ESCAPING THE STAGNATION TRAP: POLICY OPTIONS FOR THE EURO AREA AND JAPAN

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OECD

FOREWORD

The global economy continues to run at low speed and many countries, particularly in Europe, seem unable to overcome the legacies of the crisis. With high unemployment, high inequality and low trust still weighing heavily, it is imperative to swiftly implement reforms that boost demand and employment and raise potential growth. The time to act is now. There is a growing risk of persistent stagnation, in which weak demand and weak potential output growth reinforce each other in a vicious circle. Japan has lived through a prolonged period of sluggish growth, large estimated slack and low inflation, and the euro area has been on a similar path since the financial crisis.

Persistent stagnation is likely to be due to a multitude of factors, affecting both the demand and the supply side. This calls for a broad policy package to address it. Accommodative monetary and fiscal policies are needed, together with bold structural reforms that can deliver "win-wins": an immediate impact via a boost to demand and higher potential growth. Policy action in four areas could deliver this goal effectively: investment, trade, employment activation and small firms and entrepreneurship. The reforms should be designed so as to avoid any negative impact on income inequality – both for social reasons and because higher inequality is likely to dampen demand, thereby reinforcing the stagnation problem. The aim is thus to implement reforms that entail "triple wins" – higher demand, higher potential output as well as lower poverty and income inequality. Reforms should also promote green growth, which can further raise well-being by addressing environmental damage and climate change.

With Japan's launch of the "three arrows" in 2013, the EU's recent launch of an investment plan and the euro area's expected move towards quantitative easing, the likelihood of escaping the stagnation trap is increasing. Yet, further action is needed to sustain this positive reform momentum. In particular, structural reforms are urgently needed to remove regulatory bottlenecks to investment, reduce the administrative burden for business, and facilitate company restructuring. In the European Union, these efforts should be combined with a full and effective implementation of the Youth Guarantee and other activation measures. Japan would also benefit from bold structural reforms that promote trade and investment, reduce labour market dualism and increase female labour force participation.

The OECD has been working extensively with both member and non-member countries in designing and implementing structural reforms, assessing their impact on growth and inequality and tracking reform progress over time. We have also been cooperating with the European Union in these areas and have made substantial contributions to the structural reform process of the G20, assessing for instance the growth effects of countries' structural reform commitments.

The OECD stands ready to continue to support this reform agenda and contribute to the design of policies that will sustain strong and inclusive growth in our quest for better lives.

Angel Gurría
Secretary-General, OECD

SUMMARY

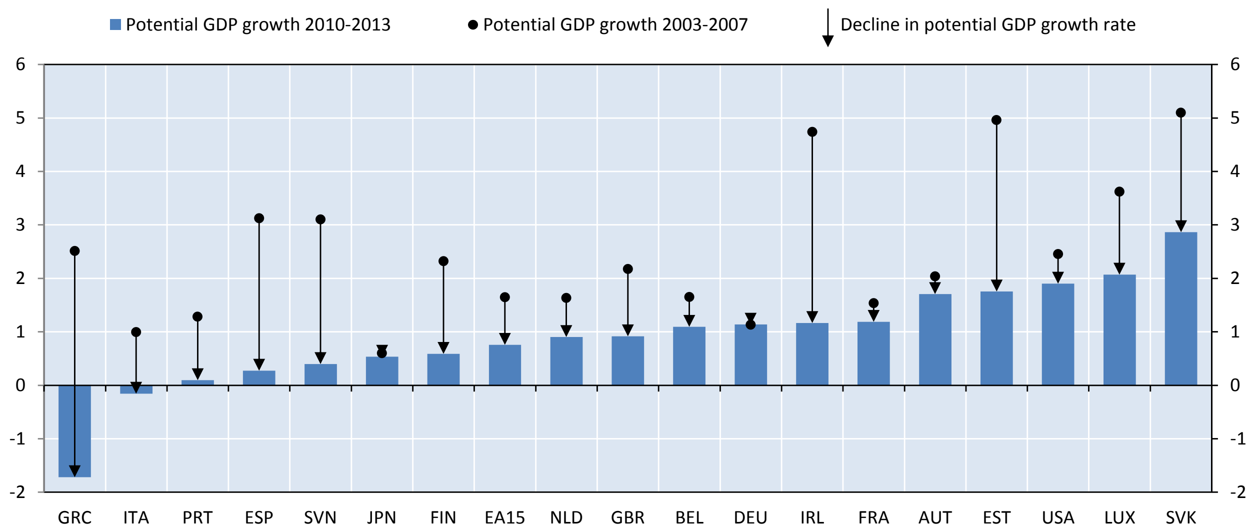
- The cylinders of the world economy continue to fire at only half speed. Growth is low and uneven and some parts of the world, such as the euro area, are at risk of falling into a trap of persistent stagnation, an extended period of low overall economic activity and low employment despite extraordinary monetary stimulus. A vicious circle is developing, with weak demand undermining potential growth (e.g. via a deterioration of the capital stock, structural unemployment and higher inequality) and weak potential growth further reducing demand (e.g. by discouraging capacity-expanding investment).
- The euro area's GDP per capita is not expected to reach back its 2007 level before 2017 at the earliest, replicating Japan's earlier experience with a "lost decade". Japan has experienced strong signs of persistent stagnation, recording average GDP growth of less than 1% per year over the past two decades. Yet, by 2013 it had surpassed its 2007 per capita income level (mirroring the United States' experience).
- Persistent stagnation should be addressed by a comprehensive stimulus package that includes structural reforms to support investment, trade, employment as well as small firms and entrepreneurship, along with more monetary and fiscal stimulus, as appropriate. Structural reforms should focus on those that reap demand gains soonest, in addition to their main impact which is enhancing the capacity of economies to grow in the long run. So designed, such reforms do not further widen output gaps. They are a 'win-win' and should be prioritised.
- Reforms that stimulate investment and trade and support small and medium sized companies and entrepreneurship can best yield such a double-dividend, together with active labour market policies. Some policies, such as training and job search programmes, can even create 'triple wins', also leading to lower income inequality and greater inclusiveness. Promoting investment in green technologies can also further improve well-being by reducing pollution and helping to addresss climate change.
- Boosting investment from its current low level will require some public funding, especially for projects with high multipliers such as infrastructure. But it also calls for structural reforms such as reducing regulatory barriers and tackling companies' bias towards share buybacks.
- Further dismantling border and behind-the-border barriers to the international movement of goods and services will serve both to expand demand and make markets more competitive and dynamic. The growth impact of lowering barriers to trade in services are potentially enormous. A reduction in the OECD's Services Trade Restrictiveness Index by 5 basis points (a modest liberalisation) could boost trade by as much as 5-9% in some sectors, such as banking.
- Improving SMEs' access to finance and easing administrative burdens on start-ups supports the most dynamic and labour-intensive set of firms. Making bankruptcy laws less punitive and improving contract enforcement also create a more growth-friendly environment.
- Employment activation provides the strongest demand effect when targeted at low-income individuals. In addition, make-work-pay policies and measures to foster labour force participation among women and older workers are key.
- Following Japan's launch of its "three arrows" policy package in 2013, there has been a pick-up in inflation and a tightening labour market. Yet, important structural reforms are still needed to promote trade and investment, reduce labour market dualism and give women better access to high-quality jobs.
- The euro area is reducing the pace of fiscal consolidation and is expected to launch extraordinary monetary stimulus. In addition, an investment plan is being launched at the EU level with some public funding that will target both the infrastructure and SME sectors. Like Japan, though, structural reforms are called for to reduce regulatory and administrative barriers to investment and trade, make bankruptcy laws less punitive, foster risk capital and ensure an effective implementation of active labour market policies.
- By themselves, regulatory and employment reforms could boost the level of GDP in Japan and the major euro area countries by nearly 2.5 per cent after 5 years.

