New Challenges to Growth and Productivity
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Summary

On September 25th 2013, the Growth Dialogue and the G-24 co-hosted a high-level seminar in Washington D.C. on 'New Challenges to Growth and Productivity.' The objective of the seminar was to take stock of the implications of recent economic developments for the growth and productivity prospects of developing countries, and discuss policies that would help these governments sustain strong growth that is both inclusive and supports job creation, against a more difficult and uncertain global environment.

Growth and Productivity – A Post-Crisis Assessment

In the last two decades, a structural transformation has taken place in the global economy. EMDCs experienced unprecedented growth, suggesting a decoupling from advanced countries. While the effects of the financial crisis were felt worldwide, there was a divergence in the economic impact between advanced economies (AEs) and EMDCs, with EMDCs recovering faster and demonstrating greater resilience.

Notwithstanding the strong economic performance prior to and in the aftermath of the crisis, panelists noted that EMDCs have subsequently experienced a significant deceleration in growth, in part because of the sharp slowdown and protracted difficulties and uncertainties in AEs. Additionally, they have been affected more recently by uncertainty stemming from the potential exit from unconventional monetary policies in AEs. It is also clear that the economic environment will be less favorable for EMDCs in the years ahead.

According to the speakers, the pre-crisis economic context of low interest rates, beneficial terms of trade and abundant liquidity is unlikely to re-emerge, which has important implications for growth. Panelists noted that growth in several EMDCs has not been productivity-driven – a fact that was largely hidden by the favorable external environment. Many of these countries remain a long way from the productivity frontier, with a substantial number having lost ground relative to AEs in recent years. For example, Latin America performed well in the aftermath of the crisis, due to a combination of the implementation of sound macroeconomic policies and low interest rates, which facilitated capital accumulation; however, without improvements in TFP performance, the growth momentum will not be sustainable. Overcoming the productivity conundrum will be as challenging as it is crucial for EMDCs in the years ahead, and growth strategies will need to be specifically tailored to country circumstances in order to be effective.

Regardless of panelists' views on the extent to which the volatility and slowdown facing some EMDCs originated from exogenous factors, there was consensus that specific domestic policy actions are advisable to help make economies more productive and less vulnerable to shocks, both internal and external. A greater focus on domestic environments and the underlying conditions to sustain growth will be crucial for EMDCs in the medium term. Among other things, this will require investment in human capital development, efficient product and labor markets, sound and resilient financial sectors and infrastructure.

Structural Reforms and Growth

The financial crisis and its aftermath have demonstrated that macroeconomic stabilization alone is not enough to sustain growth. It is now widely accepted that structural reforms are a fundamental component of resilience and long-term growth in both AEs and EMDCs, and are essential to addressing employment, equality and environmental sustainability concerns. To this end, the G-20 has developed a framework for structural reforms as a part of the agenda for Strong, Sustainable and Balanced Growth. While progress has been made towards the goals articulated by G-20 members, quantification of impact is difficult, and panelists noted that there is scope for sharper focus in implementation.

Given the heterogeneity of country circumstances, a more nuanced perspective was provided through case studies of the structural reform experiences of Mexico and the Philippines. In Mexico, an ambitious reform agenda focused on generating productivity-led growth is currently underway, spanning multiple sectors. The Philippines has also been proactive in recent years, implementing policy and regulatory reforms to address structural challenges and overcome prolonged economic underperformance in contrast with other countries in Developing East Asia. These case studies demonstrate the complexities of structural reform in differing circumstances, but also provide common insights and lessons. It is evident, for example, that some reforms become easier as others are implemented. It is nevertheless clear that the extent of the impact of reforms in both countries, and in broader contexts, will depend on follow-through by policy makers and adaptation to the challenges that lie ahead.

In spite of the differing economic and fiscal circumstances in low-income countries, structural reforms are no less imperative – and no less challenging. In Sub-Saharan Africa, a significant number of countries, even some that are non-resource producers, have succeeded in achieving growth rates above 5% for the last fifteen years. While recent progress reflects improvements in both macroeconomic performance as well as structural reforms, it was recognized that important challenges remain for more fundamental structural transformation. Looking ahead, sustaining growth, enhancing inclusiveness and facilitating catch-up across the region will require reforms in the agricultural and energy sectors, macro fiscal reforms (especially for natural resource producers) and development of financial sectors to productively channel resources. It was agreed that elements of this approach are broadly applicable in other low-income contexts.

In general, it was clear from the discussion in this session that growth and productivity are facilitated not just by investment in macroeconomic fundamentals but also in the underlying, structural conditions of an economy. Improving both the latter and the former requires structural transformation, specifically through a shift from low-productivity activities and sectors to high-productivity activities and sectors. In this respect, panelists and participants discussed the persistence of labor market informality as a substantial impediment. It was noted, for example, that informality has been a clear obstacle in the implementation and impact of the structural reform agenda in Latin America. More broadly across regions, the difference in total factor productivity between the formal and informal sectors is estimated to be between 25 and 50%. Understanding the impediments to formality, particularly vis-à-vis institutional regulatory and incentive issues, will be necessary to underpin the transformation process in many EMDCs.

