Financial and Economic Review, Vol. 15 Issue 4., December 2016, pp. 178–183.

Structural reforms for increasing competitiveness – Report on the annual conference of the *Global Forum on Productivity* (7-8 July 2016, Lisbon)*

Barnabás Virág

Even though more than 8 years have passed since Lehman Brothers filed for bankruptcy protection in September 2008 and the financial crisis emanating from the American mortgage market became a worldwide crisis, global economic growth remains subdued, especially in the developed countries. The opinion of the world's economists about the reasons for the moderate growth rate is divided. Some think that, as a legacy of the financial crisis, the high debts and significant non-performing loan portfolios in the balance sheets of commercial banks continue to be a problem even today and this permanently restrains the demand prospects of the economies. According to other evaluations, the reasons for this slow growth are structural supply factors which had already characterised the developed economies before the crisis, but the effects of these factors were masked by the rapidly rising indebtedness. In identifying these factors, these analyses mostly underline the ageing of societies and the slowdown in productivity growth.

At the initiative of the OECD and with the participation of the academic world and economic policymakers, a new global forum was established in 2015 in Mexico City with the purpose of exploring the reasons for the permanent slowdown in productivity observable in the developed economies and finding answers to the question of what must be done to reverse this unfavourable trend. The annual conference of the forum in 2016 was held in Lisbon. The leaders and experts of 32 OECD member countries, large emerging economies (China, Russia, Brazil and Argentina), the Asian Productivity Organization (*APO*), the European Union (*EU*) and the European Central Bank (*ECB*) participated in the event. Structural reforms aimed at improving productivity were the special subject of the presentations and panel discussions at this event. The following provides a brief summary of the main findings of these forums.

In his opening presentation, *Manuel Heitor* (Portugal, Minister Science, Technology and Higher Education) called attention to the role of human capital and research and

* The views expressed in this paper are those of the author(s) and do not necessarily reflect the offical view of the Magyar Nemzeti Bank.

Barnabás Virág is executive director of the Magyar Nemzeti Bank. E-mail: viragb@mnb.hu.

development in economic growth. He emphasised that, in the future, countercyclical elements must also be strengthened in the development of new economic policy thinking. A good example for this is the current economic environment. In several economies at the periphery of Europe which are struggling with recession and budget problems, permanently high unemployment has eroded human capital, while the funds intended for development and research have often been victims of adjustments. In accordance with this, it is important to develop a framework where financing education, the knowledge base and research is ensured continuously and independently of economic cycles.

Also in the opening section, *Gabriela Ramos* (*OECD*) emphasised the connection between the slowdown in productivity and the increasing inequalities of incomes. According to her analysis, businesses with lower productivity have employees with lower wages; furthermore, they do not invest in innovation and the development of human capital. By failing to do so, they essentially preserve the low income of the employees working there, which also results in the achievement of lower qualifications in the case of the children of these workers, and the final result of this is a negative loop. Economic policies preventing the slowdown in productivity and establishing a growth trend thus also assist in handling income inequalities.

In his presentation, *Jonathan Haskel* (Professor at Imperial College London) focused on the increased role of intangible assets and their connection to productivity. According to Haskel, on the one hand the slowdown in productivity can be attributed to Keynesian reasons related to a lower investment rate and capital accumulation, while on the other hand the fundamental transformation of the structure of production also plays a role in this. In contrast to previous decades, in the current world investments in intangible assets play a much greater role in the production of value added and incomes (in the broader sense, IT investments, development costs and the development of competences must also be classified here). This has a serious statistical effect as well. The methodology of the national accounts currently in use is able to measure investment in tangible assets and the products thus produced more exactly, but it can also underestimate investment in intangible assets and the value of services produced in connection with such investment. According to his observation, investments generally declined after the crisis: however, this was more typical for tangible investments, whereas in the case of intangible investments, after a smaller decline, a faster rise started. Unfortunately, this phenomenon has been less typical for the EU.

