Comment

Structural integrity

- *Structural reform is widely espoused: but seldom defined and rarely explained*
- *If effective, it sustains growth potential and increases resilience to shocks*
- *But it has to be continual, always fostering resource reallocation and adaption to change*
- *Success requires a broad range of overlapping, reinforcing, initiatives, plus macro stability*
- *We suggest developments that investors who take the long view should watch for*

Time for some clarity

Structural reform is a widely lauded but opaque process

"Structural reform" is an often lazily-employed phrase. While widely recognised as a 'good thing', it is seldom delineated or explained. Many commentators merely dub their pet dislikes in countries' policy regimes as "structural problems", with the implication that, if resolved to the commentator's satisfaction, performance would be rejuvenated. If only it were that simple.

So, what does structural reform really amount to? What does it imply for companies and individuals? And what is its role in policymaking, especially in today's vexed circumstances, when many economies are not only still cyclically depressed, but also face serious constraints on their longer-term growth potential, if not the threat of secular stagnation?

The supply side was downplayed in the Keynesian era

A little historical context is in order. During the initial post-Great-Depression, post-WWII heyday of Keynesian stabilisation policy, the overwhelming priority of policymakers in the advanced economies, and especially in the so-called Anglo-Saxon world, was the maintenance of aggregate demand. This involved calibrating fiscal and monetary policy settings, together with whatever supplementary controls on capital flows, trade, or incomes were deemed necessary, so as to ensure the full employment of resources, particularly labour. The implicit assumption was that, if demand management was successful, aggregate supply would largely take care of itself.

The challenges of the 70s encouraged a rethink

By the 1970s, however, the post-war boom was drawing to a close, and the shortcomings of this approach were increasingly becoming evident. The major economies had considerable difficulty absorbing two large oil shocks. Trend growth and productivity were slowing. Inflation had accelerated alarmingly, and was proving politically and socially costly to tame. Unemployment appeared to be on a secular upward trend. Policies, including labour, social, and in some cases industrial, put in place to make society a better place, had proved to have unforeseen consequences, including inhibiting the capacity of economies to adjust, and diminishing their resilience to shocks.

And by the 1980s structural reform was *en vogue*

In some countries this technical judgement coincided with a developing political view that the influence of the state in everyday activities had become overbearing. By the end of the decade, conventional wisdom was that too much had been expected of demand management policy; that the supply-side had been unduly neglected; and that there was a need to address burgeoning inefficiencies and scleroses and scale back or redesign government intervention. Priority was therefore given to so-called structural reforms and developing institutions that could encourage economic dynamism.

Managing change

The process targets resource allocation and flexibility …

While structural reform is seldom elucidated, our preferred working definition is "Policies that encourage, or at least do not inhibit, the flow of resources from declining and less productive activities to growing and more productive activities, and which leave economies better able to absorb shocks". In short: policies that increase economies' and societies' capacity to adapt to change.

… as economies are in a constant state of flux

Implicit in such a definition is the recognition that economies are always in transition. There are continual changes in relative prices, the pattern of consumption, and the structure of production, the result of the advance of technology, increasing per capita income and wealth, and the emergence of new global suppliers. Thus structural adjustment too has to be continual: structural reform is therefore never complete.

Making it work

The reform process is multifaceted and demanding

Making structural reform work can be a complex and challenging process for a number of reasons. First, the optimum moment for action is rarely obvious. Cyclical downturns are often considered to be the wrong time to impose additional, potentially disruptive, changes; while during an upswing, when the economy is doing well, why bother?

The costs of reform are narrowly focused and abrupt

Second, the costs of structural reform are typically narrowly focused and immediate. Furthermore, the casualties of reform are frequently powerful and vocal vested interests and, of course, the reallocation of resources involves the vexed matter of the reallocation of people too. Full adjustment by groups affected by major reforms can take a generation.

The benefits are thinly spread and delayed

A third inconvenient truth is that the benefits of structural reform are spread thinly across society and accrue only over time – they may not become fully manifest for a decade or more. Hence the gains are often reaped not by the reforming government but by the opposition. Equally unfortunate is the obverse: that short-term populist measures such as subsidies, protection, and increased regulation can offer governments much more immediate economic and political gains, even if their longer-term influence is malign.

It also requires a sympathetic macro policy backdrop

As if all this is not problematic enough, it is necessary also to calibrate macroeconomic policy with the reform process. This may mean a requirement to sustain aggregate demand, and in particular investment spending, during the early, potentially contractionary, phases. Indeed, failure to do so may undermine the entire process. However, the obverse may be true as the more expansionary elements become manifest, especially if dormant animal spirits are revived.

Execution is complex and politically fraught

Success will depend on circumstances, but some combination of the following will help: broad support across the government; an opposition that is either not deeply entrenched against the strategy, or is too weak to make much difference; "points of light" across society who provide vocal and credible support; simplicity – an easily understood agenda; the ability to assess progress, both quantitatively and qualitatively; and initiatives to temper the costs and/or compensate those who lose out as a result of these policies. It is also important to sustain the momentum of change. And while a detailed sequencing of reform is in principal desirable, it is often infeasible. The reality of all this is that reforming governments generally have to settle for delivering what they can, when they can.[1]

Down to specifics

Success requires a range of reinforcing initiatives

In framing a programme of structural reform, experience points to the benefits of overlapping, reinforcing initiatives. In general terms these extend to:

