Potential Output after the Crisis

Dave Turner, OECD

Meeting of NERO

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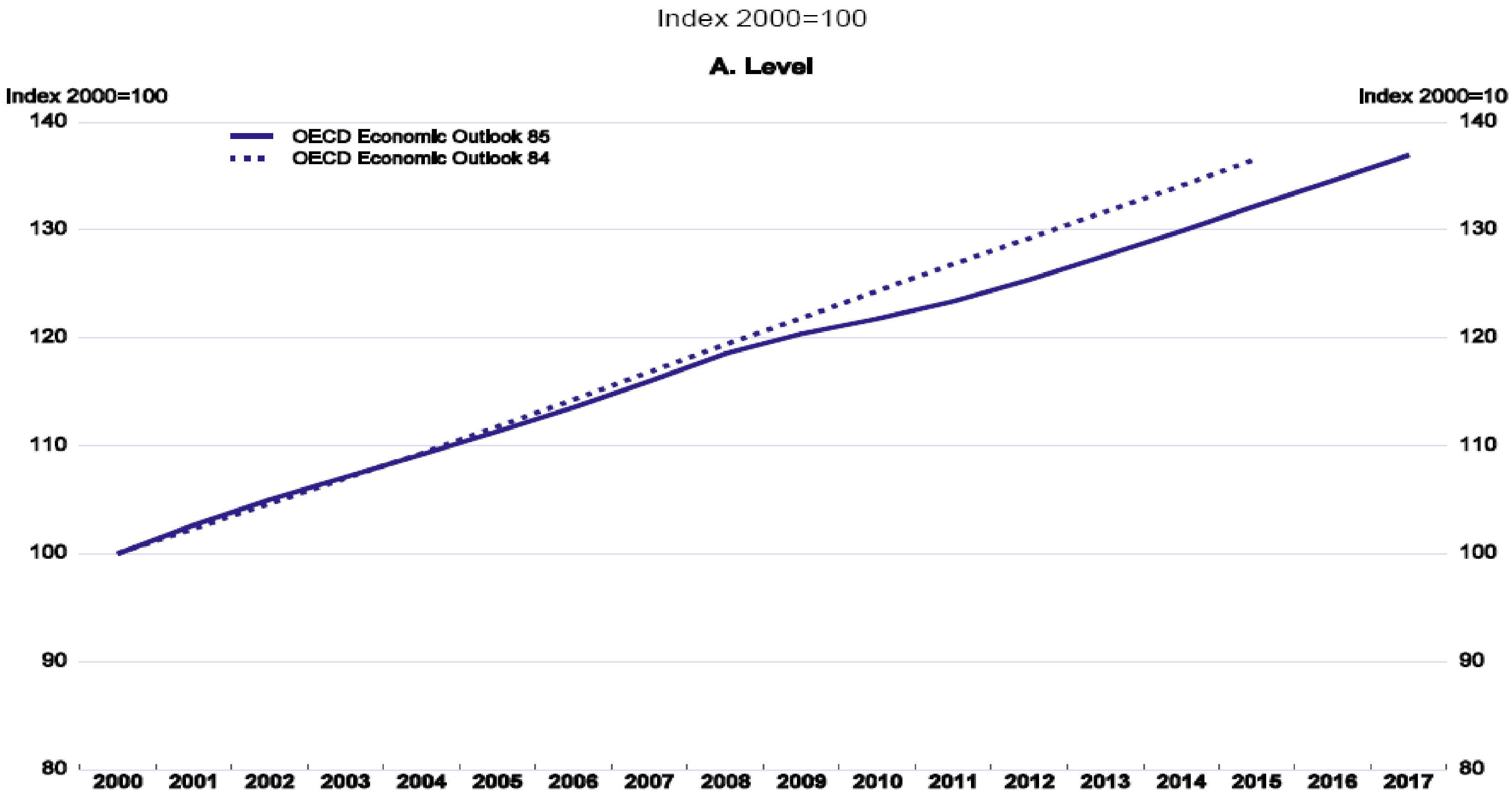
Outline

