tensions surround this rather encouraging outlook. Let me list only some of the most prominent ones.

Current account imbalances have reached unprecedented magnitudes, with a US deficit now at 6½ per cent of GDP, while surpluses reach 3½ per cent of GDP in Japan and 7 % in China. Granted, these imbalances have not entailed any major disruptions to date. But they can hardly persist indefinitely without prompting market-driven adjustment. Whether such an adjustment turns out to be smooth or abrupt remains to be seen. And the potential for unpleasant consequences should not be underestimated.

Energy prices have risen to historically high levels, in a context of strong demand, limited spare capacity and geopolitical tensions. They could be driven up to new

heights by new supply disruptions, with adverse impacts on activity and inflation in most OECD economies and beyond.

Long-term interest rates have already moved up significantly from their previous, unusually low, levels. If they were to continue to rise as they have lately, stalling or falling house prices would contribute to dent economic activity.

This is a somewhat long list of negatives, but there are also upside risks. In particular, the high levels of corporate profitability witnessed across the OECD area may foreshadow favourable surprises for capital formation, employment and growth.

Prospects in Europe

Let me now turn to Europe. As mentioned, the outlook is improving there, but from a modest basis.

This is particularly striking in Germany. There, activity stalled in late 2005 and picked up only moderately in early 2006 but business confidence has reached its highest levels since reunification, particularly in export-oriented sectors.

Going forward, the strength of the external environment is projected to feed through to euro area domestic demand. With growth modestly above potential over the

upcoming 18 months, unemployment will decline only slowly and from a high level of 8% of the labour force.

One of the policy priorities for many OECD countries, particularly in Europe, and especially for Greece, is fiscal consolidation. This is both to create room for fiscal manoeuvre ahead of the next downturn and to restore fiscal sustainability in the face of the looming fiscal pressures associated with population ageing. Greece's fiscal position improved significantly in 2005, with the general government deficit shrinking by 2½ percentage points of GDP. The government's commitment to bring it down to below 3% of GDP in 2006 is of course very welcome. But further action is needed, including better control over primary spending, as well as reforms of the tax system to eliminate many remaining exemptions and to further curtail tax evasion.

The need for structural reforms

Over the longer run, Europe's economic performance and that of the OECD members more generally obviously also depend on the quality of structural policies.

OECD experience

In the case of labour markets, the OECD has just published a thorough reassessment of its *Jobs Strategy*.² It shows how to get more people into paid employment and boost living standards while keeping welfare systems afloat. It stresses the need to move away from policies that discourage people from working, companies from hiring and workers from improving their skills. In addition, reforms to pension systems and alternative early retirement pathways are important not only to boost employment rates, but also to ease future fiscal pressures from ageing populations. These reforms are of course particularly urgent in a number of European countries.

Reforms in Europe

Indeed, GDP per capita in Europe at large is about 30% lower than in the US, because of lower productivity and because of the under-utilisation of labour resources. Thus, the scope for reforms can hardly be overstated. This is also true in the case of Greece, where there is substantial room for progress both on the productivity front and as regards employment rates.

First, while overall the Single market for goods works well, competition in a number of service sectors remains too lame. As you well know, pushing through the

² See *OECD Employment Outlook 2006: Boosting Jobs and Incomes*, Paris, June 2006.

EU services directive has been difficult. Yet, major welfare gains are in the offing and not just for the EU newcomers' workers.

Second, productivity gains depend crucially on human capital and in particular on the quality of higher education. Unfortunately, universities in Europe are not living up to their potential. Funding is too low, and excellence fails to be properly rewarded. There is no shortage of brilliant minds but they are locked away in under-funded, bureaucratic and rule-bound institutions – or migrating overseas. Europe should remove obstacles to their creativity. In fact, this afternoon, I will be opening the meeting of OECD Ministers of Education who will meet in Athens for two days to precisely discuss how to improve the quality, relevance and impact of higher education.

