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The negative impact of the financial crisis on potential output necessitates an EU-led policy response

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The crisis may reduce the EU's potential output by 5% of GDP or more. This column warns that the crisis may permanently reduce the EU's supply-side capacity unless policymakers respond with reforms. It outlines measures to address the crisis and address long-run concerns about demographic shifts, public finances, and climate change.

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The IMF's most recent forecasts project that the EU's GDP will fall 4.7% this year and continue to shrink (-0.1%) in 2010 (IMF, 2009). Financial market turbulence, credit shortages/deleveraging, higher unemployment, and steep reductions in activity in certain industries as resources reallocate will inevitably lead to a non-negligible short-run (i.e. 2009/2010) loss in the supply-side capacity of EU economies. However, the repercussions for potential output over the medium and long run are much less certain and depend on an assessment of the various channels through which the crisis could impact labour market developments, investment, and the rate of technological progress (TFP growth).

For labour markets, the key determinants are the time needed to reallocate the newly unemployed into alternative employment posts in expanding industries and whether countries can avoid "hysteresis effects" whereby a severe loss in human capital endowments, induced by long spells of unemployment, leads to long-lasting exclusion from the labour market. Investment has already fallen dramatically in the crisis, resulting in a slowdown in the rate of accumulation of productive capital. This, when combined with higher rates of capital obsolescence, is lowering potential growth in the short to medium run. In addition, these adverse effects could persist in the long run if the cost of capital is permanently increased due to changes in attitudes towards risk amongst investors. These developments can also affect the rate of technological progress in the long run, if, for example, they reduce the incentive to engage in innovative activities.

It is useful to distinguish the impact of the crisis on the *level* of potential output in the long run from the impact on long-term potential *growth rates* (ECFIN 2009). If potential growth rates eventually return to their pre-crisis path, the only permanent effect will be on the level of potential output – the magnitude of this level effect will depend on the amount of growth "lost" in the immediate crisis period and the time needed for activity to recover towards its long-term path. This is illustrated in Figure 1 as a "permanent level loss" scenario (i.e. case 2), and is the broad outcome observed for Korea since 1997[1]. A more optimistic "full recovery" scenario is also feasible if "lost" growth is fully recouped in future years: examples include Mexico (1994), Sweden (1991), and, to lesser extent, Finland (1991). However, there is also a risk that the long-term path of potential growth in the post-crisis era will be permanently lower, either as a direct consequence of the crisis (e.g. shift in risk aversion, insufficient R&D and innovation) or due to inappropriate policy responses. This is shown as a "continuous widening loss" scenario (case 3), as was the case in Japan (1991) and Thailand (1997).

Figure 1. Financial crisis and potential output: Three possible cases
Case 1. Full recovery