While country circumstances differ, the overarching consensus of the session favored greater analytical and empirical rigor, as well as lesson sharing, to drive domestic reform and transformation endeavors. To this end, it was agreed that peer dialogue and learning based on clearly articulated goals and commitments could support the individual efforts of G-24 members, while also fostering collective momentum on the growth agenda.

Rethinking the Role of Government and Fiscal Policy

Domestic fiscal policy has an essential role to play in addressing the challenges of growth, productivity, structural reform as well as broader development issues. Yet, there is a wide divergence of views on the appropriate approach for fiscally-constrained governments to take, especially in emerging markets and low-income countries. Since the crisis, fiscal room to maneuver has diminished in many countries, even those that fared well in the early post-crisis years. In many EMDCs, the reduced scope for expansionary policy coexists with increased pressures on public spending. Going forward, it will be important to balance domestic spending needs with long-term fiscal sustainability considerations.

Financing spending needs in the face of fiscal constraints is challenging, particularly in a more difficult and volatile post-crisis environment. For many developing countries, this requires increased domestic resource generation through reformed energy subsidies, greater consumption taxes, and an equitable approach to broadening tax bases. It will also require careful management of the tradeoffs in expenditures, in order to most effectively achieve spending objectives while keeping room for fiscal maneuver.

It was uniformly agreed by the panelists that, while structural transformation is the overarching goal, the role of the state differs considerably depending on a country's stage of development.

Those economies that have already progressed from imitation to innovation require labor market flexibility, increased competition, a strong emphasis on tertiary education, careful debt management and a financial system that facilitates venture capital and private equity. On the other hand, it was argued that fiscal policy in imitative economies is marginally less complex – albeit no less important – and there is scope for top-down industrial and labor market policies. Governments will require increased revenue, by way of effective taxation policies and institutional mechanisms for financing, as well as targeted growth-maximizing investment and a reduction in the barriers to innovation.

There was widespread consensus that fiscal policy for all countries involves a carefully balancing of domestic demands with the need for inclusiveness and the avoidance of excessive public debt. Participants acknowledge that, where externalities dominate and structural transformations are desired, there is a strong case for a strategic state. The associated policy actions are predicated, however, on good governance of policy implementation, strong elements of domestic competition, and the use of a global yardstick for competitiveness. It was argued and broadly understood that a strategic state is, in the first instance, an effective state in the conduct of macroeconomic and fiscal policies.

Growth, Inequality and Jobs

Employment and equality are inextricably related to growth and development, and are also key channels and complements for structural reform and strategic fiscal policy. Participants broadly agreed that these issues should be a key priority for policymakers.

The financial crisis and subsequent slow global recovery has had a widespread, negative impact on employment globally, particularly among the youth. Currently, unemployment globally averages 6%, which amounts, strikingly, to a shortfall of 200 million jobs. The associated lost opportunities to enter the labor market may have irreversible, negative labor market outcomes for an entire generation over the long term. Participants agreed that addressing this problem will require targeted policy action, in addition to broader efforts to generate high-quality and productive jobs anchored in the formal sector. This will underpin not only stable, long-term growth, but also poverty reduction and inclusion goals.

In addition to the challenge of employment, there was vigorous discussion about the interrelation between inequality and growth, and the potentially deleterious impact of the former on the latter.
In recent decades, inequality has manifestly increased across many regions and within many countries; concomitantly, adverse outcomes on growth have been widely observed. Yet, it was noted that the state of current research still does not conclusively establish the relationship directionality between growth and inequality. Nevertheless, it is clear that inequality makes growth ‘worse’, insofar as it diminishes the poverty reduction impacts, reduces economic mobility, and increases inequality of opportunity.

Reducing inequality is therefore an important policy priority for all EMDCs. However, there is little academic or policy certainty regarding the most effective means of achieving this goal. In Latin America – historically the world’s most unequal region – inequality has been gradually declining over the past decade. Research has demonstrated that government expenditure and redistributive policies can have a huge impact on domestic inequality, though there are very significant variations across countries. The biggest outright impact on outcomes has been shown to come from the monetized value of transfers in-kind for education and health, though in some cases, these beneficial effects can be offset by indirect transfers.

The session concluded with a normative discussion of the definitions and measures of inequality. In this respect, it was suggested that a focus solely on inequality of opportunity abstracts from broader political and socioeconomic dynamics that influence outcomes and the overarching 'fairness' thereof. Panelists pointed to a number of empirical and conceptual problems in existing measures of inequality, including the new indicator proposed by the World Bank. While this represents a step in the right direction, it is largely apolitical in nature and fails to account for the disequalizing arithmetic of equally shared growth. Additionally, it ignores the large proportion of the population in lower- and middle-income countries that are not specifically classified as 'poor', but remain profoundly at risk of falling back into poverty (the 'strugglers'). In Brazil, for example, about 70% of the population is not yet part of the income-secure middle class earning above $10/day. Across all countries, the members of this vulnerable group present not only a challenge for measurement, but also for policy; to the extent that they fall outside social safety nets and bear a disproportionate burden of direct and indirect taxes, their relationship with the state is potentially problematic.

Overall, it was clear from the session that growth, equality and employment are not only important individually, but are mutually reinforcing. In order for EMDCs to comprehensively and effectively address these challenges, it will be critical to approach job creation and inequality reduction in a multidimensional and meaningful way.