Third, productivity growth also requires that firm creation and exit not be impeded, and that the regulatory environment be business-friendly. In this regard:

- Red tape should be low, as both the European Commission and the OECD have emphasised in recent years, not just concerning national rules but also with respect to the EU-wide regulation made in Brussels.
- Product market regulations should not prevent competition. This holds especially for *de jure* or *de facto* obstacles to cross-border foreign direct investment, be it in old or new EU countries.

- Governments should refrain from sponsoring “national champions” or bailing out struggling firms via State aid or other more or less opaque forms of favouritism. Here as well, the European Commission’s vigilance is key, but there is room for national courts to more actively help safeguard the rights of firms penalised by the illegal aid granted to their competitors.

Reforms in Greece

In the case of Greece, with GDP per capita 23% below the euro area average and 46% below the US level, continued catch-up with living standards in the best-performing OECD countries is the major medium-term policy challenge. While unemployment declined to around 10%, it is still among the highest in the OECD.

Important structural reforms have been introduced lately, which should enhance productivity and improve labour market performance. Let me just mention the following ones :

- In the area of labour markets, legislation was introduced to abolish permanent contracts for new employees in all public entities and enterprises, measures were taken to reduce the cost of overtime and to promote flexible working hours, and a new law aims to smooth the integration of immigrants and to curtail the black economy. Moreover, shopping hours have been extended.

- Measures have also been introduced to improve the business environment, notably in the form of a gradual lowering of corporate tax rates, of a simplification of regulations affecting entrepreneurial activity, of new tax incentives for investment projects, and of a new framework for public-private partnerships.
- Last but not least, initiatives have been launched to enhance market liberalisation and competition, including via a stronger role for the Competition Commission, the pursuit of the privatisation programme, a new institutional framework for the complete liberalisation of the electricity market from mid-2007, and a law liberalising the natural gas market.

In addition, action has been initiated in a number of other important areas, including pensions, health and corporate governance in the public sector. That said, much remains to be done or completed. Let me highlight a few priorities:

- On unchanged policies, pension outlays relative to GDP are projected to increase more than in any other OECD country. The broad outlines of any reform should probably include: better linking of pensions to lifetime earnings; limiting statutory replacement rates to avoid pensions that are higher than the last salary; and the scaling back of early retirement for certain groups.

- The transition of youth from initial education to working life remains slow by international standards. General education should provide flexibility in the acquisition of new skills, and employers' representatives should be consulted in the design of training programmes so that they actually develop the skills that are in demand.
- Employment protection legislation remains among the strictest OECD-wide, and may have contributed to low labour turnover and to persistently high youth and female unemployment. High severance costs for white-collar workers should be brought more in line with those applying to blue-collar workers, while ensuring that there be no discrimination against part-time employment.
- Wage formation should be made more flexible by making it easier to opt out of sectoral or occupational collective bargaining agreements in regions of high unemployment.
- Non-wage labour costs need to be reduced by cutting social security contributions for the low paid.
- Self-employment rates are comparatively high but enterprise creation rates are modest, a symptom of substantial barriers to entrepreneurship. Bureaucratic requirements for start-ups should be reduced further and flanked by bankruptcy legislation reform.

Political economy of reform

As a former emerging economy finance minister, I am only too aware of the obstacles that stand in the way of such reforms. But I have also witnessed the tremendous benefits that are to be reaped.

This brings me by way of conclusion to one of the themes that were discussed at some length and with some passion at the ministerial OECD meetings last month in Paris, namely the political economy of reform. In a nutshell, and to put it bluntly, through what alchemy is it possible to reform and be reelected?

Indeed, in many countries, well-designed reforms have failed to be implemented or sustained due to the near-term political costs they entail, and the fact that opponents are vocal and well-organised while benefits tend to be more diffuse and delayed.

This points to the need to inform and convince the broader public regarding the benefits of such reforms – and the costs of the absence of reform. In this endeavour, the OECD can offer a wealth of information and analysis, based on the experience members have shared over the decades under its auspices, drawing on the expertise of its committees and staff. I invite you to take advantage of the unique strengths of this Organisation to support your economic reform efforts.

Many thanks.