Global growth is weakening: coordinating on fiscal and structural policies can revive euro area growth

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The
global expansion is continuing to lose steam, and faster than anticipated a few
months ago. Growth in Europe has been particularly disappointing, as trade
growth both within the EU and with external partners has stalled. Business and
consumer confidence has plummeted in advanced economies as trade tensions
persist, high levels of policy uncertainty in Europe linger, and the pace of China's
slowdown continues to raise concerns.

Global growth is projected to ease further from 3.6% in 2018 to 3.3% in 2019 and 3.4% in 2020 in our latest Interim Economic Outlook. It has been revised downwards in almost all G20 economies, with particularly large revisions in the euro area in both 2019 and 2020, driven by weakness in Germany and Italy, but also in the UK, Canada and Turkey. And the manufacturing sector seems to take a hit across the G20 on the back of trade tensions.

OECD Interim Economic Outlook Projections

Year-on-year, %. Arrows indicate the direction of revisions since November 2018.

	2018	2019	2020		2018	2019	2020
World	3.6	3.3 ↓	3.4 ↓	**G20**	3.8	3.5 ↓	3.7
Australia	2.9	2.7 ↓	2.5 ↓	Argentina	-2.5	-1.5 ↑	2.3
Canada	1.8	1.5 ↓	2.0 ↑	Brazil	1.1	1.9 ↓	2.4
Euro area	1.8	1.0 ↓	1.2 ↓	China	6.6	6.2 ↓	6.0
Germany	1.4	0.7 ↓	1.1 ↓	India[1]	7.0	7.2 ↓	7.3 ↓
France	1.5	1.3 ↓	1.3 ↓	Indonesia	5.2	5.2	5.1
Italy	0.8	-0.2 ↓	0.5 ↓	Mexico	2.1	2.0 ↓	2.3 ↓
Japan	0.7	0.8 ↓	0.7	Russia	2.3	1.4 ↓	1.5 ↓
Korea	2.7	2.6 ↓	2.6 ↓	Saudi Arabia	2.0	2.1 ↓	2.0 ↓
United Kingdom	1.4	0.8 ↓	0.9 ↓	South Africa	0.8	1.7 ↑	2.0 ↑
United States	2.9	2.6 ↓	2.2 ↑	Turkey	2.9	-1.8 ↓	3.2 ↑

Note: Difference in percentage points based on rounded figures. Dark red for downward revisions of 0.6 percentage points and more. Dark green and dark orange for, respectively, upward and downward revisions of 0.3 percentage points and more but less than 0.6 percentage points. Light green and light orange for, respectively, upward and downward revisions of less than 0.3 percentage points. The European Union is a full member of the G20, but the G20 aggregate only includes countries that are also members in their own right.

1. Fiscal years starting in April.

Some factors are supporting growth, including easier financial conditions, with major central banks having signalled a pause in monetary policy normalisation. Also labour markets remain resilient for now, and wage growth is slowly picking up, supporting household incomes and spending. However, worryingly, downside risks continue to build up and growth could be much weaker if these risks were to materialise.

Three major sources of risks are our main concerns.

First, the continued uncertainty about trade policies remains a significant drag to global investment, jobs and, ultimately, living standards. Even if the United States and China conclude a trade agreement soon, we cannot exclude that other measures will be implemented later in 2019, or that new restrictions will be put in place in specific trade-sensitive sectors, such as cars. If the US imposed tariffs on European cars, this would hit the European economies particularly hard. Motor vehicle exports represent around 10% of total EU merchandise exports to the United States and there are significant supply-chain linkages within Europe that would spread the impact widely across countries and firms.

Second, there is considerable uncertainty about the extent of China's slowdown. The government has put in place sizeable monetary and fiscal stimulus, including tax cuts and infrastructure investment. However, the jury is still out regarding the effectiveness of these fiscal measures. Meanwhile, corporate sector indebtedness is at very high level, posing risks to financial stability.