1. **OECD estimates of the hit to potential**
2. **…** estimated effects via **capital**
3. **…** estimated effects via the **NAIRU**
4. **…** likely effects via **labour force participation**
5. **…** tentative thoughts on **total factor productivity effects**
6. **Tentative conclusions**

OECD potential output is projected to take a hit of 3%

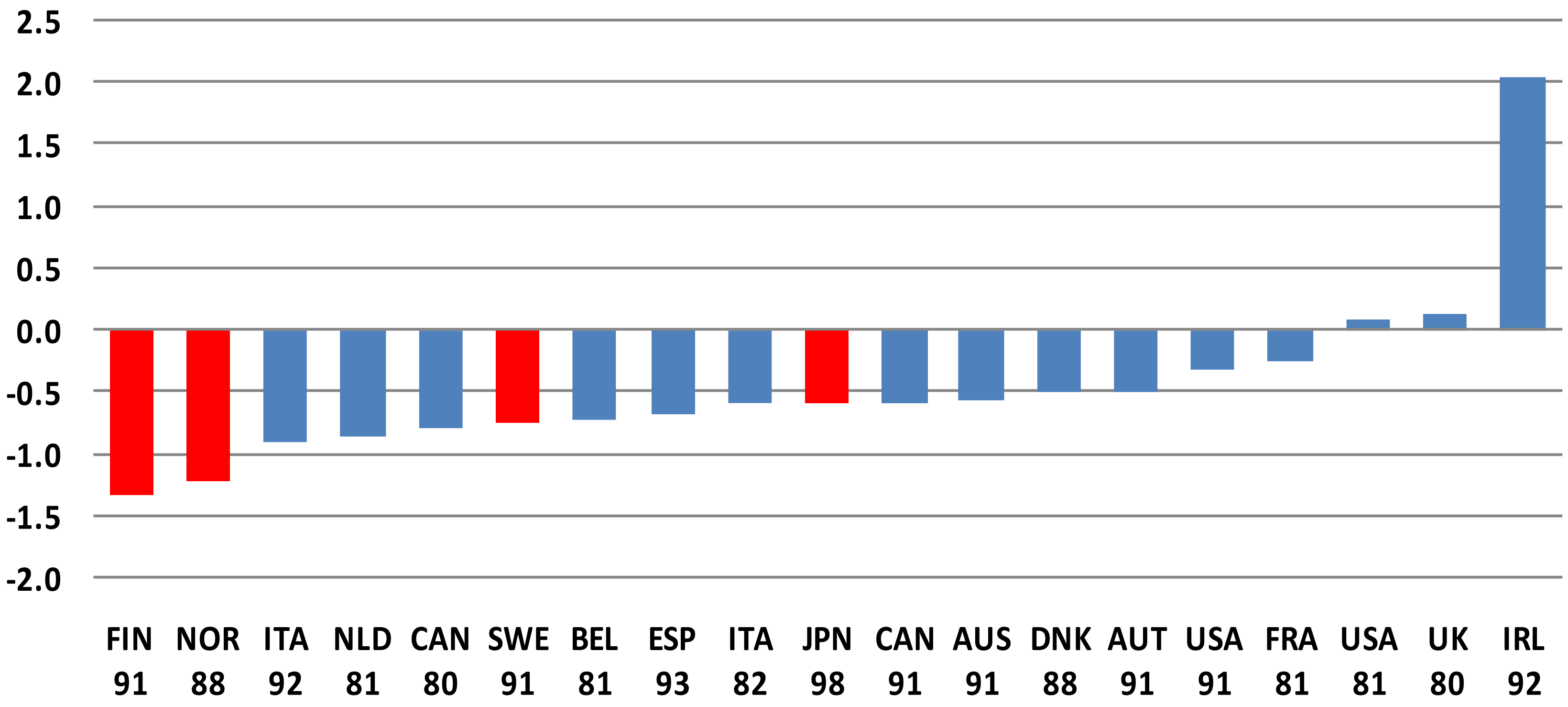
OECD estimates of hit to potential



"Levels" effect from reduced capital intensity and higher NAIRUs, see Chapter 4 of *OECD Economic Outlook* No 85.