- **Embracing technology.** New technology acts to destroy low-productivity, low-skill, low-wage jobs while opening up the possibility of high-productivity, high-skill, better paid jobs. But absorbing new technologies takes time, and involves considerable organisational change. It can require large research and development outlays; investment in education and training; and an appropriate infrastructure of standards, protocols, and protections of rights and data. It can also be inhibited by subsidies or restrictive practices that reduce the pressure for change, and by macro instability.
- **Facilitating infrastructure.** Coherence and consistency in government infrastructure policy, not least in its approach to the long-term planning and assessment of projects, the regulatory environment, and private sector financial involvement can encourage trade; the division of labour; competition in markets; the diffusion of technology; better organisational practices; and better access to new resources, both physical and human.
- **Encouraging entrepreneurship.** Entrepreneurship may benefit from reductions in regulations that discourage the entry of new firms; reduced subsidies to larger firms; better access to government research and development; job creation and training schemes; a highly skilled workforce and good infrastructure; improved access to export credit schemes; and ready access to seed, venture, and equity capital.
- **Constraining non-wage costs.** The reduction of social security/tax wedges between the cost to an employer of hiring and the wage received by the worker helps to correct the bias that leads to unwarrantedly capital-intensive production.
- **Employment protection.** A balance has to be struck such that, while sensible rights of workers are safeguarded, unavoidable structural adjustments are not prevented.
- **Competition policy.** Competition is fundamental to the functioning both of factor and of product markets. This can be fostered by lowering trade barriers, minimising collusion and cartelisation, and encouraging foreign direct investment that brings not just jobs and physical investment, but also latest technology and management techniques.

- **Education.** Good education is vital to the achievement of a highly skilled, motivated, flexible, and productive labour force. The requirement goes beyond a decent basic education to the tertiary level, vocational training, and life-time learning schemes.
- **Active labour market policies.** Government-sponsored programmes to help the unemployed find work and offer relevant training schemes facilitate labour force flexibility and dynamism. They are initially expensive: but they are a constructive improvement on mere passive income support, and pay dividends over the longer term.
- **Tax and benefit systems.** These need to be as simple as possible and, where the purpose is to affect the distribution of income, designed so as to minimise distortions in the allocation of productive resources.

Today's challenge

Investors ignore structural issues at their peril

The over-riding message of this *Comment* is that structural issues are of vital importance to relative economic performance and are overlooked by investors at their peril. The success or failure of structural policy will do much to determine countries' growth rates over the coming decade. Most countries' civil servants know, from several decades of experience and assessment, mainly at the OECD, what works and what does not. They also know that structural policy involves getting a lot of things right, and sticking with these initiatives for an extended period.

This is particularly the case in southern Europe

The breadth and specifics of the structural shortcomings of the advanced nations have changed over time, and differ from country to country. However, notwithstanding a faster pace of reform over recent years, it is Europe, and in particular its southern fringe, that seems to be the most structurally compromised amongst the OECD economies.

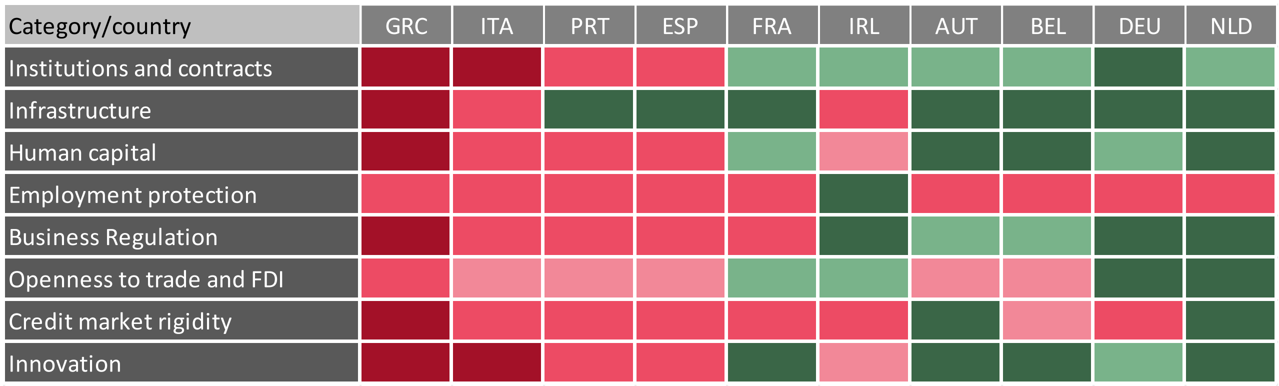
The relative position of various European economies is summarised in the heat map below. Above-average scores for each category of structural performance are coloured green; the darker the tone, the better the performance. Below-average scores are coloured red, the deeper the tone, the worse the performance.

Some countries (France and Italy are two examples) appear to have little current political appetite for reform. Others have got the balance of structural reform and macro policies badly wrong, largely because of the conditions attached to bail-out programmes. It remains to be seen whether further progress will prove possible, or whether a backlash will ensue.

In seeking to reach judgement on how much progress individual countries are, or are not, making in this area we will be watching the following in particular over the course of 2014 and beyond:

- The balance of reforms and short-term palliatives.
- The breadth of the reform agenda.
- Recognition that the process should be permanent rather than one-off in nature.
- Whether the macroeconomic context for reform is sufficiently sympathetic.
- Our principal evidence base will be the special chapters of OECD country reviews. ■

Structural policy heat map, selected euro area economies



Source: OECD, IMF and Llewellyn Consulting
Notes: This heat map draws heavily on: IMF, *Fostering Growth in Europe Now*. Washington, June 2012. Above-average scores are coloured **green**; the darker the tone, the better the performance. Below-average scores are coloured **red**, the deeper the tone, the worse the performance.

Disclaimer

[1] Alain de Serres, John Llewellyn and Preston Llewellyn, *The political economy of climate change mitigation policies,* OECD Economics Department Working Paper No. 887, September 2011.