Yannis Stournaras: Openness to trade and economic growth

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the London Conference at Chatham House, London, 2 June 2015.

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The success and popular support for any government depends to a large extent on its ability to deliver economic prosperity. Yet tensions are rising between national interests that governments are elected to defend and economic integration that the global economy demands and which a successful economy requires.

1. Can governments sustain the past consensus that free-trade agreements and inward investment deliver economic growth in the aggregate even if they can exacerbate inequality in the short-term?

There are several benefits to international trade, including the ability to use comparative advantage, the removal of domestic monopoly positions and provision of competition for producers, and diffusion of innovation and know-how to domestic companies. Moreover, as recent economic history and the development of global value chains have shown, greater openness to trade is usually associated with faster economic growth. Furthermore, openness itself induces governments to adapt their policies and institutions to best international practices so that they become more export and business friendly. This facilitates inward FDI which can further boost growth prospects through various channels, i.e., by improving competition, innovation etc.

Of course, trade liberalization, outsourcing and the globalization trend observed in past decades might have widened inequality. Let me refer to two possible channels. First, if the biggest share of low-income workers is employed in low productivity firms that face tough import competition, then international trade could increase income inequality by lowering the relative earning of low-income workers. This can happen because growth may be concentrated in labor intensive sectors with low efficiency of labor and, consequently, low relative wages. Second, outsourcing usually implies the reallocation of low skill activities from high to low income countries. However, these activities are usually high skill in the context of the skill distribution of the low income country. Therefore, outsourcing can make labour demand more skill intensive in both rich and poor countries, leading to increasing income inequality.

Nevertheless, the growth dividend from the greater openness to trade can and should be used in a way that addresses income inequality and poverty. One such way is to promote policies that facilitate the accumulation of human capital, i.e. increase tertiary educational attainment, while another possible option is to consider targeted cash transfers to those in need.

On Greece

One of the goals of the reform program that is implemented in Greece since 2010, besides correcting fiscal imbalances, is the improvement in competitiveness, the re-orientation of economic activity towards exports of goods and services and the improvement in the institutional framework and business environment in order to attract FDI and to boost the long term prospects of the Greek economy.

Despite delays and mixed signals occasionally provided by domestic policy makers, there has been significant progress in terms of the export performance in recent years.

- For example, nominal exports of goods and services increased by 29.4% in cumulative terms from 2009 to 2014 (while imports declined by 12.4%). This development reflects the significant rise in exports of goods (54% in nominal terms;

31% in real terms) which increased in line with our Euro Area peers, while the performance of services was rather sluggish (on account of global factors that affected the shipping sector until late 2013 and uncertainty that impacted tourism until mid-2012).

- Net exports have been positively contributing to economic growth in the period 2010–2014 and are expected to continue so in the coming years.
- Moreover, the share of total exports to GDP has increased from less than 20% in 2009 to more than 30% in 2014 and Greece's export share in global trade has increased by 30% over the same period. However, exports as a share of GDP are still low compared to the European average of 44%.

2. Are current sovereign debt levels unsustainable? How can these be addressed whilst maintaining the support of national populations, and who should bear the burden?

It is true that most advanced countries have seen their government debt to GDP ratios rising during the global financial crisis. This reflected their efforts to address financial sector vulnerabilities and to take discretionary action or let automatic stabilizers operate in order to contain the effects of declining economic activity during the great recession. However, most of the countries, including Greece, initiated fiscal adjustment programmes in order to correct fiscal imbalances and to address the debt overhang problem. In fact, Greece has done one of the biggest fiscal consolidations among developed economies during peacetime with cyclically adjusted deficts declining by more than 16% of GDP within four years.

Although rising debt-to-GDP ratios are and should be a cause of concern for all countries because they can undermine economic growth, economic history and recent research (by the OECD, the BIS, and the IMF) suggest that the debt intolerance thresholds are state and country dependent. However, if this threshold is reached, countries immediately lose market confidence, face rising borrowing costs and explosive debt dynamics and consequently fiscal policy destabilizes (instead of stabilizing) the economy.

As has been shown e.g., by the OECD, for higher-income countries, the debt threshold ranges from 70 to 90% of GDP, while for emerging economies the debt threshold is even lower at 30 to 50% debt of GDP, as they are exposed to capital flow reversals.

Hence, countries facing fiscal challenges should design credible multiannual fiscal consolidation programmes, whose objectives should be clearly and openly communicated to the public. However, governments which apply austerity programs loose political capital. This is because fiscal consolidations hurt growth and deepen the recession, hence reducing living standards. Recent evidence and international research have shown that governments are more likely to succeed and maintain the support of the population when consolidations are introduced in the aftermath of an election, and when the party in office has a clear and strong mandate to reform. Therefore, governments with fresh political capital like the current one in Greece have a better chance in succeeding.

At the same time fiscal consolidation programs should aim at increasing the efficiency and effectiveness of spending (e.g. ,health and education spending and spending on social policies) and eliminating distortions in taxation (broaden the tax base, cut expenditures rather than increase labour taxes, and increase property and environmental taxes).

