Summary for non-specialists
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Impact of the current economic and financial crisis on potential output

Euro area GDP is forecast to fall by 4% in 2009 and recover to only +0.1% in 2010. This dramatic reduction in actual growth is not only due to cyclical conditions, but also due to a slowdown in the growth of the productive capacities of our economies. Besides the immediate negative impact on potential output, a key question is what will be the impact on potential output over the longer-run.

Looking back at past experiences, a number of scenarios are possible. In the more optimistic scenario based on, say, the Swedish and to a lesser extent Finnish cases, potential growth rates will eventually return to their pre-crisis path and the only permanent effects of the crisis will be on the level of potential output. How large this level effect will be is uncertain since it will depend on the amount of growth "lost" during the crisis and the period needed for activity to recover/converge towards its long term path. However, past experiences also point to the possibility of more pessimistic outcomes, for example Japan. In particular, potential growth rates in the post-crisis era could be permanently lower than their pre-crisis levels as a result of greater risk aversion in financial markets or lower R&D spending and, in this scenario, potential output would be on a continuously lower and diverging path than before.

It is too early at this stage to come to firm conclusions. Nonetheless, one needs to start reflecting, both by looking at experiences of past crises and through the use of modelling tools.

Given the global nature and roots in the financial system of the current crisis, the analysis in the Commission paper points to a large negative impact on potential output in the short-run and the prospect of a prolonged period of slow growth as economies adjust to their post-crisis growth. Our models point to a sharp downward revision in potential growth rates in the short run – the euro area potential growth rate will be cut in half in 2009-2010 compared with 2008 from around 1¼ % to ¾ %. This weaker short term-term outlook will give rise to a cumulated output loss of over 3% in the euro area by 2013, compared with a pre-crisis regime, which is an optimistic estimation based on the assumption of a return to the pre-crisis regime by 2013.

As regards the long run implications, it is plausible that the crisis will lead to a "permanent level loss" in potential output (i.e. the economy eventually returns to its pre-crisis potential growth rate but fails to recoup some of the output losses incurred during the crisis/recovery period). However, there are non-negligible downside risks that long-run potential growth could be adversely affected leading to a "continuous widening output loss" in particular if financial conditions remain more restrictive in the long run thereby negatively impacting on R&D investments. Moreover, we should not forget that prior to the onset of the crisis, the EU was struggling to close the productivity growth rate gap with leading OECD countries, and that going forward, population ageing will start to act as a drag on potential growth rates as a large share of the population leaves the labour force and enters into retirement.

One of the most striking conclusions when one looks at past crises, be they in Sweden, Finland or Japan, is that policy responses matter. In other words, the policy choices we enact now will determine whether the crisis has permanent effects on output and thus on the welfare of our citizens.

As regards "policies to avoid", these are already well specified in the EERP, namely governments should avoid protectionism, avoid measures such as early retirement schemes that lower labour market participation rates, and ensure that the policy responses to the crisis don't prevent essential restructuring from taking place.

As regards "policies to promote",

- the effects of the crisis on potential output can be mitigated, first and foremost, if financial market problems are tackled quickly and decisively. This will not only yield benefits in terms of better credit supply in the short run, but importantly will also contribute to higher potential output over the long-run through more effective resource allocation;
- Also, and especially in Europe, active labour market measures and positive incentive structures are needed to ensure that the newly unemployed move quickly into new jobs and avoid being permanently excluded from the workforce (so-called hysteresis effects);
- over the long-run, productivity is the key to raising potential output and this will require action in terms of opening up markets, especially in services, supporting the business environment through a lower administrative burden and especially supporting R&D/innovation.
- finally, given the global nature of the crisis, an export-led recovery cannot be counted on, and other growth engines will be needed. For example, measures to increase productivity growth, including the changeover to low-carbon technologies, may be essential in achieving sustainable growth - especially in the light of the global nature of the crisis.