… broadly consistent with evidence form previous severe downturns

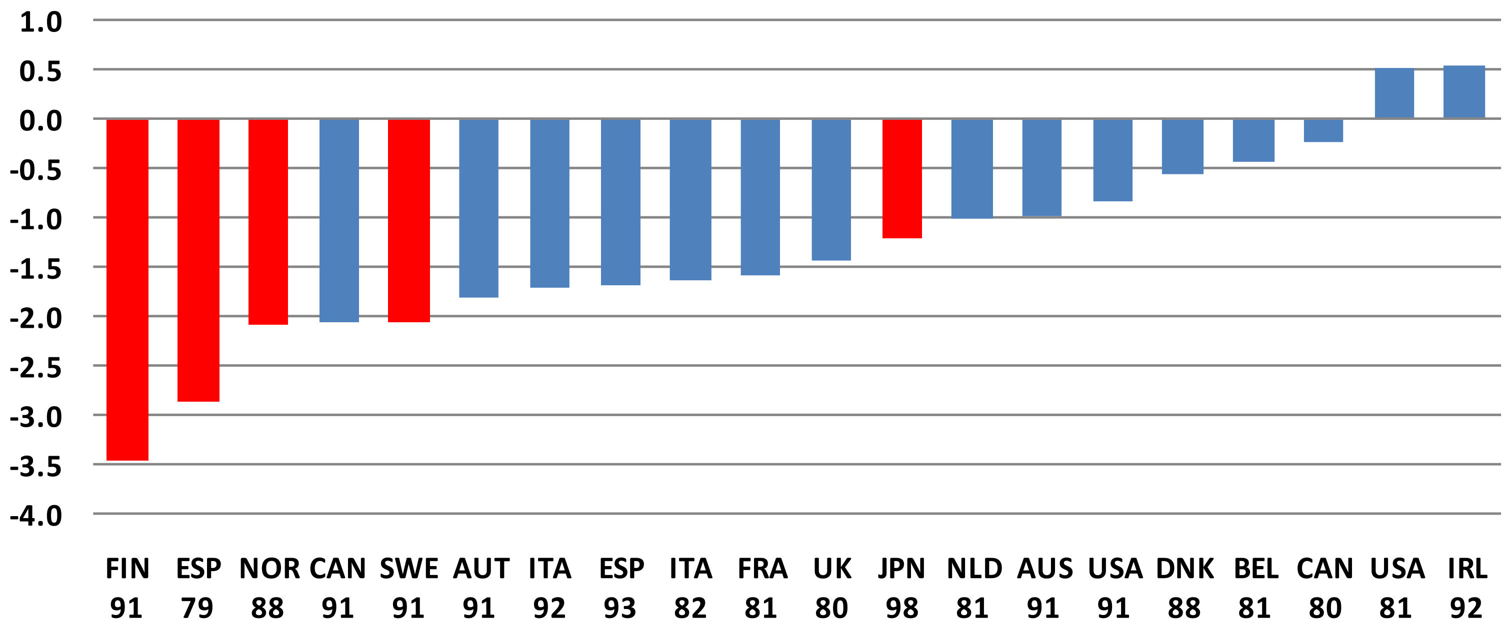
Potential output growth (% pa), 5 yrs following start of downturn compared to 5 yrs preceding it



Estimated effects via capital

Growth in the capital stock falls, particularly following banking crises

Capital stock growth (% pa), 5 yrs following start of downturn compared to 5 yrs preceding it



For current projections, long-run decline in capital intensity is based on a static equilibrium calculation of the effect of higher capital costs, reflecting permanently higher risk aversion (see Box 4.2 in EO85). Much of this adjustment is projected to have already taken place by end 2010.