The use of certain fiscal instruments could have beneficial effects on equity leading to fair-burden sharing and maintaining the support of the electorate. For example,

- better targeting social benefits could have beneficial effects on equity.
- Increases in effective retirement age would improve equity and lower inequality.

- The reduction in tax exemption and tax credits will broaden the tax base and along with a more progressive income tax scale will exert a positive effect on equity and lower inequality.
- Higher wealth and property taxes, if based on a progressive scale, will also lower inequality.

Finally, it is essential to improve the institutional setting by improving budgetary procedures, introducing fiscal rules and independent fiscal councils and improving medium term fiscal planning. All these actions will enhance transparency, improve accountability and fiscal planning and will contribute to better spending control and improve the probability of successful fiscal consolidation.

A better exploitation of government fixed assets through a targeted privatization programme and the adoption of growth promoting structural reforms will also facilitate the reduction of high debt ratios without increasing inequality.

On Greek debt

Last but not least, let me now refer to the case of Greece. The outstanding total amount of the Greek general government debt by end-April 2015 is €313 billion and the debt-to-gdp ratio is estimated at 172%. However, a few points are worth highlighting.

- Nearly 80% of Greece's general government debt is held by the official sector, i.e. bilateral loans by EU countries under the GLF, IMF loans and EFSF loans, as well as debt securities held by the ECB and NCBs.
- Greek debt is benefiting from very low interest rates currently and quite extended maturities on GLF and EFSF loans. While Greece benefits also from the deferral of principal payments on GLF and EFSF loans by 10 years and a 10-year grace period for interest payments on most EFSF loans.
- In addition, Greece has been receiving the profits made by the ECB and NCBs on their Greek government bond holdings (SMP and ANFA).
- As a consequence of these actions, the average maturity of the Greek government debt has increased from 6.3 years in 2011 to about 16.5 years by end 2014 and debt servicing costs have decreased to levels comparable with other southern European countries, while the actual debt servicing cost on a cash basis is much lower, i.e. about 1.7% of GDP if one takes into account that the interest paid to the ECB and euro-area national central banks (NCBs) is returned to Greece and interest payments on EFSF loans are deferred until 2022.
- Therefore, in view of the existing favourable debt servicing arrangements, the stock of debt need not pose such a big concern, conditional on there being a credible commitment to the reform program that will be agreed with our EU partners.
- Of course, the timeline of the schedule of the debt's repayments and interest payments may pose challenges in future years. In particular, while official loans have been supplied with low interest rates, there is a 'hill effect' from 2022 onwards, i.e., by the time that interest payments rise significantly due to the beginning of repayment of deferred interest for EFSF loans.
- Taking into account that Greece will have to refinance maturing debt at higher market rates over the next few years, the interest-to-GDP ratio is projected to increase significantly from 2022 onwards to likely 6% of GDP under reasonable interest rate scenarios. This will impose significant challenges to debt sustainability looking forward.

- Hence, smoothing interest payments over time (in particular over the period 2022–2030), along the lines of the Eurogroup decision of 27 November 2012, will provide significant positive effects on growth and improve debt dynamics without imposing costs to creditors.
- Research at the Bank of Greece suggests that smoothing the interest-to-GDP ratio over the critical period of 2022–2030 by gradually removing interest payments to future years may have a significant positive impact on growth of the economy and lead to a faster reduction of the debt-to-GDP ratio to sustainable levels by 2035.
- In the short term, i.e. over the period 2015–2022, if a swap of IMF loans (which come at a higher cost) with ESM loans (which come at a low cost and have a much longer duration) could occur, this would have improved debt dynamic considerably.

3. Can ageing societies overcome the risks of stagnating economic growth? How will their governments bridge the generational gap without alienating either the young or the old?

Advanced economies face increasing age related challenges. The decline in fertility rates and the increases in life expectancy have increased the share of old-age in total population.

In the future the challenges will become more pressing – for example in the case of Greece, according to the 2015 Ageing Report of the European Commission, the share of elderly population (65 and over) as a % of total population is expected to increase from 20.3% in 2013 to 33.0% in 2060. While the share of very elderly population (80 and over) as a % total population is projected to increase from 5.8% in 2013 to 15.3% in 2060. This trend reflects increased life expectancy;

- for men it is projected to be 84.9 year in 2060 from 78.0 in 2013, while
- for women it is 89.0 years in 2060 from 83.3 in 2013.

The fertility rate is projected to only marginally increase to 1.58 in 2060 from the very low of 1.34 in 2013.

Given that labor supply and savings are higher among working age adults than among those aged 65 or above, it can be expected that a country with a large cohort of elderly is likely to experience slower growth than one with a lower elderly share. Nevertheless, future behavioral changes cannot be excluded – for example, individuals might decide to increase saving over their working-life in view of the projected increase in life expectancy.

Ageing societies are expected to face mounting health and pension spending pressures putting at risk public finances which, in turn, will further reduce future growth prospects.