INTRODUCTION

The world economy seems unable to leave behind the legacies of the crisis and reach a cruising speed that will deliver strong employment, rapid productivity growth and reduced inequality. The cylinders of the world economy continue to fire at only half speed. Global trade volumes continued to move in line with activity in 2014, by around 3%, in a marked break from pre-crisis norms, when global trade grew twice as fast as world GDP. Investment is also just idling along in most countries and investment gaps remain large, not only in relation to past norms but also relative to projected future steady-state levels. Governments and households, key sources of demand, are also in many countries still engaged in a process of balance sheet repair.

At rates between 1½ and 2 percent, economic growth in the OECD was slower over the period 2011 to 2014 than during the initial rebound from the crisis and also well below the pre-crisis pace. The current recovery is also slower than during past crises episodes. Japan and, increasingly, the euro area have been the main laggards. This disappointing growth performance is mirrored in a decline in countries' potential growth rates relative to the pre-crisis period (Figure 1). The moderate rate of growth means that a substantial degree of labour market slack remains in the advanced economies, especially in some euro area countries. Inflation is very low in the main OECD areas and in some countries prices have fallen.

Figure 1. Potential growth rates are well below pre-crisis rates



Source: OECD Economic Outlook 95 database.

A number of reasons have been put forward to explain the current economic conjuncture of sluggish growth, large estimated economic slack and low inflation, despite the Central Bank achievement of near-zero nominal rates, narrow credit risk and term premia, and low volatility:

- **First, interest rates cannot fall below zero, and so investment remains too costly.** Aggregate demand remains weak: fiscal tightening has contributed to slower demand, especially in the euro area. Many Central Banks have pursued policies of supporting aggregate through expansionary policy, despite nominal interest rates below zero. Nevertheless, investment has failed to recover. Meanwhile, Central Banks have a limited ability to stimulate demand as a result of a fall in neutral real interest rates (i.e. those rates prevailing when aggregate demand is in line with supply and inflation is stable at the target). One explanation for the lack of investment focuses on the fact that interests rates cannot go below zero. The decline in the real neutral rate which would induce investment to revive is attributed to several factors[1], including a fall in the demand for debt-financed

[1] See, for instance, Summers (2014) and Krugman (2014).

investment as a result of the crisis, a loss in the attractiveness of advanced countries (particularly within Europe) as a destination for international investment that is more and more flowing to emerging markets, slowing population growth which dampens the demand for new investments irrespective of the way they are financed, as well as rising inequality and households' attempts to repair their balance sheets, both of which push up savings.

- **Second, business investment may not be responsive to the cost of capital, rather only to aggregate demand.** Irrespective of the decline in neutral rates, a decline in the responsiveness of business investment to changes in the interest rate may have occurred, preventing monetary policy from showing the desired effects. This decline in the interest rate elasticity of investment is attributed to the high uncertainty that companies are facing with respect to the future economic and policy environment and which makes them very reluctant to invest irrespective of the level of the interest rate, and the sizable amounts of accumulated cash that makes companies less dependent on borrowing in order to finance potential investment projects.
- **Third, longer term, supply-side factors may be reducing potential growth**. The current conjuncture of sluggish growth might also be due to supply side factors, specifically, a fall in countries' potential rate of growth. This fall could be caused by a slowdown in the pace of technological progress or, as pointed out by Robert Gordon, a stagnant labour force, an end of the mass education revolution as well as increases in income inequality and public debt.[2] The slowdown in investment and potential growth may also be partly driven by a decline in the prices of capital goods and the increasing importance of intangibles in economic production which may not be registered in standard macroeconomic statistics. Similarly, production in the "sharing economy" is by definition missing from the reported headline figures.

The various explanations that have been put forward are closely interlinked. Some factors such as negative demographic trends contribute to both lower supply and lower demand. In addition, demand and supply side factors reinforce each other. Demand weakness is likely to undermine potential growth via deterioration of the physical capital stock and the depreciation of the human capital of those without a job (so-called labour hysteresis). The slow-down in potential growth, in turn, may weaken demand even further, notably by discouraging capacity-expanding investment.

Against this background, this note presents the evidence on persistent stagnation in the main OECD areas and discusses the policy settings that are needed to prevent countries from falling into this trap or help them getting out of it. Persistent stagnation is likely be caused by a combination of the factors described above, which calls for a comprehensive policy package. Accommodative monetary and fiscal policies need to be accompanied by structural reforms that ensure that the macroeconomic stimulus has the desired effect. For instance, a generalized continuation of monetary easing, without any change to the structure of financial markets and the allocation of assets, is likely to sow bubbles without enhancing real investment. Structural reforms are also important to mitigate hysteresis effects as well as to boost potential growth and neutral rates.

The note focuses focuses on 'triple wins' structural reforms, that can support short-term demand, increase long-term productivity growth, while also avoiding any negative impact on income inequality. Four main areas for structural reform are identified that can fulfil this criteria: investment, SMEs and entrepreneurship, trade, and employment activation. Since the signs of persistent stagnation are currently the strongest for the euro area, and to a lesser degree Japan, the note also discusses concrete macroeconomic and structural policy settings required in these regions. Since the focus of the note is on the short term problems faced by these countries and the immediate policy response, it does not discuss the fundamental shifts that are under way in terms of how economies operate, such as the rising importance of intangible assets, the emergence of the sharing economy, the digital revolution, and technological convergence. As mentioned earlier, these trends have implications for statistical reporting of macroeconomic trends. They are also essential to understand the broader landscape for growth in the years to come.

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[2] See Gordon (2014).