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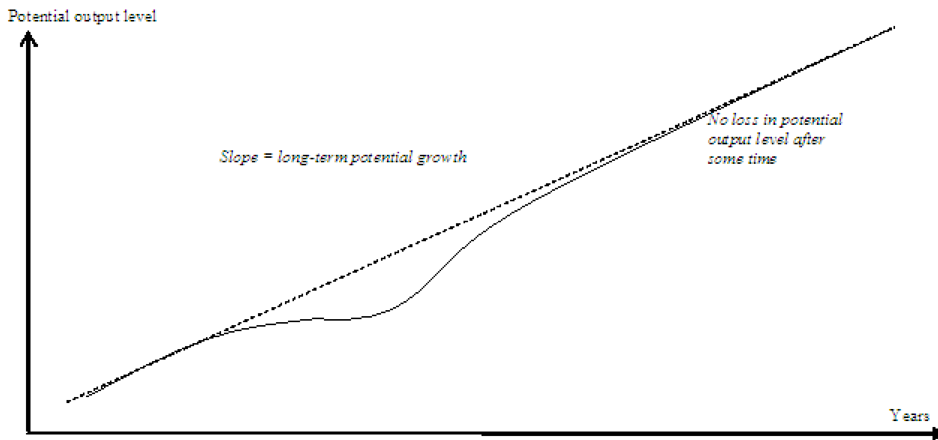
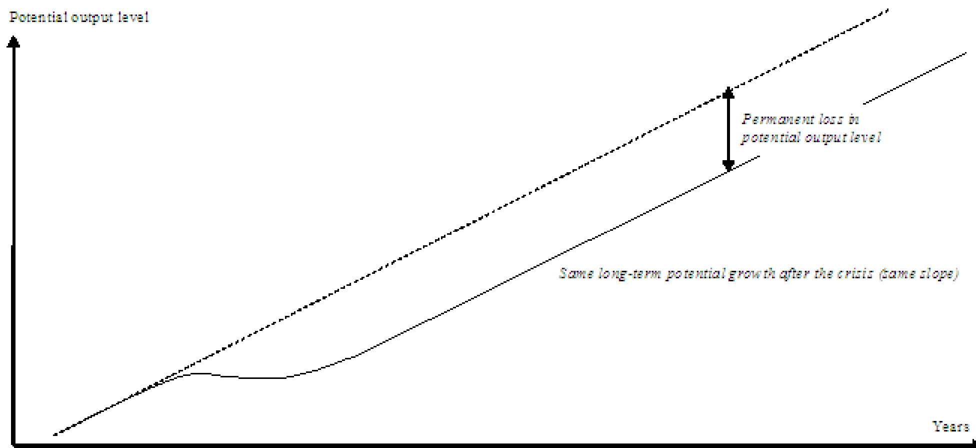
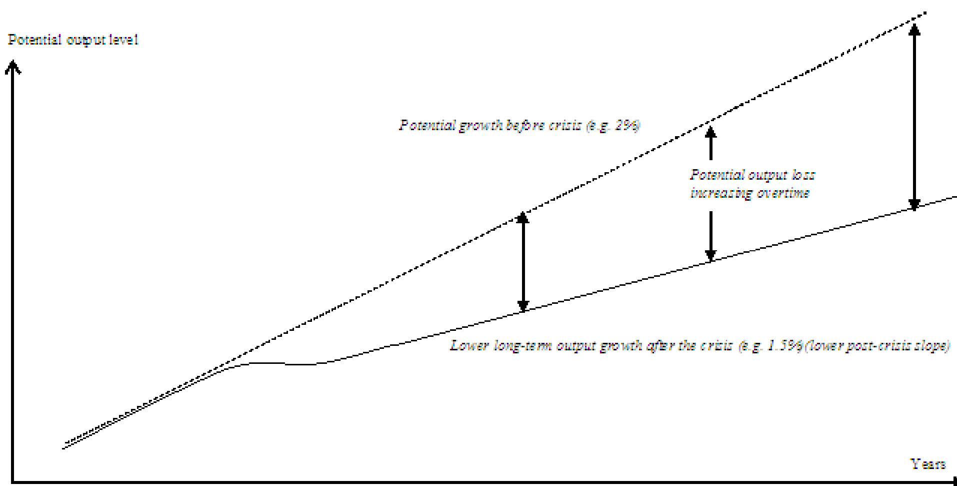


Case 2. Permanent loss in potential output level, no change in long-run potential growth



Case 3. Continuous widening loss due to lower long-run potential growth



Expect significant losses in potential output over the long run

According to ECFIN estimates of the short-term impact, the severe economic crisis will lead to a sharp downward revision in potential growth rates. These estimates indicate that the potential growth rate of the EU in 2009/10 will be cut in half compared with 2008 (i.e. from around 1.5% to 0.75%) due to increased structural unemployment, a substantially reduced contribution from capital accumulation, and moderate growth in technological progress (total factor productivity).

The effects in the medium to long term are more uncertain. Nevertheless, simulations with the Commission's QUEST III DSGE model based on "realistic" assumptions (i.e. a quasi-permanent deterioration in financing conditions, with borrowing costs staying on average 1-1.25 percentage points higher over the next 20 years compared with the pre-crisis period) point to the possibility of a slow recovery in the EU's medium-term potential growth rate (a point of view shared by recent OECD & IMF analyses), as well as highlighting the risk of a long-run, cumulated, loss in potential output of around 4.5% of GDP. In addition, the simulations suggest that permanent losses in the potential growth rate could materialise due to the negative impact of the higher borrowing costs on intangible investments

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(R&D, innovation, and ICT capital) and consequently the rate of technological progress. EU economic policies in the years to come should therefore assume a permanent loss in potential output of the order of 5% of GDP as a result of the crisis.