There are various policy options to address the ageing related future growth challenges. First and foremost, it is important to fully utilize the labour input by taking actions to increase the employment rate. A low employment rate implies that a significant part of the working age population is either unemployed or inactive (outside the workforce). For example in Greece (according to the 2015 Ageing Report) the employment rate (for the age group of 15–64 years old) was 48.7% in 2013 on account of very high unemployment (about 28% for ages 15–64) and low labour force participation, in particular, for the age group 55–64 (42.4%).

Therefore action should be taken to

- First, address the very high unemployment because it can have severe long term repercussions, though the hysteresis effects, as it can induce people to drop out of the labour force. At the same time, long term unemployment leads to human capital erosion and a fall in potential growth – translating a cyclical problem into a structural one.

- Second, action should be taken to raise the currently low participation rate by females and older individuals.

For example countries facing these challenges should adopt policies that discourage age and sex discrimination by employers, promote life-long learning and education, allow for more flexible work arrangements for older workers and women, and increase state-funded child care provisions.

Furthermore, policy makers should also consider increasing the statutory retirement age when this is low by international standards. Alternatively, an already high statutory retirement age might have to be made binding by limiting the early retirement schemes. In addition, a life expectancy component could be build into the social security system.

Finally, migration policies might have to be reconsidered as a whole in Europe in view of the future demographic pressures.

Besides the abovementioned policies aiming at better utilizing the labour input, additional policies should be put forward such as increasing infrastructure investment, facilitating business investment and adopting reforms that can permanently boost the level of potential output and its growth rate in the medium term. For example

- adopt product market reforms, put greater emphasis on innovation, R&D and education,
- facilitate the use of high-skill labour as well as ICT in order to boost labor productivity etc.

Overall, ageing and shrinking working age population makes it even more pressing to boost innovation and productivity gains as a source of future growth.

On Greek pension reform

In the case of Greece, a very ambitious pension reform was introduced in successive waves in the years 2010–2014. The reform increased the statutory retirement age to 67 years and the minimum age for retirement to 62 years, strengthened the link between contributions and benefits to provide stronger incentives for labour force participation, applied a uniform pension calculation method among all pension schemes, reduced the generosity of benefits and enforced stricter eligibility conditions for those receiving invalidity pensions, while it also introduced a life expectancy component from 2021 onwards (to be adjusted every three years).

In view of the adopted reforms (according to the 2015 Ageing Report of the European Commission) the public pension expenditure is projected to decline until 2060 by about 1.9% of GDP (the 5th best performance in the EU). While the participation rate of older individual (5564) is projected to increase from 42.4% in 2013 to 78.0 in 2060, raising the overall employment rate to 69.8% in 2060 from 48.7% in 2013.

Nevertheless, the phasing out period of favorable retirement provisions for those with mature pension rights before the introduction of the reform and the remaining pockets of exemptions from general pension rules still create pressures in the social security system.

4. Can countries count on technological advances to deliver new routes to economic growth and social inclusion?

Technological advances and innovation have not run their course and will continue boosting future productivity growth.

The so-called pessimistic view holds that the recent slowdown in productivity is a permanent phenomenon because the types of innovation that took place in the first half of the 20th century (e.g. electrification, internal combustion engine etc) are far more important than those that took place latter (e.g. ICT revolution) and those that will occur in the future.

Nevertheless, as correctly pointed out by the optimists the underlying rate of technological progress has not slowed and the ICT revolution will continue transforming the firms operating at the technological frontier. Moreover, big payoffs from general purpose technologies are fully realized only if organizational structures are re-organized to benefit from new technologies, while in many cases innovation arises from combination of previous innovations.

Recent empirical work conducted by the OECD and focusing on the globally most productive firms has shown that productivity growth at the global frontier has been robust despite the slowdown in average productivity growth. For example, labour productivity at the global frontier increased at an average annual rate of 3 ½ % in the manufacturing sector over the 2000s, compared to an average growth in labour productivity of just ½% for non frontier firms.

Nevertheless, technological advances (along-side with increased competition due to globalization) tend to raise income inequality as they benefit high-skilled workers more than other. This development could persist if it results to skill-biased technological change and to the extent that tertiary education attainment does not keep pace with technological progress.

Therefore, in order for all actors of the economy to benefit from the technological advances at the global frontier policies should aim at:

- Fostering innovation at the frontier by improving public funding and the organization of basic research, as well as
- Properly designing innovation policies that they do not excessively favour applied versus basic research.
- Facilitating the diffusion of new technologies to non frontier firms through trade openness, participation in global value chains and the international mobility of skilled workers.
- Creating a market environment where more productive firms are allowed to thrive by promoting well-functioning product, labour and capital markets, so that they facilitate the penetration of new and existing technologies.
- Improving skills through human capital investment (tertiary education, training, reduce school drop outs etc) to reduce inequality, improve employment opportunities and enhance social inclusion. Finally, the growth dividend from technological innovation can also be distributed with targeted cash transfers to those facing the risk of poverty.