A fragile global economy needs urgent cooperative action

by Laurence Boone, OECD Chief Economist

A year ago, the OECD warned about how trade and policy uncertainties could significantly damage the world economy and further
contribute to the growing divide between people. A year later, global momentum
has weakened markedly and growth is set to remain subpar as trade tensions
persist. Trade and investment have slowed sharply, especially in Europe and Asia.
Business and consumer confidence have faltered, with manufacturing production contracting.
In response, financial conditions have eased as central banks have moved
towards more accommodative monetary stances, while fiscal policy has been providing
stimulus in a handful of countries. At the same time, low unemployment and a
slight pick-up in wages in the major economies continue to support household
incomes and consumption. Overall, however, trade tensions are taking a toll and
global growth is projected to slow to only 3.2% this year before edging up to
3.4% in 2020, well below the growth rates seen over the past three decades, or
even in 2017-18.

While growth was synchronised eighteen months ago, divergence has

emerged between sectors and countries depending on their exposure to trade
tensions, the strength of fiscal responses and policy uncertainties. The
manufacturing sector, where global value chains prevail, has been hit hard by
tariffs and the associated uncertainty on the future of trade relationships,
and is likely to stay weak. Business investment growth, also strongly linked to
trade, is set to slow to a mere 1¾per centper year over
2019-20, from around 3½ per cent per year during 2017-18. However, services,
less subject to trade jitters and where most job creation takes place, continue
to hold up well. In parallel, growth has weakened in most advanced economies,
especially those where trade and manufacturing play an important role, such as
Germany and Japan, with GDP growth projected to be below 1% in both countries
this year. In contrast, the United States has maintained its momentum thanks to
sizeable, albeit waning, fiscal support. Divergence is also visible among
emerging-market economies, with Argentina and Turkey struggling to recover from
recession, while India and others are benefitting from easier financial
conditions and in some instances fiscal or quasi-fiscal support.

Moreover, the global economy remains largely dependent on
persistent policy support. Ten years after the financial crisis, with subdued
inflation, central bank balance sheets remain at unprecedented levels, interest

rates – short and long-term – are historically low, and government debt, except
for a few cases, is much larger. With a few exceptions, emerging-market
economies have kept large reserve buffers. In short, central banks have barely
normalised the monetary policy stance and their support remains essential.

Overall, in spite of unprecedented policy support in the wake of
the global financial crisis, the recovery has not been vigorous and lasting
enough to translate into higher wages and better standards of living. Since 2010,
real GDP per capita, an imperfect proxy for living standards, has increased by
only 1.3% per annum in the median OECD country. Even though unemployment is at
its lowest rate in nearly four decades, real wages are projected to grow by
less than 1.5% per year in 2019-20, below the 2% pace in the decade prior
to the crisis in the typical OECD economy. This means that, ten years after the
crisis, standards of living have improved too slowly to significantly reduce
inequalities, which had widened for the two decades running up to the crisis.
For example, for median households in the large advanced economies, the pace of
increase in real disposable income has fallen since the crisis, except in the
United States.

The outlook remains weak and there are many downside risks that cast

a dark shadow over the global economy and people's well-being.

- First, the mediocre growth outlook is conditional on no escalation of trade tensions, which cut across the Americas, Asia and Europe. Simulations in this Outlook's first chapter show that renewed tensions between the United States and China could shave more than 0.6% from global GDP over two to three years.
- Second, manufacturing and services do not work in isolation. While services have remained buoyant, providing a buffer, it is unlikely that they decouple for long from manufacturing. More than a third of manufacturing gross exports comes from services, and services contribute, directly or indirectly, to more than half of global exports. In addition, manufacturing crucially depends on investment, which is not only an engine of growth and employment today but also shapes tomorrow's growth and living standards.
- Third, China remains a source of concern, as the deployment of monetary, fiscal and quasi-fiscal tools not only has uncertain effects on activity, but might continue to fuel non-financial corporate debt, already at a record high level. We estimate that a 2-percentage point reduction in domestic demand growth in China, sustained for two years and combined with heightened uncertainty, could reduce global GDP by 1¾ per cent by the second year.
- Finally, private sector debt is growing fast in major economies. The global stock of non-financial

corporate bonds has almost
doubled in real terms compared with 2008, at close to USD 13 trillion,
and the quality of debt has been deteriorating, including a heightened stock of
leveraged loans. A new bout of financial stress could erupt.

Looking ahead, trade tensions are not only hurting the short-term
outlook but also medium-term prospects, calling for urgent government action to
reinvigorate growth. The global economy was expanding in sync less than two
years ago, but challenges to existing trade relationships and the multilateral
rules-based trade system have now derailed global growth by raising uncertainty
that is depressing investment and trade. The post-World War II process of
globalisation driven by multilateral agreements that allowed ever-increasing
trade openness is being challenged.

Against this backdrop, we strongly urge governments to use all
the policy tools at their disposal. Primarily, based on a common diagnosis
about trade issues, taking into account the interdependence of economies with
production chains split across borders, it is imperative to reignite
multilateral trade discussions. Then where demand is weak, in the euro area for
example, rather than further relying on monetary policy, governments should take
advantage of the low-interest rate environment to complement structural efforts

with fiscal stimulus where public debt is relatively low. Such a combination can
address the current weakness, enhance resilience and boost long-term growth in
a sustainable way for the benefit of all. Policy priorities include investing
in infrastructure, especially digital, transport and green energy, enhancing
people’s skills, and more generally implementing policies that favour equal
opportunities. For example, in the euro area, combining structural reforms that
lift productivity growth by 0.2 percentage point per year for five years and a three-year
fiscal stimulus of the order of 0.5% of GDP in countries with lower debt to
finance public investment would not only result in higher growth in the short
term, but raise GDP by around 1% in the longer term.

Reforms are also needed to reap the benefits of digitalisation for all. The special chapter of this Economic Outlook analyses the changes
arising from digitalisation and the package of policies required to help digitalisation
translate into stronger and more inclusive growth. Digital technologies change
the way firms produce goods and services, innovate, and interact with other
firms, workers, consumers, and governments. These technologies offer a vast
potential to enhance firm productivity and ultimately living standards, but the
gains have been disappointing so far. Labour productivity has slowed sharply
across OECD countries over the past decades and only a small share of

“superstar firms” are benefiting from digitalisation. Weak productivity growth
has led to sluggish wage growth and routine tasks performed by low and
medium-skilled workers are increasingly being automated. These trends have
far-reaching implications for living standards and inclusiveness.

Governments and companies need to implement a range of policies to
promote an efficient and inclusive digital transformation. Reaping the benefits
of digitalisation requires changes in business practices, work organisation and
skill composition that imply a vast reallocation of resources within and across
firms and industries. These changes can take time and entail transitory
adjustment costs that can be painful for vulnerable groups. A range of reforms
are thus needed: education to enhance people’s cognitive skills; training to
raise technical and managerial skills; business access to funding capacities for
investment in intangible assets and R&D, especially in equity; as well as evolving
competition policy to adapt the regulatory environment to changes to business
models created by the digital transformation and ensure efficient resource
reallocation. If governments and companies take action to address these
shortfalls, adoption of digital technologies and gains from digitalisation may
finally be up to our expectations.

Over the past year, some downside risks to global growth have materialised as trade and policy uncertainty have weakened business and household confidence. Growth is set to remain subpar as trade tensions persist, while contributing to the divide between people. Governments can and must act together to restore growth that will be sustainable and benefit all.

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