Stronger Growth but Risks loom large

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After a lengthy period of weak growth, the world economy is finally growing around 4%, the historical average of the past few decades.

This is good news. And this news is even better knowing that, in part, the stronger growth of the world economy is supported by a welcome rebound in investment and in world trade. The recovery in investment is particularly worth emphasising, since the fate of the current expansion will be highly dependent on how investment will perform.

Although long anticipated, the pick-up in investment remains weaker than in past expansions. The same is true for global trade, which is expected to grow at a respectable, albeit not spectacular, rate, unless it is derailed by trade tensions.

However, contrary to previous periods, 4% world growth is not due to rising productivity gains or sweeping structural change. This time around the stronger economy is largely due to monetary and fiscal policy support.

Real GDP growth

Year-on-year, %

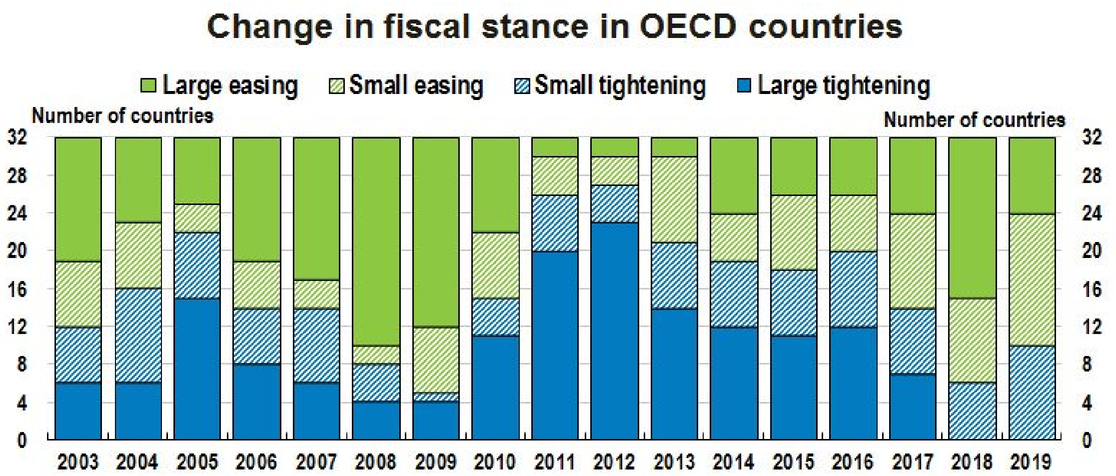
	2017	2018	2019		2017	2018	2019
World	3.7	3.8	3.9	G20	3.8	4.0	4.1
Australia	2.3	2.9	3.0	Argentina	2.9	2.0	2.6
Canada	3.0	2.1	2.2	Brazil	1.0	2.0	2.8
Euro area	2.6	2.2	2.1	China	6.9	6.7	6.4
Germany	2.5	2.1	2.1	India[1]	6.5	7.4	7.5
France	2.3	1.9	1.9	Indonesia	5.1	5.3	5.4
Italy	1.6	1.4	1.1	Mexico	2.3	2.5	2.8
Japan	1.7	1.2	1.2	Russia	1.5	1.8	1.5
Korea	3.1	3.0	3.0	Saudi Arabia	-0.7	1.6	2.1
United Kingdom	1.8	1.4	1.3	South Africa	1.3	1.9	2.2
United States	2.3	2.9	2.8	Turkey	7.4	5.1	5.0

Note: The European Union is a full member of the G20, but the G20 aggregate only includes countries which are also members in their own right.
1. Fiscal years starting in April.

For many years, monetary policy was the only game in town. During the international financial crisis, central banks cut interest rates aggressively, injected funds into the economy and purchased assets at a record pace in an attempt to boost the economy.

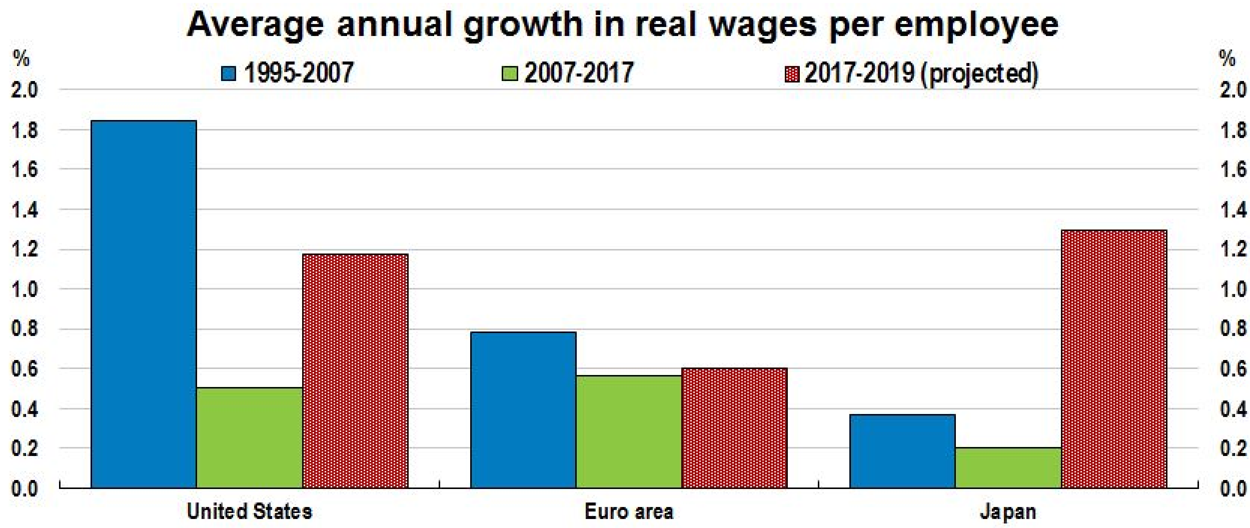
In contrast, in most countries, fiscal policy remained prudent or even became contractionary. Still, historically low interest rates provided an opportunity for governments to use their available fiscal space to help foster growth, as the OECD argued forcefully in 2016. Many OECD governments are now following this advice. At first, the resources enabled by lower interest payments were used by governments to avoid cutting expenditures or raising taxes. With the improving economic situation, many governments have started to undertake additional fiscal easing.