THE EVIDENCE ON PERSISTENT STAGNATION

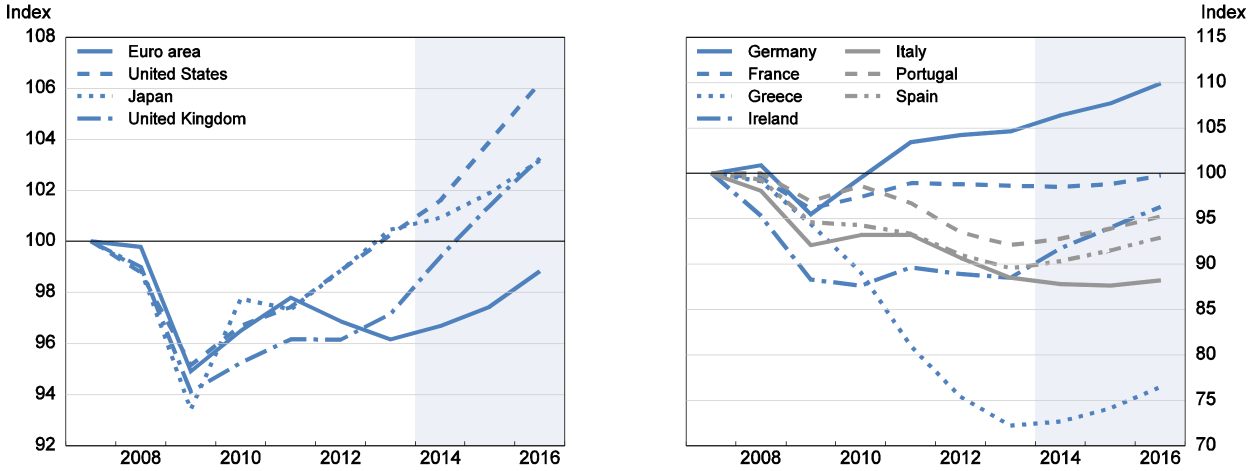
Obtaining clear evidence about a persistent stagnation trap is complicated by considerable uncertainty surrounding estimates of economic slack, its impact on inflation, crisis-related hit to potential output and neutral interest rates. The euro area as a whole, and in particular some of its member countries, seems to be most likely affected by persistent stagnation. In the United States and the United Kingdom, evidence is less firm, while Japan has had two decades of weak growth in the context of a falling working-age population.

- ***Euro area***: In the area as a whole, the crisis-related hit to potential output has been significant and the fall in the neutral interest rate implies that the decline in interest rates to close to zero may not be giving sufficient stimulus. Actual and potential growth dynamics have been mediocre and slack remains large, especially in labour markets. Investment and confidence are low and intra-EU trade remains very weak. The stagnation features have been particularly strong in the vulnerable countries.
- ***Japan***: Labour hysteresis effects since the Great Recession have been absent, but GDP growth has been generally sluggish since the early 1990s and deflation has persisted for 15 years. Estimated neutral rates have been well below actual rates for almost two decades, suggesting that the zero-interest-rate policy had long failed to provide sufficient support to demand, though quantitative easing was introduced in 2001 and significantly expanded in 2013 when Japan also introduced qualitative monetary easing measures. While the collapse of the bubble in the early 1990s and the banking crisis held down growth during the 1990s, the economy was held back during the following decade by longer-term factors, notably the sustained drop in the working-age population, as well as headwinds from deflation. Of course, the two crises – the 2008 global financial crisis and the 2011 Great East Japan Earthquake – also slowed growth.
- ***United States***: Hysteresis effects have been present but muted compared with elsewhere. Although the neutral interest rate is likely to have fallen, monetary policy has still provided stimulus to aggregate demand through conventional and unconventional measures. Consequently, average GDP growth has been not far from historical averages, even if economic slack still persists. Investment growth has recently begun to pick up.
- ***United Kingdom***: Hysteresis effects appear to have been strong and neutral rates have fallen, but less than real short-term interest rates. Consequently, monetary policy has succeeded in boosting GDP growth and eliminating economic slack. Investment has strengthened and now exceeds GDP growth.

The euro area economy's recent dismal performance stands out from the others, and is leading to a 'lost decade' (Figure 2). The region's GDP per capita is not expected to reach its 2007 level before 2017 at the earliest. In contrast Japan and the United States surpassed their respective 2007 level in income per capita in 2013, while the United Kingdom did so in 2015.

Figure 2. The euro area underperforms the United States, the United Kingdom and Japan

Real GDP per capita levels, index 2007 = 100



Source: OECD Economic Outlook 96 database; Eurostat; and United Nations.

MACROECONOMIC POLICY IMPLICATIONS

Persistent stagnation or the risk of falling into it should be addressed by a comprehensive stimulus package. Combining appropriate monetary and fiscal policies with structural reform, as in the 'three arrows' popularised by Japan's Prime Minister Abe, could have the desired effect of boosting demand in the short term while increasing potential output. However, large uncertainty about the size and persistence of hysteresis and risks associated with certain measures poses policy dilemmas:

- ***Monetary policy***. With policy interest rates at their effective lower bound, further stimulus would have to come from unconventional measures, including quantitative easing (QE), forward guidance or schemes to provide funding to banks. The effectiveness of QE measures depends on the institutional and financial systems in each region. Furthermore, there is some evidence that the effectiveness of such measures may decline as they are used more extensively and asset prices become richly valued. Thus, their effectiveness is not certain as they may also encourage excessive risk-taking and asset price booms that lead to financial instability and costly recessions. Prudential measures could offset some of these risks, but there are limits to their effectiveness and it is doubtful if they can counter a generalised rise in risk-taking. Moreover, tightening regulation for commercial banks can result in regular bank activities migrating to lightly regulated shadow banks.
- ***Fiscal policy***. Fiscal stimulus could be at least partly self-financing (as a permanent increase in potential output implies a permanent increase in taxes) in the presence of hysteresis, high fiscal multipliers and sustained low real interest rates. Nevertheless, such a strategy involves risks. The cost of increased debt may turn out to be higher due to reduced private investment and increasing economic vulnerability. There is also a fiscal sustainability risk for countries with very high debt levels. In general, the composition of public expenditure should be directed towards spending items with a large impact on growth such as public investment and, in particular, infrastructure investment. Similarly, revenue-neutral tax changes that reduce the tax burden on low-wage workers and instead raise indirect taxes on property or the environment could help boost activity and employment.

STRUCTURAL POLICY IMPLICATIONS

More monetary and fiscal stimulus should be accompanied by structural reforms that boost potential growth, thereby increasing the effectiveness of the stimulus measures. The presence of hysteresis effects strengthens the case for accommodative policies, with potentially beneficial longer-term implications for economic activity. Structural policy reform, however, risks widening output gaps from already high levels and reduce inflation further if it were to weaken aggregate demand. To the extent that hysteresis effects operate, the widening of economic slack could on its own permanently reduce output, thus offsetting to some extent the beneficial long-run effects of structural reforms. For this reason, reforms that have immediate positive demand effects should be prioritised when economic slack is large.

Reviving investment

Reforms that stimulate private investment clearly fall into this category: they help increase both demand and potential output. Investment rates are still very low in relation to past trends, especially in euro area countries (Figure 3). While investment in innovation, particularly in knowledge-based capital is vital to raise countries' growth potential over the medium to long run, investment in infrastructure and other forms of physical capital formation has the greatest potential to help countries boost demand and overcome the risk of persistent stagnation. The need for investment in infrastructure, including ICT infrastructure, is indeed enormous in many countries and the social returns from this investment are often expected to be extremely high. Promoting investment in green infrastructure can also improve well-being by reducing pollution and helping to addresss climate change.