What can we learn from past crises?

Past episodes of financial distress point to several useful insights on the possible impact of the present crisis on potential growth:

- First, crises due to financial distress are characterised by losses in output and employment that are twice as large as those from "classical" downturns, and moreover they can weigh on long-term growth rates. The prompt resolution of problems in the banking sector is fundamental to minimising the effects of the crisis on potential output over the long run;
- Second, the impact of crises on long-term potential growth has been very mixed. TFP growth rather than labour market performance explains the different outcomes across countries;
- Finally, and most importantly, policy responses matter greatly. For example, Sweden and Finland reversed their economic fortunes and benefited from accelerated potential growth rates, due in large part to the TFP-enhancing restructuring and innovation policies pursued by both governments.

Overall, both ECFIN estimates of the impact of the present crisis and the analysis of past crises point to the strong likelihood of a large negative impact on potential output in the short run, followed by a prolonged period of slow growth as economies adjust to their post-crisis growth paths. Whilst it is too soon to draw definitive conclusions, a "permanent level loss" (case 2) in potential output seems plausible, i.e. the economy eventually returns to its pre-crisis potential growth rate but fails to recoup all of the "lost" output. In addition, the risk that the crisis will have a negative impact on long-run potential growth rates (case 3) cannot be excluded, especially if financial conditions remain more restrictive in the long run, thereby negatively impacting R&D investments, TFP growth, and incentives to reform.

Five priority areas to boost potential output, prepare for ageing, ensure public finance sustainability, and address climate change

The central lesson from the Great Depression and from Japan in the 1990s is that the first policy priority must be to ensure that the financial sector is reformed and recapitalised so that it can resume performing its vital intermediation function. Absent that, years of slow growth are practically unavoidable as "zombie banks" struggle to survive without contributing to growth.

Beyond this, however, the lessons from past experiences and economic analysis indicate that a convincing policy agenda aimed at strengthening the supply side of the economy ought to be drawn up and implemented rapidly. Failure to do so would further aggravate the situation and make it even more difficult to "exit" at a later stage. Developing such a structural reform agenda will also require coherence, with the need to simultaneously address the other key long run challenges facing the European economy: demographic ageing, the need to ensure sustainable public finances, and the fight against climate change (Koopman and Székely, 2009).

1. Avoid the damaging policy mistakes of past crises

The pressures to mitigate the short-run effects of the crisis increase the risk that governments might repeat the policy mistakes of past crises. Governments should resist these pressures, especially with respect to measures that can severely harm potential output over the medium to long term. Governments should avoid protectionism, any measures that lower labour market participation rates (such as early retirement schemes), and any short-term policy responses to the crisis that prevent essential restructuring from taking place or undermine the commitment to sustainable fiscal policies. Similarly, they should resist pressures to defer current reform efforts aimed at stimulating productivity, labour market participation, or promoting sound public finances.

2. Improve the EU's labour market

Past crises have shown that labour markets can significantly affect potential growth by negatively impacting human capital. Reforms to reverse such a trend are currently essential due to the imminent shrinkage of the labour force as a result of demographic ageing and, to a lesser extent, the present recession. The following reforms are vital in this regard:

- Firstly, segmented labour markets, with high protection for insiders and limited protection for workers on fixed-term contracts, have led to low structural employment rates, skyrocketing unemployment in the present crisis, and the marginalisation of certain groups. Such structures need to be reformed in line with the "flexicurity" approach that shifts the emphasis to equipping workers to operate in more flexible labour markets.

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- Secondly, tax and benefit system reforms are crucial to reducing benefit dependency by making work economically attractive. A reduction in the disincentives to work and to hire and a greater link with targeted active labour market policies will contribute to an improvement in the functioning of labour markets. In addition, by establishing a better link between the duration and, possibly, the generosity of unemployment systems on the one hand and the business cycle on the other, unemployment systems could also provide a stronger macro-economic "stabilisation function".
- Finally, reforming disability and early retirement schemes and increasing the effective retirement age remain priorities for increasing the labour supply of older workers and contributing to sustainable economic growth in the face of adverse demographic developments.