Now that monetary policy is finally starting to return to normal, governments are stepping in to provide fiscal policy support. We can say that **fiscal policy is the new game in town**: three quarters of OECD countries are now undertaking fiscal easing. The fiscal stimulus in some countries is very significant, while it is less ambitious in other countries. Still, this fiscal easing will have important repercussions for the world economy. In the short run, it will add to growth. However, countries that have been experiencing longer expansions might find that this fiscal stimulus (where it is large) will also add to inflationary pressures in the medium term. Only time will tell if these short-run gains might be offset by some medium-term pain. What matters is that, in making these choices, governments are fully aware of the medium-term impact of their policies, and do not focus only on the short-term benefits from fiscal stimulus.



Note: The fiscal stance is calculated based on changes in the underlying primary balance as a percentage of potential GDP. Large fiscal easing is for a deterioration of the balance by more than 0.5% of potential GDP and small easing is for a deterioration by less than 0.5% of potential GDP. Large and small fiscal tightening are defined analogously. Chile, Mexico and Turkey are excluded due to the lack of data. Projections for 2018 and 2019.
Source: OECD Economic Outlook database; and OECD calculations.

The strong growth we are witnessing is also associated with robust job creation in many economies. In fact, it is particularly satisfying to see that **in the OECD area, unemployment is set to reach its lowest level since 1980**, even though it remains high in some countries. Thanks to this robust job creation and the related intensifying labour shortages, we are now projecting a rise in real wages in many countries. This increase is still somewhat modest. However, there are clear signs that **wages are finally on the way up**. This is an important development, since the global crisis had a severe impact on household incomes, particularly for the unskilled and low-income workers.



Note: Real wage growth is calculated from nominal wage growth and the GDP deflator. Projections for 2018 and 2019.
Source: OECD Economic Outlook database.

In spite of all this good news, risks loom large for the global outlook. What are these risks? First and foremost, an escalation of trade tensions should be avoided. It is worth remembering that, in part, the rise in trade restrictions is nothing new. After all, more than 1200 new trade restrictions have been implemented by G20 countries since the outset of the global financial crisis in 2007. Still, as outlined in Chapter 2, since the world economy is much more integrated and linked today than in the past, a further escalation of trade tensions might significantly affect the economic expansion and disrupt vital global value chains.

Another important risk going forward is related to the rise in oil prices. Oil prices have risen by close to 50% over the past year. Persistently higher oil prices will push up inflationary pressures and will aggravate external imbalances in many countries.

In the past few years, very low interest rates have encouraged borrowing by households and corporations in some countries and led to overvaluation of assets (e.g. houses, equities) in many others. In this context, rising interest rates might be challenging for highly indebted countries, families and corporations. Of course, this rise in interest rates has been widely anticipated and should thus not cause any major disruptions. Nevertheless, if inflation rises more than expected and central banks are forced to raise rates at a faster pace, it is likely that market sentiment could shift abruptly, leading to a sudden correction in asset prices.

A swifter rise in interest rates in advanced economies might also continue to lead to significant currency depreciation and volatility in some emerging market economies (EMEs) that are highly reliant on external financing and facing internal or external imbalances. Geopolitical tensions might also contribute to sudden market corrections or a further rise in oil prices. Brexit and policy uncertainty in Italy could add pressures to the expansion in the euro area.

What does this all mean for policy? Since private and public debt remain high in some countries, improving productivity, decreasing debt levels and building fiscal buffers is key to strengthen the resilience of economies. As monetary and fiscal policies will not be able to sustain the expansion forever and might even contribute to financial risks, it is absolutely essential that structural reforms become a priority. In the past couple of years, few countries have undertaken substantial structural reforms. Most of the countries that reformed are large EMEs, such as Argentina, Brazil and India. In the advanced economies, important labour reforms were introduced in France and a sweeping tax reform was implemented in the United States. However, as the 2018 *OECD Going for Growth* points out, these important exceptions do not counter the rule that reform efforts have been lagging.

Why is this important? Because the only way to sustain the current expansion and to make growth work for all is to undertake productivity-enhancing reforms. As many *OECD Education Policy Reviews* and OECD *National Skills Strategies* show, it is crucial to redesign curricula to develop the cognitive, social and emotional skills that enable success at work, and to improve teaching quality and the resources necessary to deliver those skills effectively. In many countries, investment in quality early childhood education and vocational education and apprenticeships are of particular importance. Skills-enhancing labour-market reforms are also crucial. Reforms to boost competition, improve insolvency regimes, reduce barriers to entry in services and cut red tape are also key for making our economies more dynamic, more inclusive and more entrepreneurial. Investment in digital infrastructure will also be essential in this digital age. In addition, there are significant opportunities to reduce trade costs in both goods and, in particular, services, boosting growth and jobs across the world.

In spite of stronger growth, there is no time for complacency. Structural reforms are vital to sustain the current expansion and to mitigate risks. Therefore, at this juncture of the world economy, **it is truly crucial to give reforms a chance**. After monetary and fiscal policies have done their jobs, it is time for reforms to sustain the expansion, to improve well-being, and to make growth work for all.

References

Economic Outlook, May 2018.