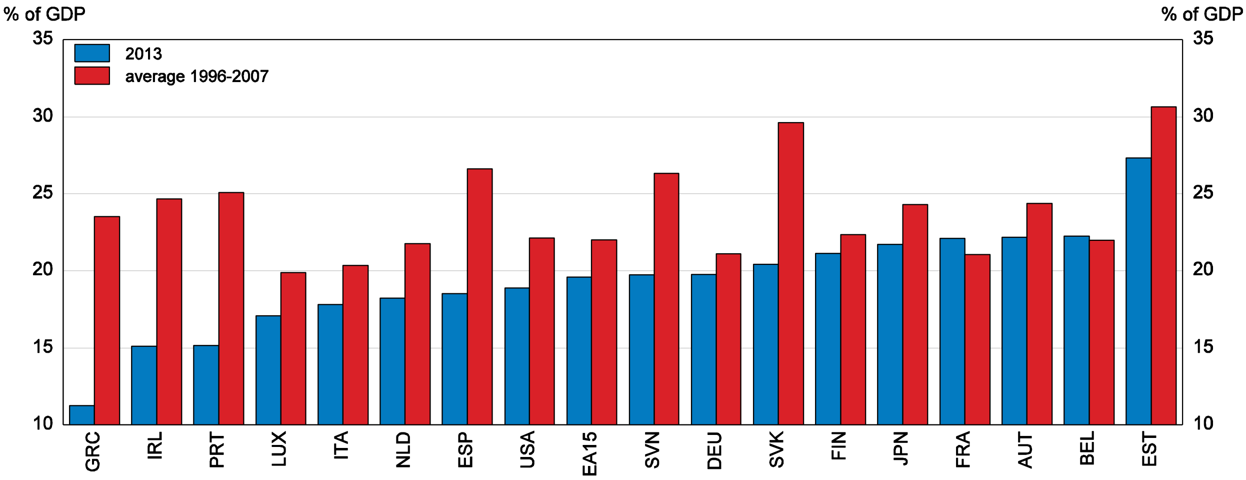
Private sector infrastructure investment remains very low in many countries, even as companies hold record levels of cash and the cost of borrowing is at historical lows. While the United States has so far been a notable exception thanks to heavy investment spending by oil-related companies, this risks changing going forward as a result of the lower oil price. Non-infrastructure investment has also stagnated in most advanced countries in recent years (while it has been expanding rapidly in many emerging markets). Instead, there has been a tendency for companies to engage in M&A activity or buy back their own capital to increase the price of shares outstanding.

There are many possible reasons why companies may be reticent to invest in the current environment. From a home country point of view it may simply be that larger multinational enterprises (MNEs) choose to invest elsewhere. This would be associated with some shift in the centre of gravity of advanced-country investment towards emerging markets (for global supply chain, labour cost and tax incentive reasons) and may be perceived as stagnation in the home countries of the companies concerned (and policy errors would follow if this were wrongly interpreted as being due to domestic factors alone). From the viewpoint of the global operations of companies there is evidence that the process of investing strongly in emerging markets may have gone too far. Over-investment can be said to occur when the return on equity of companies is less than the cost of equity as such investments destroy shareholder value. This is very clearly the case on average in emerging market economies. Over-investment would result in downward pressure on margins and a rational view might be that it is better to give earnings back to shareholders rather than invest cash in value destroying ventures.

Investment is also held back by uncertainty related to the subdued prospects for growth and the operation of financial markets as well as concern about what the world may look like on a full normalisation of policy. The financial re-regulation process is not complete and long-term relationships in banking are subject to change, including via the impact of fragmentation in banking and the reduction of cross-border flows. Macro policy is not running at normal interest rate levels, and there is a sense that if this is so economic growth is not durable at normal rates. Hence, in a low-interest rate environment some investors cheer companies that focus on dividends and buybacks to improve investor (tax effective) yields, in large part because growth of earnings per share is perceived as more uncertain. This works against investment. Where borrowing is used to finance over investment in emerging markets, the risk of financial crises rises and works against more sustainable long-term investment. Private companies in particular will become more cautious—damping the investment incentives in favour of hoarding cash or undertaking buybacks.

Figure 3. Boosting investment has a great potential to lift countries out of persistent stagnation

Share of current investment to current GDP



Source: OECD Economic Outlook 96 database.

The significant lack of investment in many advanced countries and the multitude of reasons behind call for a bold package of reforms to support private investment:

- ***Promoting reasonable returns for private investors***. One reason for the reluctance of companies to invest in infrastructure and other long-term or higher-risk projects is the low expected private returns. Appropriate risk mitigation by the state in well-designed public-private partnerships can help address this problem. Mechanisms such as credit and revenue guarantees and first-loss provisions can act as catalyst for private investment, but they should avoid excessive risk for taxpayers. In addition, poor governance, including regulations and red tape, bribery and corruption, unclear property rights and long judicial processes in the event of disputes, bid rigging and biased procurement processes make infrastructure investment unattractive in many countries. One important example of a regulatory barrier to green investment is local content requirements, which raise costs without creating jobs. Moreover, state-owned enterprises often play too large a role in infrastructure markets, limiting efficiency and impeding competitive neutrality.

- ***Mobilizing institutional investors***. Infrastructure investment financing has also been affected by bank deleveraging and financial sector reforms. Institutional investors have great potential to cover some of the financing gap, as less than 1% of more than USD 80 trillion of institutional assets are invested in infrastructure. However, major barriers to long-term investment remain. Institutional investors face obstacles related to upfront financing and risks, including regulatory risks.

- ***Completing financial sector and international tax reform***. Financial sector reform or, more specifically, the lack of its completion, also adds to the credit constraints faced by companies, especially smaller ones, and makes them reluctant to undertake investment projects. Governments need to complete the financial reform process and, in doing so, make financial regulation more consistent across borders. Reforms must also be time-consistent in order to create certainty for investors. Policies that enhance stable crisis-free growth (including macroeconomic policies) are also key to reducing uncertainty by conquering fears that economic growth is not sustainable at normal interest rate levels. Finally, governments need to make progress in the area of tax reform, including the fight against base-erosion and profit shifting, to create certainty for companies regarding their future after-tax returns.

- ***Removing restrictions on international investment flows***. The global shortfall in investment over the past few years also calls for bolder action to liberalise restrictions on international investment. While countries have made steps in the right direction, progress is slow and uneven. Even within OECD countries, restrictions on foreign investment remain in key network sectors such as energy and transport. Worldwide, many service sectors remain partly shut off to foreign investors. FDI in service sectors can also help strengthen countries' participation in global value chains. Overall productivity of manufacturing firms is substantially affected by FDI restrictions and stringent product market regulations that constrain competition in service sectors such as financing and logistics and consequently raise input costs for other sectors that make use of these services as intermediate inputs. To avoid distorting international investment and creating overinvestment in some regions and underinvestment in others, it is also crucial to better coordinate tax policy across countries. In addition, a broader reform of the international monetary system might be needed to avoid biasing international investment flows towards specific regions or countries.

- ***Tackling companies' bias towards share buybacks***. Corporate laws (including in particular tax laws) and regulatory rules need to be revisited to ensure that they do not favour share buybacks over other types of investment. In the limit, governments might even consider restraining buybacks. In addition, executive option and share allocation schemes need to become better aligned with long-term investment objectives as opposed to quarterly or annual earnings-per-share targets.