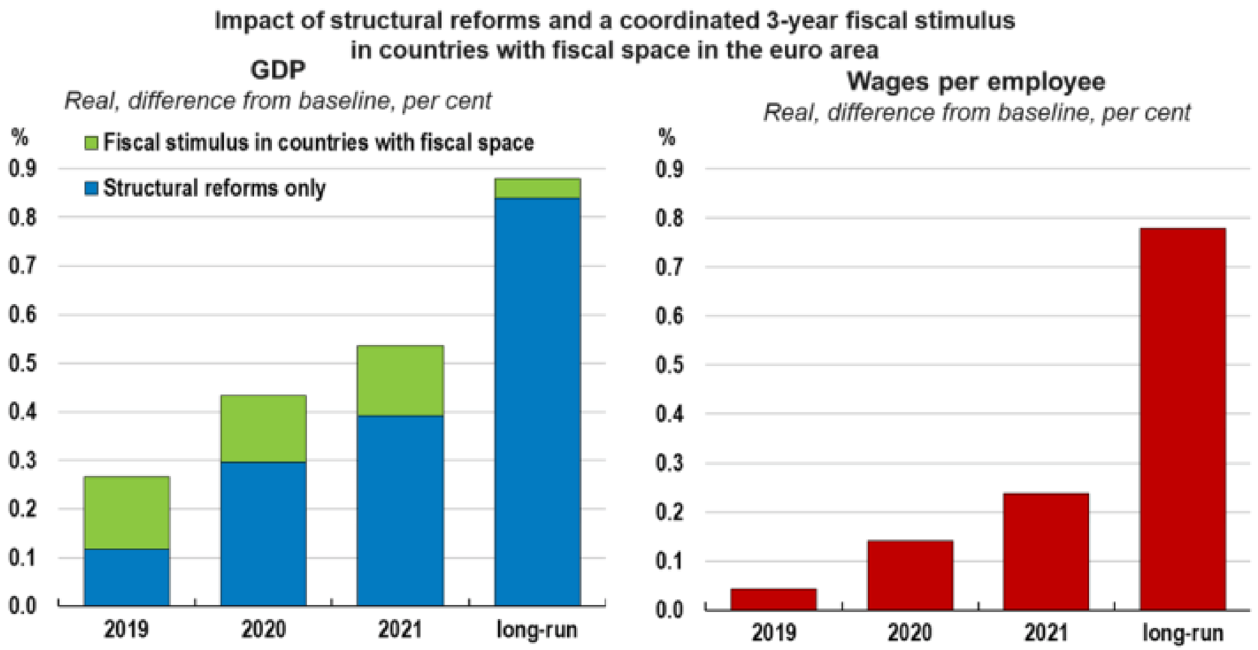
China has significantly contributed to global growth for the past two decades, so that any sharper deceleration than expected would cascade to the rest of the world. Countries in East Asia, commodity exporters and Japan would be particularly hard hit by a sharp slowdown in Chinese demand growth. Reduced demand in China would also affect global confidence adding significantly to these costs, particularly in the advanced economies. Overall, taking direct trade and confidence effects into account, our simulations suggest that a decline of 2 percentage points in the growth rate of demand in China for two years would lower global GDP growth by over 0.5 percentage point in the first year already.

Third, in Europe further weakness coming from China, Germany, Italy or the United Kingdom could quickly spread to other European economies, given the importance of trade linkages across the EU: EU countries trade more between themselves than with the rest of the world, and very often goods or services are produced across several countries. In the euro area, where most credit to firms is distributed through banks, the weakness could be aggravated if sovereign yield increased, raising banks funding costs and in turn reducing credit supply, dampening investment and consumption, and ultimately jobs. Brexit is also an immediate downside risk. We have already seen a clear dent in the growth rate of investment in the UK since the Brexit referendum. And the costs of a no-deal would be significant. According to our estimates, it could amount to 2% of GDP for the United Kingdom by 2020 already.

One final risk is that a sharper-than-expected slowdown in global growth could trigger corporate bonds downgrades or even defaults. The outstanding stock of corporate bonds at the end of 2018 was twice that in 2008 in real terms (at USD 13 trillion), the quality of outstanding debt has continued to decline, and there are signs that corporate earnings growth has begun to slow. Significant bond repayments are also due in emerging-market economies in the next three years, especially in China.

In this environment, governments must intensify multilateral dialogue on trade, and in the euro area coordinate all levers of policy to avoid a sharper downturn.

Monetary policy normalisation has been on pause in the main advanced economies, and rightly so given rising uncertainty, weaker growth prospects and contained inflation. But monetary policy can and should not act alone.



Note: The level of technical progress is gradually raised by 1% by the fifth year in all countries, and countries with fiscal space also increase government investment by 0.5% of GDP for three years. Euro area monetary policy is assumed to be set in a way that takes into account the eventual long-run improvement in output. Countries with fiscal space here include Germany, the Netherlands, Austria, Finland, Ireland, Slovak Republic, Slovenia, Estonia, Latvia, and Lithuania.
Source: OECD calculations.

Taking advantage of accommodative monetary conditions, euro area governments should coordinate fiscal and structural policies to revive growth both in the short and medium term. A moderate fiscal stimulus in countries that have fiscal space, targeted at public investment, would lift growth during the time it takes for structural reforms to deliver their full effect. On the structural front, there is ample scope for reforms to encourage innovation and business dynamism in Europe by streamlining permits and licenses, improving the transparency of regulation and reducing barriers to entry in network industries, professional services and retail sector. The co-ordinated fiscal and structural policy action would also benefit workers and give a necessary boost to wages. But more importantly, the coordinated action could lift confidence in governments' capacity to reap the full benefits of the euro area. Euro area governments would show, that by acting together they can lift growth and improve the lives of all. This would demonstrate that Europe is stronger than its individual member states.