Estimated effects via NAIRU

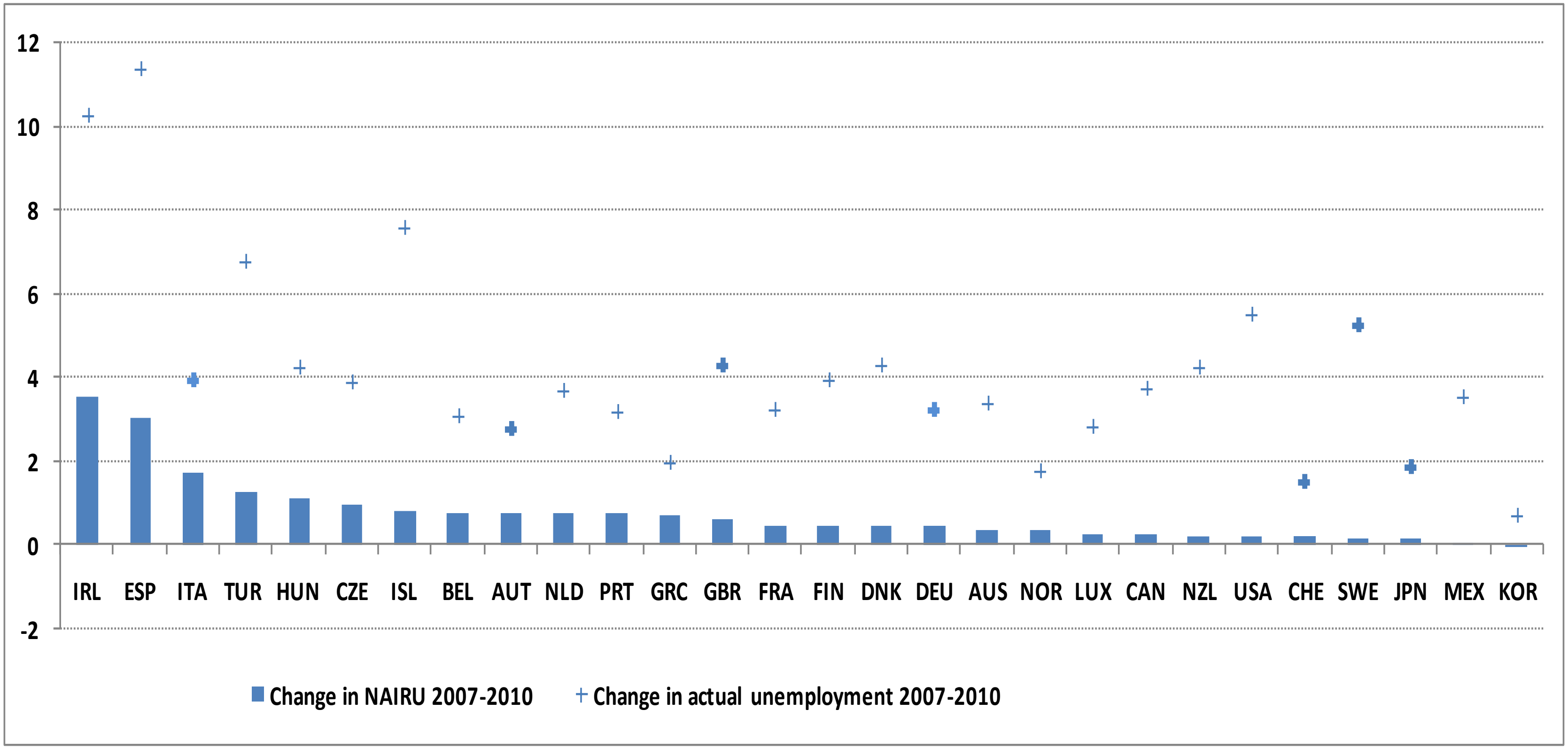
Hysteresis effects on the NAIRU vary considerably across countries

Increase in NAIRU varies according to:

➢ proportion of rise in unemployment that is translated into long-term unemployment

➢ relative effect of long-term unemployed on inflation

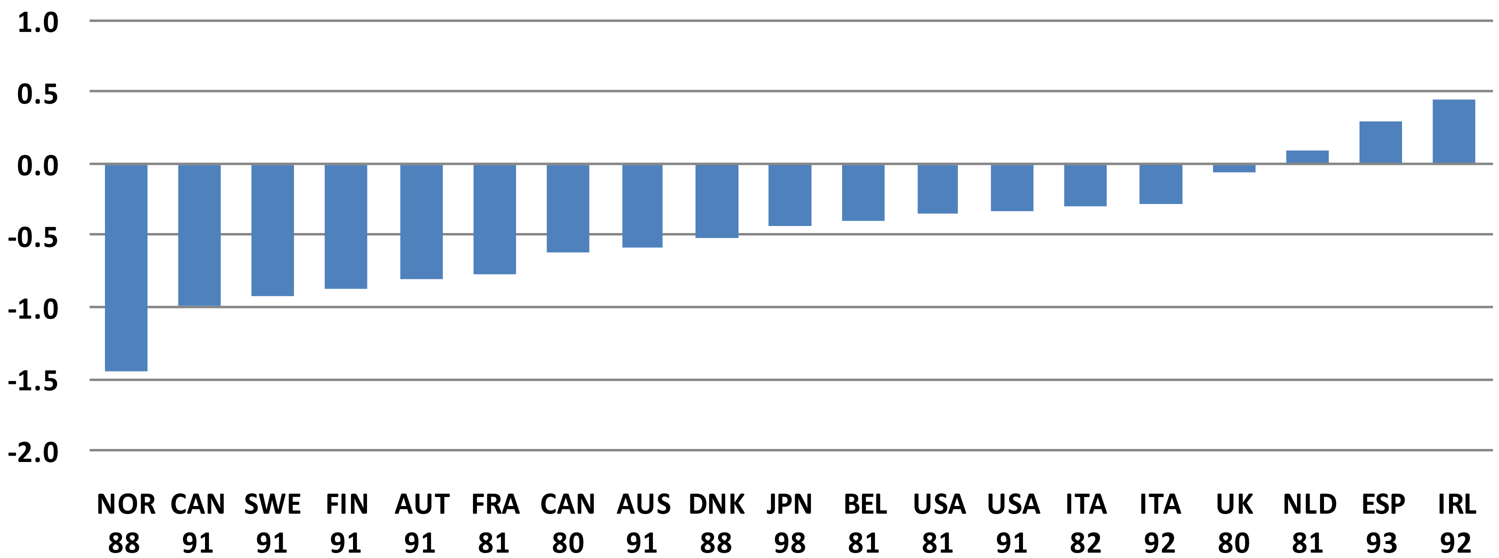
➢ Extent of recent institutional reforms (esp to EPL, unemployment benefits)