The enhanced role of intangible investments significantly influences the trend in productivity growth and its distribution within economies via four channels: first, it emphasises the effect of financing opportunities; second, the advantages stemming from intangible investments appear more strongly at the companies undertaking such investments, making catching-up more difficult for companies which are left out from the developments or enter later on. Third, intangible investments have a strong spillover impact in the direction of economic efficiency (*total factor productivity, TFP*), and thus the role of these investments has increased in the explanation of economic cycles. Finally, these investments fundamentally affect the productivity of the labour force and, via this, wage setting as well, and thus they also have an effect on the trend of income inequalities.

Using Italian data, *Andrea Linarello* (Banca d'Italia) and *Ottavio Ricchi* (Italian Treasury) presented some reasons for the permanently low productivity growth. According to their evaluation, poor allocation of resources also contributes to the development of this phenomenon in Italy. According to their results, after the crisis financing restraints also hindered the spread of new technologies, especially in the case of SMEs, contributing to the slow corporate diffusion of leading novelties.

Mario Centeno (Portugal, Minister of Finance) emphasised the importance of the forum as an opportunity which promotes international co-ordination, so that the roots of the productivity paradox can be understood better: despite the significant advances achieved in the areas of education, technology and global integration, productivity growth has slowed down. Although the measurement of productivity is one of the greatest challenges, he argued that cyclical factors played a role in the slowdown in productivity, proportionally with the slowdown in investments. Structural changes – i.e. the shift towards services, the stalling diffusion of innovations among companies and the immobility of labour force between sectors – also made it difficult to achieve higher productivity increases, aggravating the persistence of wage inequalities. In terms of the advances, it is important that policies supporting higher productivity growth should result in higher income for average voters, since it has become clear by now that real economy problems entail political consequences. Portugal is taking specific steps through its national reform programme, which focuses on improving human capital and skills, R+D co-operation between companies and universities, and regional and social cohesion.

Angel Gurria, Secretary-General of the OECD, mentioned that approximately eight years since the start of the global financial crisis, the global economy finds itself in the trap of low growth, characterised by weak productivity and business investments, a slowdown in trade, weakened labour markets and significant inequalities. The accumulated loss of productivity growth already amounts to 10 per cent in this period. Productivity growth is not manna from heaven; it is the consequence of pursuing appropriate policies and removing incorrect policies. Today, we live in the newest wave of digital innovation, but research has shown that these advantages do not spread to all companies. Reforms must be found which improve access to education, healthcare, and traditional and modern infrastructures.

Jonathan Timmis (OECD Secretariat) underlined that an enormous body of literature is available on the effects of trade in goods on productivity, and in connection with this, research on globalisation and productivity up to now has been based on trade in final products, but noted that we know less about the specific role of global value chains. The policy lessons drawn from studies on trade in final products and services cannot be transposed directly to the world of global value chains. Services are an area of vital importance for global value chains, this is why it is emphasised that there are still – until now less explored – policies, such as the policy related to competition in the service market, which are worth improving.

The connection of global value chains and productivity needs to be examined in more detail, especially with respect to the fact that, in terms of geography, global value chains move towards areas outside traditional production locations (North America and Europe) and they appear in central hubs of key importance (e.g. in China within Asia) and supplier countries connecting to larger areas (e.g. in Vietnam), or in countries of the periphery. These developments may have an effect on productivity growth and the spread of productivity, altering the hubs and the new peripheries. Global value chains provide indirect assistance – especially to small and medium-sized enterprises – so that they can profit from the spillover effects.

Peng Zhang (China State Information Center) examined how industrial productivity is affected by the connection to global value chains. Increasing participation in global value chains correlates with higher industrial total factor productivity, but the relation is not linear. Total factor productivity decreases in the case of participation at the highest level in global value chains.