Policies to support investment will also impact the distribution of income. Most notably, greater openness to foreign investment facilitates the integration into global value chains (GVCs), which is likely to increase employment opportunities. But participation in global markets is not automatic and countries with insufficient technological capabilities or less productive firms are at risk of being left behind. Structural policies that boost investments in knowledge-based capital and associated skills can therefore be thought as important complements of more open investment policies. At the same time, fiercer competition may destroy some jobs and reduce workers' bargaining power. Complementary policies are thus also needed to help displaced workers find new jobs and to redistribute the gains across population groups. As such, it will be important for countries to pursue active labour market policies and investments in education and training – to better match labour supply with demand – and to develop adequate social safety nets.

Supporting SMEs and entrepreneurship

Strengthening SMEs and reviving entrepreneurial dynamics are also crucial for kick-starting post-crisis growth and preventing persistent stagnation. SMEs and entrepreneurs are key drivers of innovation and productivity growth by turning creativity and intellectual assets into economic value, bringing new ideas to the market and displacing less productive ventures. New spin-off ventures enable the commercialisation of knowledge that would otherwise remain un-commercialised in large firms, universities and research organisations. Through the development of new products and services, SMEs and entrepreneurs may also contribute to higher employment and demand, thus limiting potential adverse effects on the output gap.

SMEs and start-ups are also a major source of job creation. Across OECD countries, SMEs account for about 70% of employment and generate about 65% of value added. Young SMEs are particularly important – evidence suggests that even though SMEs of 5 years old or less have a small weight in the economy (they represent on average 17% of employment), they contribute more than twice as much to job creation (42% of the total) and only to 22% of all job destruction, making them (net) job creators. This was true even during the crisis – young firms remained net job creators.

Yet, in the aftermath of the global economic crisis, start-up rates have declined in many OECD countries, notably in those southern European countries which have been stricken most heavily by the recession (e.g. Italy, Spain and Portugal). This has led to a decline in the stock of companies which has been associated with higher unemployment. A key challenge for policy makers is to restart and sustain the mechanisms for enterprise creation as well as to undertake structural reforms to address long-standing market and institutional failures which limit SME growth. Reforms are particularly vital in the following four areas:

- ***Health of the banking sector***. Access to finance is one of the barriers that limit SME growth in many countries. Bank lending is crucial for SMEs' working capital and investment needs, but in a post-crisis deleveraging environment bank lending is reduced. This has affected SMEs in particular because credit sources tend to dry up more rapidly for small firms than for large companies during lending squeezes. Restoring banks' health to improve bank lending is thus key to foster SME finance.

- **Financing instruments**. A second key lever to improve SME's access to finance is to support the development of a broad range of non-bank financing for SMEs, especially venture capital that targets new, innovative and fast-growing companies. Securitisation, which has been tarnished by the subprime crisis needs to be revitalised, conditional on being safer, simpler and more transparent. This may involve some (initial) government and regulatory support. In addition, there is a need to strengthen the frameworks for other alternative financing instruments for SMEs that are currently underdeveloped (e.g. asset-based finance, private placements, mini-bonds, mezzanine and equity financing). At the same time, the take-up of a broader range of financial instruments by entrepreneurs and SMEs needs to be encouraged through better financial education and awareness campaigns. To avoid that the current very low interest rate environment leads to excessive risk-taking, resulting in capital misallocation and the build-up of financial fragilities by increasing leverage in the non-bank financial sector, adequate regulatory responses and heightened vigilance by supervisors are needed.

- ***Bankruptcy laws***. Reforming bankruptcy laws is particularly important at a time when a larger-than-usual number of firms fail. Success in entrepreneurship requires experience, and serial entrepreneurs are often those who create the most successful enterprises with the largest impact on employment. Liquidation and discharge procedures need to allow entrepreneurs a fresh start. This includes reducing the stigma from bankruptcy, so that honest entrepreneurs are not deterred from re-starting a new venture. For this purpose, and to preserve creditors' interest, it is essential to have efficient insolvency proceedings and strong out-of-court procedures in place. There is also a need for a clear and effective strategy to deal with zombie firms.
- ***Business environment***. Reducing regulatory uncertainty, complexity and inconsistency as well as corruption and infrastructure deficiencies is key to facilitating the creation and expansion of firms, particular as SMEs are disproportionately affected by such burdens. In addition, improving contract enforcement and reducing tax burdens are areas where governments can make strides, as starting a business at a time of weak demand requires as much facilitation as possible by the government.

Policies to support SME development and entrepreneurship may also impact the distribution of income. While success stories in entrepeneurship can boost incomes at the upper end of the income distribution, entrepreneurial opportunities are also a good channel for economic and social participation and upgrading, and for tapping into talent and innovativeness that flourish in different parts of societies. The economic empowerment of marginalised groups, including young people and women, may allow more efficient use of skills and contribute economic as well as social value to societies. In the short to medium term, therefore, there is a real opportunity for governments to use entrepreneurship policies to meet the dual objectives of productivity growth and job creation, which is key in the current context of prolonged slow growth and high unemployment.

While competition can promote inclusiveness by lowering prices through reduced producer margin, it also encourages firms to invest in new technologies and knowledge-based capital, which increases the demand for specific skills and render others obsolete. Furthermore, workers in previously protected industries can face a decrease in bargaining power due to market forces. Such side-effects of pro-competition reforms are likely to widen wage disparities but since they also enhance employment opportunities, they may not worsen income distribution overall. Higher income inequality is undesirable for social reasons, but also because it would dampen demand and, hence, reinforce the stagnation problem. Effective active labour market policies that relocate displaced workers and support relevant skill formations therefore need to accompany pro-competition reforms to fully reap their benefits.

Boosting trade

Revitalising the trade engine is a third central element in the fight against persistent stagnation. Trade can boost potential output by fostering competition in domestic markets and by facilitating technology transfer. The demand-side effects are less clear-cut, but generaly positive overall. While reducing trade barriers may help countries in or at risk of persistent stagnation to better access foreign markets, it may also divert domestic demand away from domestically produced goods and services towards imports. However, cheaper inputs mean cheaper exports and thereby support domestic employment, although in different industries.

Over the past several years, the OECD's work on measuring trade in value added (TiVA) and global value chains (GVCs) has changed our understanding of global trade, investment and production patterns, leading to a better measurement of the gains from trade and the costs of protectionism. As the work on TiVA has shown, most trade today is in intermediate inputs – over 50% of goods trade and almost 75% of services trade – highlighting that success in international markets today depends as much on the capacity to import high-quality inputs as on the capacity to export.

