

Editorial

Struggling with the Crisis: Structural Reforms Can Make the Difference

The uncertainty surrounding world economic prospects for the coming year and beyond is unusually high. This is largely because the course economic policies will take in major OECD economies remains unclear. Worst-case outcomes can be forestalled provided monetary policy remains very supportive, sovereign debt and banking sector problems in the euro area are contained, and excessive fiscal tightening is avoided where there is room to proceed gradually, not least in the United States. But even then unemployment would stay high through 2013, there would be no prospect of recovering the output foregone with the crisis, and public budgets would remain on unsustainable paths across most of the OECD. Even under a more optimistic scenario, underpinned by a decisive resolution of the crisis in the euro area, the need to work off the divergence in cost competitiveness among member countries could still produce economic and political headwinds. On the other hand, failing to address such divergence would keep in place the fundamental imbalances that have led to the current crisis. More generally, growth needs to be lifted in most advanced economies and made more sustainable in most emerging markets.

The structural reform priorities we have identified in Going for Growth are key to addressing these issues in OECD and non-OECD countries. In separate work we carried out as part of the G20 Mutual Assessment Process, we estimated that a broad and ambitious reform agenda could raise annual GDP growth by as much as one per cent on average across the OECD over the next ten years. In the BRIICS, product market liberalisation could deliver sizeable gains as well, both in terms of growth and global rebalancing. Productivity-enhancing reforms, not least a reduction in entry barriers in product markets, can go some way towards restoring the external competitiveness of those European countries hit by the sovereign debt crisis, provided complementary labour market reforms ensure wage moderation. More generally, growth-enhancing structural reforms should be an essential part of the policy action needed to put the euro area on a sustainable path.

Some of our Going for Growth recommendations would also mitigate risks that higher unemployment turns structural. In particular, sheltering active labour market policies from ongoing fiscal consolidation efforts – and indeed strengthening them where possible – would help job seekers find new jobs more quickly and ensure that those at risk of discouragement remain attached to the labour market. And in economies that experience renewed economic set-backs, it will be important to build on the lessons from the crisis in terms of what works to cushion the labour market impact of adverse economic shocks, such as making use of short-time working schemes and, more broadly, of state-contingent policies.

The good news is that governments are now acting more forcefully on the structural front than they did before or in the early stages of the crisis. This year's edition of *Going for Growth* provides a unique and detailed review of the policy measures taken by each country since the start of the crisis in 2007. This stocktaking exercise shows that the pace of structural reform has clearly accelerated over the past two years. Even more encouraging, this acceleration has also taken place where it is most needed, not least in some of the most affected euro area countries.

One often voiced and legitimate concern is that structural reforms could initially deepen the slump. The truth is that economic theory is thin and empirical evidence virtually non-existent on the short-term effects of reforms. Our new research, gathered in a special chapter, fills some of this gap and delivers an optimistic message: fears that reforms may depress economic activity in the short run are overblown. Indeed among the wide range of reforms we looked at, none was found to have had systematic adverse short-term effects in the past, while many quickly stimulated output and employment. At the same time, our analysis suggests that some labour market reforms can indeed be temporarily detrimental if implemented in bad times. Where possible, these should wait until the labour market improves decisively, and be preceded by product and financial market reforms. Another important implication of our analysis is that a comprehensive reform package is necessary to alleviate the adverse short-term effects of some reforms while contributing to kick-start the economy, especially through investment induced by stronger product market competition. In any event, effective communication and consensus building are of the essence to foster the confidence households need to take advantage of reform-driven income gains.

Another legitimate concern is that reforms may harm the least well-off. Income inequality was already on the rise in most OECD countries before the crisis, and it has likely risen further in its aftermath. It is also a major issue in the BRIICS. Two special chapters in this report yield encouraging lessons regarding what reforms do to inequality both in the long term and in the wake of macroeconomic shocks like financial crises. We find that several reforms, notably enhancing the quality and equity of secondary education, liberalising product markets and making employment protection legislation more uniform across workers, appear to have favourable growth and distributive impacts. Some tax reforms can also be beneficial on both grounds. Starting with a drastic cut in tax expenditures would seem especially warranted at the current juncture, not least since it would also help fiscal consolidation. Now not all growth-friendly reforms would yield such double or triple dividends, of course. In particular, it remains challenging to design tax and transfer systems in ways that are conducive to both higher growth and lower inequality. For one, the experience of some Nordic countries shows that it can be done. And again, broad reform packages including win-win policies could deliver on both goals.

As mentioned at the outset, the global economy could take different paths in the coming months depending on the decisiveness and effectiveness of policy action. While this requires appropriate and possibly bold contributions by macroeconomic policies, structural reforms are necessary both to accelerate the exit from the deep phase of the crisis, especially in some regions, and to make longer term growth stronger, more sustainable, and possibly less unequal.



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