Global Letter Economic recovery and resilience

The principal determinant of the strength of recoveries will be the quality of structural policies

Growth rates of GDP as economies climb out of their COVID-19-induced troughs are all very exciting. But more important will be those, for output and even more for productivity, at which economies settle once they approach more normal levels of capacity utilisation.

After all, the period from 2008 to 2019 was characterised by slow growth, low investment relative to desired savings, sub-target inflation, and near-zero nominal interest rates. Will that be the sort of performance to which economies revert, or will the world prove to have changed in some way or ways that change this underlying trend, one way or the other?[1] And specifically, how resilient may economies prove to be in the course of the forthcoming green and digital transformations?

Past evidence

In assessing this issue, it is worth recalling three stylised features from past episodes:

- **The cost of recessions.** Invariably, recession results in some permanent loss of GDP. Output seldom reaches its prior (extrapolated) trend line:[2] and moreover, growth during the first four years of recovery is typically between ¼ and ½ of a percentage point slower than the average of all expansion years.[3]
- **Recovery from recessions.** Structural reforms[4] not only boost the growth of GDP and of productivity[5] in general;[6] they also reduce significantly the extent of the output loss after a shock.[7] Reforms that increase product market competition and improve the ability of workers to move between jobs are particularly potent.
- **The importance of investment**. The principal reason for much of this is of course that economic growth is endogenous: investment is typically hit hard during recessions, labour skills atrophy, and the growth of productive potential is thereby reduced.[8]

Of course, no two recessions are alike: each has its own unique features.[9] But these stylisations, derived from evidence from over 150 countries, describe quite general properties of economic behaviour in recessions.

Hence four basic questions

1. **Will structural policies prove important** in determining post-COVID outcomes?
   - Our prior is that they will. It would be surprising were the specifics of this recession to overrule such basic, longstanding, pervasive, characteristics.[10]
2. **Will performance across countries diverge**, given the pace of structural change necessitated by the combination of the digital and the green transitions?
   - Our prior is 'Yes', and that it will be the quality of individual countries' structural policies, particularly competition[11] and labour market,[12] that will determine much of the divergence.
   - The gap between advanced economies and developing countries in particular is likely to widen. EMs are lagging with their vaccination roll-outs, have had more limited policy support, and generally have weaker structural policy settings.
3. Our analysis ranks the Nordic economies highly, puts most of the big OECD economies in the middle of the pack, while southern European countries rank particularly poorly.[13] **Will US investment and productivity pick up strongly** compared with other countries, given the strong growth to which its large fiscal boost is giving rise?
   - Our prior is 'Yes', in the belief that the 'accelerator' is a proven, powerful, and ubiquitous phenomenon.
4. **Will climate change boost investment generally**, by accelerating scrapping of a significant part of the existing capital stock, and replacing it by carbon neutral investment as climate change regulations start to bite?
   - Our prior is 'Maybe' – and most likely a 'Yes' in the economies that have the best structural policies.[14]■

[1] Thus the World Bank observes in its latest *Global Economic Prospects* that "*Past recessions were typically followed by several years of disappointing growth outcomes and downgrades of long-term growth expectations*." And that "*As a result of the pandemic, the slowdown in potential growth over the 2020s may be 0.3 and 0.6 percentage points steeper for the global economy and EMDEs (Emerging Market and Developing Economy), respectively, than anticipated before the pandemic – unless effective policy action is taken or major technological advances materialize*." See World Bank, 2021. *Global Economic prospects.* January. p. 117 and the studies cited therein. Available online. [Accessed 10 January 2021]

[2] The late Christopher Dow, the father of such analysis, showed in 1998, using UK data, that following a recession GDP typically never got back on to its (extrapolated) pre-crisis trend line – rather the recovery levelled off somewhere below it, so that some output was permanently lost. See Dow, C., 1998. *Major Recessions: Britain and the World, 1920-1995.* Oxford University Press. Later studies for many other countries confirmed this basic finding.

[3] This conclusion was based on an analysis of two principal data sets, consisting of panels of annual observations spanning 192 countries from 1960 to 2001 for the World Bank dataset, and 154 countries from 1960 to 2000 for Penn World Tables dataset. These are the two broadest datasets available and common in the literature. See Cerra, V., and Saxena, S., 2015. *Growth Dynamics: The Myth of Economic Recovery*. IMF Working Paper WP/05/146 p. 23. Available online. [Accessed 1 January 2021]

The authors subsequently updated this data set, and reached similar conclusions: " *… recessions are typically not followed by high-growth recovery phases, either immediately following the trough, over several years of the subsequent expansion, or even over the complete subsequent expansion that follows a complete recession."* See Cerra, V., and Saxena, S., 2017. *Booms, Crises, and Recoveries: A New Paradigm of the Business Cycle and its Policy Implications.* Available at [Booms, Crises, and Recoveries: A New Paradigm of the Business Cycle and its Policy Implications (imf.org)] [Accessed 24 May 2021]

In an earlier, equally monumental, study of 190 countries, the same authors find that balance of payments (BOP) and banking crises, *on average*, generate a permanent loss in the *level* of real output. On average, the magnitude of the persistent loss in output is about 5 percent for BOP crises, 10 percent for banking crises, and 15 percent for twin crises See Cerra, V., and Saxena , S., 2008. *Growth Dynamics: The Myth of Economic Recovery.* American Economic Review, 98(1): March: 439-457.