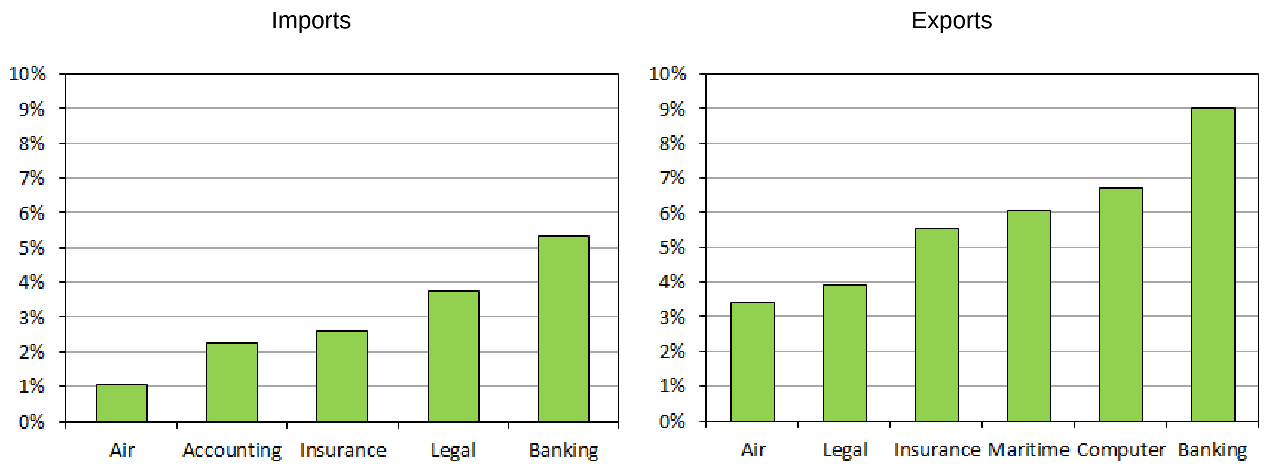
To revitalize both imports and exports, countries need to look both "behind the border" at regulatory measures as well as at trade facilitation measures "at the border":

- ***Making customs and border procedures more efficient***. Inefficient customs and other border procedures impose unnecessary costs on traders every time an import or an export crosses a border. The OECD has estimated that a 1% reduction in these trade costs would generate benefits of about 40 billion USD. The WTO Trade Facilitation Agreement (TFA) reached in Bali offers an immediate opportunity to reduce these unnecessary costs; OECD analysis estimates that trade costs could be reduced by as much as 14% for developing countries and up to 10% for developed countries if the TFA is implemented. Likewise, it is important for countries not only to avoid introducing new forms of protectionism, but also to begin to wind back restrictive measures that prevent firms from trading. Doing so can stimulate business activity and lead to higher growth and jobs.

- ***Liberalizing services sectors***. Efficient service sectors (in particular, telecommunications, logistics, transport, finance, professional and business services) are crucial for improving productivity and growth, in addition to their role in creating value. Services account for 80% of employment, 75% of GDP, and 50% of value added exports in emerging and advanced economies. The new OECD Services Trade Restrictiveness Index (STRI) reveals that even modest reforms in regulations that restrict services trade could considerably boost trade. For instance, a reduction in the STRI index for commercial banking services by 5 basis points (which represents a relatively modest liberalization) would boost a country's imports of those services by 5.3% and its exports by 9%. In the insurance sector, a similar reform would be expected to raise imports by 2.6% and exports by 5.6% (Figure 4). Adopting a liberal trade and investment regime and a pro-competitive regulatory stance in key infrastructural service sectors will also be essential for countries to maximise benefits from the internationalisation of services markets.

Figure 4. The GDP growth effects of lowering barriers to trade in services are enormous

Estimated impact on imports and exports of a reduction in the STRI by 0.05



Source: Nordås, N. and D. Rouzet (2014), The impact of services trade restrictiveness on trade flows: first estimates, OECD Trade Policy Analysis Paper, forthcoming.

- ***Complementing the multilateral trading system with ambitious and comprehensive bilateral or regional agreements.*** In the increasingly interconnected world, the multilateral trading system remains the first best option for boosting global trade, growth, and jobs. While it will be up to WTO members to find a path forward on the multilateral agenda, countries can nevertheless make progress to open markets unilaterally, but also through ambitious and comprehensive agreements like the Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership. Such partnerships can in fact strengthen the multilateral system to the extent they go beyond commitments made in the WTO and remain open to additional participation by countries committed to their high standards. The same can be said for sectoral agreements, such as the Trade in Services Agreement and the Environmental Goods Agreement.

In the same vein as effective flanking policies are needed for countries to seize the opportunities created by openness to foreign investment, trade opening requires complementary policies to fully reap its benefits and ensure that these benefits are shared across the entire population. Again, active labour market policies and investments in education, skills and training are key.

Raising employment

Promoting more and better jobs and thereby reducing inequality also yields a double-dividend in terms of higher demand and higher potential output. The demand effect is likely to be stronger for policies targeted at low-income individuals due to their higher propensity to consume. Even though there are finally some welcoming signs of improvement in labour markets of some of the most affected countries, employment remains significantly lower than before the crisis in many countries. An estimated 202 million people remain unemployed globally, and many more are under-employed in low-paid and often precarious jobs. OECD work has identified several policies that can make a difference:

- ***Providing targeted policies to help unemployed jobseekers overcome barriers to finding work.*** Training and other activation measures are needed for the long-term unemployed who often experience a range of difficulties in finding jobs. These include poor or inadequate skills, stigma effects associated with long-term unemployment, and a weakened motivation to look for a job along with an increased risk of withdrawing from the labour force altogether. Addressing these barriers requires well-designed activation measures which support and incentivise job search and job finding amongst vulnerable groups, particularly youth, improve their productive participation in society and increase their self-sufficiency.
- ***Promoting labour force participation, particularly among women and older workers***. The most important factor in the return-to-work decision of mothers is often the availability of affordable, flexible and good-quality childcare. Flexible workplace arrangements, such as part-time employment opportunities and teleworking can also assist working mothers. Tax and benefit systems still often penalise second earners in a household, and need to be reformed. For older workers, too, the financial advantage of continued work can be low, because of inappropriately designed pension and early-retirement systems. Care is also needed to avoid disability benefits becoming a route into early retirement. In addition to ensuring that older workers have an incentive to work, they also need to have the right skills. Too often, the needs of older people to develop their skills have been neglected by employers and by employment services. Finally, demand for older workers needs to be promoted, for example by addressing the widespread prejudice among employers about the aptitudes of older workers.
- ***Putting in place make-work-pay policies to make work more attractive and tackle rising labour market inequalities***. While work can be an effective and sustainable way out of poverty, it does not entirely eliminate the risk of poverty, particularly for lone parents and single-earner households with children. Indeed, in-work poverty in OECD countries remains sizeable – in 2011 it amounted to 8.5% of the working-age population – and has increased slightly since the mid-1990s. In-work benefits can be particularly effective for fighting in-work poverty and boost consumption among the most vulnerable. A moderate minimum wage can further help to mitigate in-work poverty and reduce labour market inequalities, without having major negative employment effects.

POLICY REQUIREMENTS TO OVERCOME THE PERSISTENT STAGNATION TRAP

Euro area

As discussed above, there are significant signs of persistent stagnation in the euro area and particularly in the most vulnerable member countries. To overcome this problem, the euro area as a whole requires more accommodative macroeconomic policies, combined with measures to strengthen the banking sector. Further unconventional monetary accommodation is needed and the pace of structural fiscal adjustment could be slowed in some countries where there is space to do so. To ensure an efficient transmission of monetary policy, it will also be essential to finalise the repair of bank balance sheets. While the recent comprehensive assessment of euro area banks' balance sheets has facilitated greater price discrimination among bank shares, the effect in terms of restoring investor confidence will be stronger if the assessment is complemented in the next round by a stress test against a simple leverage as advocated by the OECD at a level at least equivalent to that imposed on foreign bank organisations in the United States.