Trend labour force participation is typically reduced following severe downturns

Likely effects via participation

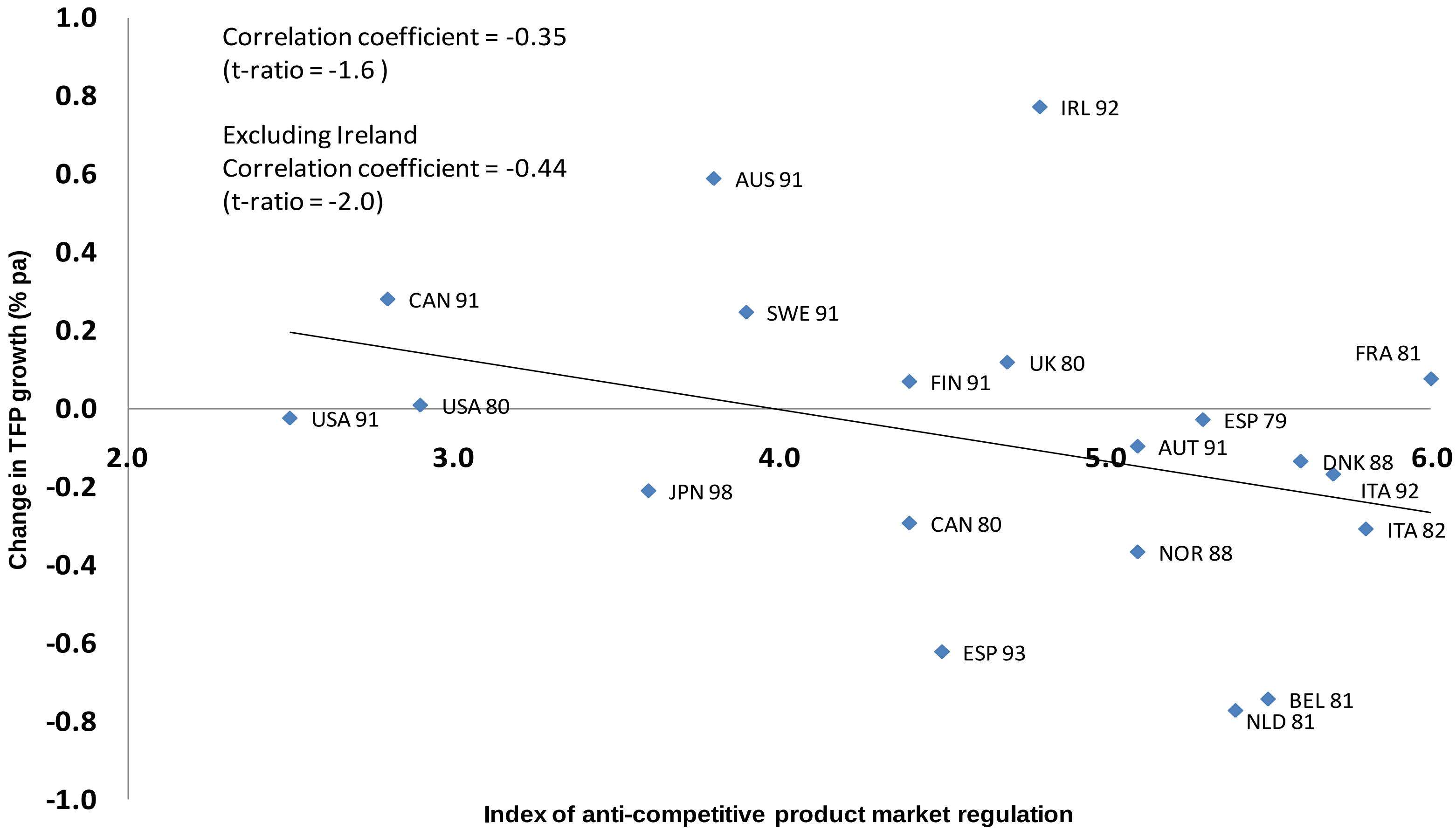
Trend labour force participation rate (%), average annual change 5 yrs following start of downturn compared to 5 yrs preceding it



Severe recessions have long-lasting effects on participation. Young often most affected (more education?). But also country-specific evidence of hysteresis–type effects.

Tentative thoughts on tfp

TFP effects are mixed, but more likely to be negative when regulation is anti-competitive



Tentative conclusions and further questions

Conclusions

- Current estimate is of a permanent fall in OECD-wide level of potential by 3% +

- Main identified effect via higher cost of capital=> capital intensity

- Hysteresis effects on NAIRU, wide cross-county variation
  - Policy dependent, different (better) this time?

- Possibly large negative effects on participation
  - Evidence from Nordics of hysteresis-type effects.
  - Young most vulnerable (but less concern if more education?)
  - But loss of pension wealth lead to retirement postponement?

- Sign & size of TFP effects difficult to identify
  - More likely to be positive if product market competition strong?
  - R&D channel probably small?
  - possibly large if endogenous growth considerations are important ???