Keiko Ito (Senshu University, Japan) examined what effect global procurement costs and transaction costs between companies have on domestic supplier networks in Japan. Japanese data have shown that companies conduct a disproportionately large amount of business with the suppliers which are closest in space. The activity of companies performed in other countries leads to a churning of their domestic buyers and suppliers, and it is more likely that the companies procure the materials necessary for production from domestic suppliers further away, but the average distance of suppliers decreases. This is why policies aimed at decreasing search and transaction costs, and information asymmetries are of key importance in realising the productivity advantages provided by participation in global value chains.

Joaquim Oliveira Martins (OECD Secretariat) summarised the work performed by the Public Governance and Territorial Development Directorate up to now in connection with the contribution of cities to growth. He pointed out that there is a positive (but not linear) connection between the density of cities and productivity growth. Urbanisation goes together with development, but it is only a necessary condition. The advantages are derived mostly from the transfer of knowledge and the interaction of skills, whereas external economic effects and costs stem mainly from congestion and environmental pollution. He noted that the proximity of cities in general is accompanied by growth in productivity, and therefore, the contribution of urban areas to productivity growth is usually significant. The productivity growth of cities is often in positive connection with the size of cities. In terms of the role of policies, he emphasised that the results highlight the importance of good urban governance (leading bodies in good working order can improve the welfare level of city dwellers), whereas fragmentation is liable to decrease the growth contribution of urban agglomerations. The advantages of agglomeration economies are: sharing facilities, gains stemming from specialisation, appropriate labour market (ample specialised labour force, low hiring and training costs), and rapid spread of new ideas.

Manuel Caldeira Cabral (Portugal, Minister of Economy) noted that the slowdown in productivity and the widening deviation of productivity growth between companies were problems that had an effect on almost everything (e.g. on profitability, investments, inequality of incomes) and that affected most OECD economies, among them Portugal as well. Moreover, since 2010 real wages have already increased slower than the productivity of labour, which has an impact on domestic demand. The minister outlined the growth and competitiveness strategy of the Portuguese government, which features five strategic pillars: capitalisation, innovation, simplification, internationalisation and education. The government's "Industry 4.0" programme has determined priorities for the digitalisation of the industry. In the framework of the "Simplex +" programme, efforts have been made for decreasing the burdens of bureaucratic procedures for companies.

In the closing session, *Dirk Pilat* (OECD, Deputy Director, Directorate for Science, Technology and Innovation) formulated some findings of key importance. The first group of questions raised was about the fact that there is an urgent need for determining the state of affairs: what is happening with productivity and what are the triggering factors of the trends in progress? The measurement of productivity still represents a challenge. This is an especially important question in the case of services (and the public sector), but in general also in connection with the wide-ranging digitalisation of economies. Measuring the most important elements of the political system of the individual countries represents a serious challenge from the point of view of empirical analysis. Measuring the main forces of productivity, such as intangible investment, business dynamics and management quality, represents a challenge in and of itself as well. Solving the measurement problems is a prerequisite for improving policy-type analyses. We must better understand to what extent the current trends are cyclical in nature and to what extent they are based on structural basic questions.

Pilat underlined that the fall in productivity growth has also had an effect on social integration. Companies which fall behind are unable to increase wages in the absence of reallocation, they contribute to the inequalities of incomes. In several countries the lack of appropriate skills is probably a factor of key importance between wage inequality and the distribution of productivity. Employees often do not find an appropriate job at companies where they could achieve their full production potential.

In terms of policies this means that further structural reforms must be carried out unambiguously, especially in the area of services. Urgent investments are necessary in the areas of skills, infrastructure and intangible assets, and policies must support these investments and must encourage a dynamic business environment and the timely allocation of funds.

References:

OECD: Summary Record (2016) (http://www.oecd.org/global-forum-productivity/events/Summary_report_GFP_Lisbon_Final.pdf)

OECD Presentations (2016) (http://www.oecd.org/global-forum-productivity/events/presentations7thjuly.htm and http://www.oecd.org/global-forum-productivity/events/presentations-friday8july2016.htm)