At the same time, euro area countries need to make further progress with structural reforms to boost potential output growth. These reforms should be designed so as to have the least negative impact on demand and income inequality (and, if possible, a positive impact):

- ***Boosting investment***. Priority should be given to reforms that stimulate investment. Further support is expected to come from the *Investment Plan for Europe* – the so-called Juncker *Plan* –announced by the European Commission in November 2014. At the core of this plan is the European Fund for Strategic Investment (to be managed by the European Investment Bank) that is expected to raise EUR 315 bn in investment over the three years of its operation (2015-2017), with public guarantees of EUR 21 bn. Some observers have raised doubts whether sufficient private investors would be available for raising the expected amount without additional assurances. Moreover, even if the money can be raised, the size of the additional investment will amount to less than 1% of EU GDP, calling into question the plan's impact. Scepticism has also been raised regarding the proposed pipeline of projects and the fact that only one quarter of the funds will be directed towards SME and mid-capped companies. However, despite these critiques, the initiative is certainly a step in the right direction. To ensure that the plan creates *additional* investment and does not simply make already planned projects more profitable, it will be important to select higher-risk projects which would not have been realized without the public guarantees.
- ***Improving the general investment environment***. Funding alone is not sufficient to boost investment. Therefore, another important element of the Commission's plan is the European Capital Markets Union that should improve the general investment environment in Europe and remove regulatory bottlenecks, thus reducing fragmentation and the cost of funding projects as well as diversifying the supply of finance for SMEs and long-term projects. Nonetheless, at a macro level, there are limits to how much Europe can do by itself to encourage additional investment as international investment flows depend on the regions' attractiveness relative to other countries.
- ***Improving the general business environment***. Reducing regulatory uncertainty and lowering the administrative burden for businesses will facilitate the creation and expansion of firms. Some countries have already started to act. For instance, Italy streamlined the civil justice system by a geographical aggregation of courts, thematic specialisation of judges, stricter rules on filing appeals and alternative forms of conflict resolution. Also the EU Commission has launched a number of initiatives over the last decade to improve the quality of legislation (estimates by national authorities suggest that EU-origin regulations account for 40-50% of the total administrative burden imposed on firms). This includes an Impact Assessment system for new Commission proposals, the EU Administrative Burden Reduction (ABR) initiative, and the Regulatory Fitness Performance Programme (REFIT). While the European Parliament and the Council have adopted many measures in line with the ABR, many of these remain to be implemented at the national level. The Commission is in the process of extending this effort through the REFIT programme. But despite these welcome efforts, deeper reforms that involve changes in policy design programme are also needed to further reduce administrative burdens.

- ***Better harmonizing regulations***. Efficiency gains can be reaped from better harmonisation of regulations. In particular in network sectors that are still regulated on a national basis (*e.g.* telecommunication, energy), efficiency gains can be achieved by making regulations more compatible. Co-operation between national regulators should be further strengthened, with a view to move towards cross-border regulators. Tax-related administrative burdens also increase heterogeneity and costs for companies. They should also be harmonised and simplified while allowing national governments to set tax rates that reflect national preferences.

- ***Reaping the benefits of the digital economy***. The digital economy is opening up new opportunities for the Single Market. However, polls indicate a lack of trust among consumers in cross-border e-commerce, calling for more effective data protection security measures. The regulatory framework for the digital economy should establish technical and legal security and privacy standards. In addition, to ensure a level playing field, the authorities need to be able to prevent network or platform providers from abusing market power.

- ***Broadening the range of financing instruments for small and young firms***. New entrepreneurship financing methods need to be developed to reduce reliance on loan finance – which is particularly pertinent in the most vulnerable countries. This heavy reliance on loan finance in a time when banks are deleveraging and reducing their risk-weighted assets has reduced credit availability. By switching to non-bank financing instruments, for example mini-bonds, SME's in some countries managed to overcome part of these financing constraints. Equity tools, which are hardly used in European markets also have the potential to provide financing for innovative and high-growth SMEs. To the extent that investors' return expectations are not compatible with what SMEs can deliver, the public sector might have to step in, for instance by guaranteeing for the first losses on lending to SMEs.

- ***Fostering risk capital***. A crucial issue with investment in SMEs is the riskiness especially of small, innovative start-ups. Seed and venture capital as well asprivate and public equity finance more broadly for higher-risk growth companies needs to be fostered. Especially in Europe there is a lack of a risk equity culture. Fostering private pension savings and promoting education around equity investment could be a way to stimulate participation in growth markets. Furthermore, fostering dedicated exchanges and platforms for high-growth small-caps, as well as developing the ecosystem (brokers, market-makers, advisors, equity research) more generally, would help the development of SME equity finance and maintain liquidity in such markets.

- ***Revamping bankruptcy laws***. Governments need to make bankruptcy laws less punitive and give a chance for company restructuring. A number of countries have recently started reforming their bankruptcy laws in that direction. In Italy, companies can now ask for a three-month protection from creditors as they try to come up with a new business plan. In Spain, a new law introduced the principle of a "cram-down" of a debt restructuring agreement on dissenting creditors. But EU Member States need to accelerate the implementation of the EU Small Business Act, which demands governments to ensure that honest entrepreneurs who have faced bankruptcy quickly get a second chance by promoting a positive attitude in society towards giving entrepreneurs a fresh start, completing all legal procedures to wind up the business in the case of non-fraudulent bankruptcy, and ensuring that re-starters are treated on an equal footing with new start-ups, including in support schemes.

- ***Reducing trade barriers.*** Trade barriers are most prevalent in the services sectors where both intra-EU trade and trade with third countries face significant trade costs. Trade barriers are particularly onerous in the professional services where the licensing requirements vary considerably within the EU, making it difficult and costly to provide services across borders or establish a business in another country. The mutual recognition directive goes some way in mitigating the trade costs for intra-EU trade, but much more needs to be done to reform and open the professional services. In the telecoms sector individual EU countries, such as France, have well regulated and open telecommunication markets, but the EU market remains fragmented to the detriment of consumers as well as businesses. There is evidence that barriers to trade and competition in this sector not only impede trade in telecommunication services, but affect trade and competitiveness in most sectors. The OECD STRI shows that some EU countries, notably the Netherlands and the UK have among the lowest barriers to trade in services in the OECD, while others have significant barriers to trade. There is thus ample scope for benchmarking towards best practice also within the EU.

- ***Bringing people back into work.*** Taking action now to strengthen the labour market attachment of groups that face significant employment barriers in many European countries, such as the long-term unemployed, women, migrants and older workers is essential. Often prompted by the crisis, a number of European countries have recently undertaken significant reforms in these areas, developing training programmes and job-search assistance which are responsive to the needs of participants. In several countries, such as Italy, Portugal and Spain, as well as a number of Central and Eastern European countries for example, these reforms also seek to promote the creation of open-ended contracts, while at the same time reducing the gap in regulations between them and different atypical contracts. This often involves clarifying conditions for hiring and separation of workers under different contracts, and tackling abuses in the use of temporary contracts. However, the position of young people in the labour market of some countries remains dire, giving rise to the risk of long-term 'scarring' of those unable to get an initial foothold in the labour market. Short-term measures to boost job creation need to be combined with reforms to enhance access to jobs, improve education outcomes and strengthen the compatibility between the skills acquired by students and those needed by business. In this context, the European Union has developed a Youth Guarantee initiative in its Member countries, whereby young people up to the age of 25 should receive a good quality offer of employment, continued education, an apprenticeship or a traineeship within four months of leaving school or becoming unemployed. If fully implemented, this initiative has the potential to contribute to better labour market outcomes for school leavers and thus reduce the risk of scarring for them.