A further implication of the failure of output to revert to its (extrapolated) trend line is that countries experiencing multiple shocks tend to fall even further behind.

[4] Structural policies are taken to be those that "*encourage, or at least do not inhibit, the flow of resources from declining and less productive activities to growing and more productive activities*". Structural policies are important in a wide range of policy areas, including: labour and product markets; public investment and infrastructure; fiscal structural reforms; natural resources and subsidy reform; and international trade.

[5] Structural policies are of course not the only policy determinant of economic performance – demand side policies, quality of institutions (for example central banks), trading arrangements and more all have an influence. And causation of course may run in both directions: just as structural reform contributes to good economic performance, so also, in a virtuous circle, does good economic performance make it at least somewhat easier to press ahead with structural reform.

That is not to say, however, that putting structural policies in place is easy. On the contrary: while well-constructed and well-implemented structural reform generally benefits the economy and the labour force as a whole, it almost inevitably results in some people losing. This can provoke political resistance, on occasion strong. If the business of sharing the aggregate gains fairly is not addressed, the results can be resistance, populism, or even worse. Moreover, in some cases the benefits of structural reform have accrued – or are perceived as having accrued – to the already well-off, to the corporate sector, and to owners of real and financial assets.

[6] The IMF finds that "*Large-scale reforms … demonstrate a generally positive relationship with post-reform productivity growth*." See IMF, 2015. *Structural reforms and macroeconomic performance: initial considerations for the Fund.* Especially pp. 19-20. Available at [Structural Reforms and Macroeconomic Performance: Initial Considerations for the Fund; IMF Policy Paper, October 13, 2015] [Accessed 24 May 2021]

[7] These conclusions were reached on the basis of a detailed econometric analysis. The effects are not only statistically significant, but also quantitatively important: a difference in the OECD's product-market regulation (PMR) indicator of one standard deviation is typically associated with a difference in output losses of 2½ percentage points. The reason is the straightforward one that "*More flexible product markets … allow[s] for an easier reallocation of resources across firms and sectors in the aftermath of an adverse shock*." See Ollivaud, P., and Turner, D., 2015. *The effect of the global financial crisis on OECD potential output*. p. 42 and Table 2, p. 54. Available at

https://www.oecd.org/economy/growth/the-effect-of-the-global-financial-crisis-on-oecd-potential-output-oecd-journal-economic-studies-2014.pdf [Accessed 23 December 2020]

[8] Indeed, the IMF has found, for a panel of more than 100 countries over a range of time horizons, a positive correlation between structural policy settings and investment growth: see for example IMF, 2015. *Structural reforms and macroeconomic performance: initial considerations for the Fund,* especially p. 20, para. 25. Available at https://www.imf.org/external/np/pp/eng/2015/101315.pdf [Accessed 27 May 2021]

[9] This time, financial sector disruptions, which events as recent as 2008 have shown to be particularly devastating, and have particularly long run economic consequences, have been contained. And fiscally-supported furlough schemes in many countries have kept workers attached to their place of employment, facilitating their return to work.

[10] The output lost this time may be less than after 2008, partly because this was not a financial crisis; and partly because the policies followed were generally more supportive. Thus the IMF: "*Taking into account this uncertainty, the medium-term (five-year horizon) outlook in the current forecast envisions output losses, relative to pre-pandemic projections, of about 3 percent for the world economy ... By comparison, the lasting damages over a comparable period from the global financial crisis were larger, at almost 10 percent for the world as a whole*." IMF, 2021. *World Economic Outlook: Managing divergent recoveries.* P. 53. Available at World Economic Outlook, April 2021: Managing Divergent Recoveries (imf.org) [Accessed 26 may 2021]

[11] The OECD notes that "*Enhancing competition policy is one of the most frequent recommendations in the area of product markets regulation*": see OECD, 2021. *Going for growth: Shaping a vibrant recovery*. P. 31. Available at Going for Growth 2021: Shaping a Vibrant Recovery (oecd.org) [Accessed 26 May 2021]

[12] Particular important is supporting people through transitions. See OECD, 2021. Op. cit. p. 20.