3. Use Europe's Single Market as an engine for restructuring in Europe

Crises tend to lead to a significant restructuring of economic activities – both between and within industries – which turns out to be of crucial importance in boosting productivity. Therefore, once economic growth resumes, short-term measures aimed at preventing viable companies from failing during the crisis should be removed quickly. In the European context, the efficient functioning of the Single Market will be essential in ensuring that industries can restructure on a European scale, thereby benefiting from economies of scale and scope.

Following good progress in facilitating market "entry" during recent years, the emphasis must now be placed on facilitating "exits" and "churn". The vigorous implementation of competition policy and the removal of the remaining obstacles to competition will be very important in this respect. Consequently, key EU industries need a careful, evidence-based assessment of obstacles (based on market-monitoring tools) coupled with a strong determination to remove such obstacles. Also, the implementation of the services directive by the end of 2009 will be fundamental in opening up a large and hitherto somewhat-shielded chunk of the EU's economy.

4. Reform Europe's knowledge triangle (education, R&D and innovation) and healthcare systems

Reforms aimed at ensuring a modernisation of the framework conditions underpinning the EU's knowledge economy are essential in boosting (total factor) productivity. This will be particularly important since the crisis could permanently impair R&D due to changes in the financial system. Policies to stimulate Europe's R&D and innovation systems need to be pursued, especially since there remains significant potential for further improvement in many Member States. Making the European Research Area a success will, therefore, be an essential pre-requisite. Also, a high level of educational attainment, associated with a productive, skilled, adaptable workforce, is a precondition for lifelong learning (and for higher labour market participation rates). Finally, there is considerable scope for making healthcare and long-term care systems more efficient and thereby raising productivity. Given that these industries represent some 8% of EU GDP and are highly dependent on public operating frameworks, effective policies could have significant macroeconomic effects.

Increasing the long-run productive capacity of an economy does not come for free – it requires considerable investments in infrastructure, human capital, R&D, and innovation. In the presence of constrained public finances, some of the constraints may be relaxed by raising the efficiency and effectiveness of public spending and strengthening the role of the private sector in areas such as health, long term care, education, R&D, and innovation.

5. Develop and deploy “green” technologies to address climate change

One of the biggest challenges for the world economy is to fight climate change, which in the long run means "decarbonising" our economies. The European Union has set ambitious targets for reducing greenhouse gas emissions by 2020. It is clear from extensive analysis and modelling work that technology will have to play a major role in reaching such objectives. In addition, well-designed and targeted innovation policies in the area of "green technologies" could play an important role in stimulating TFP growth and boosting investment coming out of the present, deep economic crisis.

Furthermore, many of the existing environmental technologies are beginning to mature, with a significant additional efficiency potential being available due to economies of scale and learning curve effects. A decisive push for the development of such technologies and their deployment through market mechanisms (in the industries covered by the EU's emission's trading system), in combination with standards and incentives (for households, buildings, and transport), would lead to significant capital formation by businesses and households and would provide a boost to TFP. Developing such a strategy would require careful design – notably with regard to its institutional structure and the need to find the right balance between targeting specific technologies and avoiding a strategy aimed solely at picking "technological winners".

Concluding remarks

The present crisis will reduce EU potential output by about 5% of GDP. Such a decline will manifestly have major implications for citizens and companies. These losses could be significantly larger if the underlying financial market problems are not speedily resolved or policymakers repeat the mistakes of the past. This assessment highlights the urgent need to develop a EU-level policy agenda aimed at boosting potential output. Furthermore, it is the considered view of the authors that a determined effort to simultaneously address, in a coherent manner, the EU's main medium- to long-run policy challenges could yield rich dividends – not just in terms of potential growth but also in rallying public support behind the priorities for reforms which we have set out in this column.

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1 Examples of different post-crisis scenarios for potential growth were made by the IMF's chief economist, Olivier Blanchard, in a presentation to a conference on long-term investment in Paris on 22 June 2009.

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