Japan

Japan has set a target of achieving 2% real growth over the decade 2013-22 through the three arrows of Abenomics. The first arrow, bold monetary policy, should continue under the current QE programme until the 2% inflation target is sustainably achieved. The second arrow, flexible fiscal policy, is limited by Japan's very high sovereign debt, which is expected to continue to increase over the next decade even with sustained consolidation. Failing to improve the fiscal position thus risks sparking adverse financial market reactions. To ensure market confidence, the top priority should be to produce a detailed and credible long-term consolidation plan, including social security reforms to limit spending increases in health and long-term care and revenue increases. In addition, Japan could support activity through revenue-neutral fiscal reform, including in particular a lowering of direct taxes rates and a broadening of their base.

In view of limits to macroeconomic stimulus in Japan and an ageing society, bold structural reforms – the third arrow of Abenomics – are needed to boost actual and potential GDP:

- ***Making product markets more conducive to competition***. The government needs to implement bold product market reforms, especially in services sectors. The challenge is to boost total factor productivity (TFP) growth throughout the economy, but particularly in services, which account for a growing share of output. Indeed, TFP growth in the non-manufacturing sector has been declining since its peak in 1991, widening the gap with the manufacturing sector. The wide gap has led to an inefficient SME sector characterised by low productivity, weak profitability and high leverage. Japan's overall PMR indicator is slightly below the OECD average, but well above leading OECD economies, suggesting a need for across-the-board reform.

- ***Achieving greater international trade openness***. Japan should continue pursuing comprehensive regional trade agreements with major trading partners, including by scaling back protection in sectors where it is highest. In addition, the country should further dismantle non-tariff barriers, for instance by simplifying administrative procedures and improving market access. Japan has entered into 14 Economic Partnership Agreements (EPAs) since 2002, primarily with smaller Asian economies, which cover less than a quarter of Japan's trade. The government has set a target of boosting the share to 70% by 2018. Expanding Japan's participation in comprehensive trade agreements depends on the extent to which it opens its agricultural sector. Border measures contribute to the overall high level of assistance: the Producer Support Estimate was 50% in Japan in 2011-13, three times the OECD average. Prices received by farmers are double the world market prices, imposing heavy burdens on taxpayers and consumers. Indeed, higher prices boosted consumer spending on agricultural products to 1.7 times what it would have been in the absence of government policies.

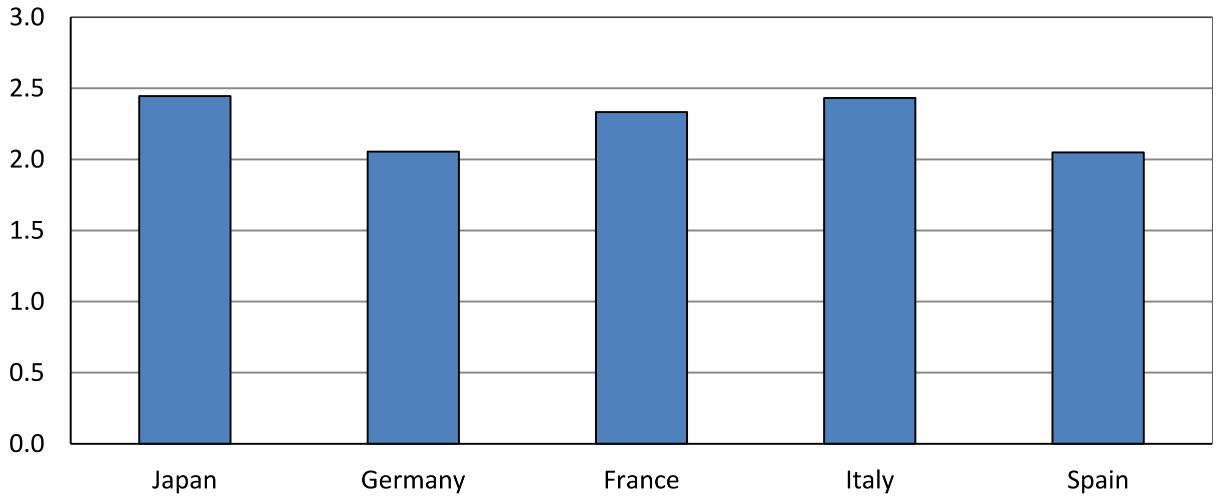
- ***Increasing FDI inflows***. Improving the climate for foreign direct investment inflows is also vital to support growth. The stock of inward FDI in Japan has fallen in recent years as a share of GDP and remains the lowest in the OECD. The government aims to double the stock by 2020, which requires addressing the low level of corporate mergers and acquisitions, the high corporate income tax rate, the lack of clarity and accountability in Japan's corporate governance framework, uncertainties in the regulatory environment, inflexible hiring and firing rules for labour and the lack of mid-career mobility, as well as restrictive rules on the entry of workers. Barriers to the entry of foreign firms also need to be lowered, particularly in air and maritime transport as well as in telecommunications (where foreign investment is limited to one third of the shares of the main operator, NTT). The government could also review its notification requirement for foreign investment.
- ***Reducing labour market dualism***. Japan needs to implement policies to break down labour market dualism, which the government has identified as the major cause of rising inequality and relative poverty. In addition, labour market dualism has negative implications for growth as non-regular workers receive less training from firms. A comprehensive approach is necessary, including increasing the coverage of non-regular workers by social security insurance schemes, reducing employment protection for regular workers, upgrading training programmes to enhance the job prospects of non-regular workers and ensuring that the social safety net is adequate. Breaking down labour market dualism would also provide more attractive job opportunities to women, who account for 60% of non-regular workers.

The impact of reform

The gains from implementing some of the reforms advocated above can be quantified based on past OECD empirical studies. OECD models can be used to simulate the impact of reducing the stringency of product market regulation and employment protection, lowering the disincentives to work at old age as well as increasing public spending on active labour market polies and childcare. Together, these reforms are expected to raise the level of GDP in Japan and the major Euro area countries by nearly 2.5 per cent after 5 years (Figure 5). Such impact could be interpreted as a lower-bound of all the reforms proposed in this note, as, for instance, some of the reforms regarding investment and SMEs are not included in the simulation.

Figure 5. GDP effects of structural reforms

Cumulative gain in potential GDP after 5 years by implementing the recommended structural reforms, in %



Note: This quantification assesses the impact on potential GDP over a 5 years horizon of structural reforms to overcome the persistent stagnation trap. It relies on existing OECD empirical studies of the links between structural policies and productivity or employment. It is based on a scenario where the stringency of product market regulation and employment protection as well as the disincentives to work at old age are reduced while public spending on active labour market polies and childcare are expanded.

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