[13] Four economies are measured as having the best structural policies overall – Finland, Switzerland, the Netherlands, and New Zealand; and they are followed by Japan and Great Britain. Interestingly, among the G7 economies, only Japan and the UK are in the top 10. Particularly striking is that the US scores just below Canada and Germany. France has an average score, while Italy is the lowest-placed major economy. The Nordic economies generally score well above the OECD average. Some other smaller economies too appear relatively well placed – Chile and Estonia arguably 'punch above their weight'. Southern European economies, however, generally rank relatively poorly. Spain and Portugal, for example, score lower than Chile. The 'bottom' group includes Mexico, Turkey, and Greece.

	FIN	CHE	NLD	NZL	JPN	GBR	DNK	SWE	NOR	LUX	AUS	CAN	DEU	USA	AUT	EST	BEL	FRA
1. Institutions	5.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	3.0	3.0	3.0	3.0	3.0	3.0
2. Infrastructure	3.3	3.7	4.0	3.0	3.7	3.0	3.7	4.0	3.7	3.7	2.7	3.3	3.0	3.3	3.0	3.7	3.0	3.7
3. Human capital	3.7	4.3	3.7	3.7	4.2	3.5	3.3	3.3	3.5	3.5	3.5	3.8	3.5	3.5	3.3	3.3	3.3	3.0
4. Market regulation	4.0	3.0	5.0	4.0	3.0	4.0	4.0	3.0	3.0	3.0	4.0	3.0	4.0	3.0	4.0	4.0	3.0	3.0
5. Labour market efficiency	3.0	3.7	3.0	4.3	3.0	3.3	3.7	3.0	3.3	3.0	3.7	3.7	2.7	3.3	3.0	2.3	2.0	2.7
6. Innovation	4.0	4.3	3.7	3.0	3.7	3.7	3.7	4.0	3.7	3.7	3.3	3.3	4.0	3.7	3.3	3.0	3.7	3.0
7. Financial market efficiency	4.0	4.0	3.0	4.0	4.0	4.0	3.0	4.0	4.0	4.0	3.0	3.0	4.0	4.0	3.0	3.0	4.0	3.0
Total score (higher = better)	**3.9**	**3.9**	**3.8**	**3.7**	**3.6**	**3.6**	**3.6**	**3.6**	**3.6**	**3.5**	**3.5**	**3.5**	**3.5**	**3.4**	**3.2**	**3.2**	**3.1**	**3.0**
Standardized total score	1.4	1.4	1.2	1.2	1.0	1.0	1.0	1.0	1.0	0.9	0.7	0.7	0.7	0.7	0.4	0.3	0.2	0.1

	IRL	KOR	CZE	ISR	LIT	CHL	PRT	SVK	ESP	SVN	LAT	POL	HUN	ITA	GRC	TUR	MEX
1. Institutions	4.0	2.0	2.0	3.0	2.0	3.0	2.0	1.0	2.0	2.0	2.0	2.0	1.0	1.0	2.0	2.0	1.0
2. Infrastructure	2.0	3.7	3.0	2.0	3.3	1.7	3.0	2.3	3.0	3.0	3.0	2.7	2.7	2.3	2.7	2.3	1.3
3. Human capital	4.0	3.5	3.0	2.8	2.8	1.8	2.2	2.3	2.3	3.2	2.7	2.8	1.8	2.2	2.0	1.2	1.3
4. Market regulation	3.0	2.0	3.0	1.0	3.0	3.0	4.0	4.0	3.0	2.0	3.0	2.0	4.0	4.0	2.0	1.0	2.0
5. Labour market efficiency	3.3	3.7	2.3	3.3	2.3	3.7	2.7	2.3	2.7	2.3	2.0	3.0	2.7	2.0	2.7	2.7	3.0
6. Innovation	3.0	3.7	3.0	4.0	2.7	2.0	2.3	2.7	2.3	2.7	2.0	2.0	1.7	1.7	1.7	1.7	1.7
7. Financial market efficiency	2.0	2.0	3.0	3.0	3.0	3.0	2.0	3.0	2.0	2.0	2.0	2.0	2.0	1.0	1.0	2.0	2.0
Total score (higher = better)	**3.0**	**2.9**	**2.8**	**2.7**	**2.7**	**2.6**	**2.6**	**2.5**	**2.5**	**2.5**	**2.4**	**2.4**	**2.3**	**2.0**	**2.0**	**1.8**	**1.8**
Standardized total score	0.1	-0.1	-0.4	-0.4	-0.4	-0.6	-0.6	-0.8	-0.8	-0.9	-1.0	-1.0	-1.2	-1.6	-1.6	-1.9	-2.0

All that said, our measures are now somewhat elderly, and we are updating them to see if there has been significant change.

[14] Thus the OECD comments: "*Weak reallocative capacity can imply that economies are poorly prepared to face any pandemic-related restructuring as well as the digital and green transitions, which may amplify scarring effects, mute wage and career prospects and hinder economic growth*." See OECD, 2021. *Op. cit.* p. 18.