Growth is taking a dangerous downward turn

by Laurence Boone, OECD Chief Economist

For over 18 months, since the outbreak of trade hostilities, growth has been weakening, slowly but surely. In May 2018 the OECD, along with other organisations, was predicting global growth of around 4% for 2019, whereas our current forecasts are for growth of below 3%. In the first half of 2018, global investment was increasing at an annualised pace of nearly 5%, and trade over 4%. This year, the annualised growth rate of investment could slide to below 1%, with trade turning negative in the second quarter. Growth prospects have plummeted in the wake of trade and investment.

An urgent response is required, failing which we run the risk of finding ourselves stuck in a long period of low growth, the brunt of which will be felt primarily by the most vulnerable.

This is because the events of the last 18 months are not just a passing trend. The proliferation of tariffs and subsidies and the increasing unpredictability of trade policies have destroyed growth in international trade, triggering a sharp slowdown in industrial output and investments. When companies do not know what tomorrow will bring, they exercise their "wait-and-see option". Given that an investment is a long-term commitment, they are waiting for this insidious trade war to settle down in order to know where to invest. However, when temporary uncertainty is recurrent and rooted, large amounts of investments are withheld, thereby affecting not just present day demand but also tomorrow's growth potential and employment.

The investment gap created by this situation will have a long-term and structural impact on growth, all the more so as it

will take time to clarify the new trade policy environment. This is clearly exemplified in the digital sector, given how the fastest investor always has a strong edge. But it is also the case for infrastructures, which are essential for business development. And at present, in addition to the digital sector, there is a global and structural need for infrastructure investment of nearly 7 trillion dollars per year, taking into account the energy transition in addition to traditional investment requirements. Paradoxically, the investment gap is growing at a time when governments can obtain long-term financing at very low, even negative, rates.

There is a therefore a danger of growth being bogged down for a long time. It is dangerous to use the good performance of the service sector as compared to the decline in industry as a justification for policy inaction given that the two are inextricably linked. It is equally risky to draw a distinction between countries with a large industrial sector and countries that are more service-based and therefore supposedly less at risk, given that integrated supply chains exist at both the regional and global level, and between services and industries.

The top priority is to remedy the drop in demand caused by the collapse in trade, which is affecting capital investments in particular. This can be achieved using a three-pronged economic policy, with a clear low rate policy, an infrastructure investment policy, and reforms to promote innovation. Monetary policy will struggle to halt the current downward spiral on its own, but it is detrimental to say that it has reached the limits of its capacity. Monetary policy may not be able to do everything, especially after years of providing support, but it still has a lot to offer. By providing long-term protection to the financing costs of both business and States, monetary policy creates the conditions required for private and public investment.

The euro area, for example, would already be in a much better position if it had turned to its budgetary tools, i.e. public investment, and carried out reforms to promote innovation much earlier! In our September Outlook, we demonstrate how annual public investments of around 0.5 percentage points of GDP in low-debt European countries, alongside reforms in favour of innovation in all the countries, would have allowed for a less aggressive monetary policy and encouraged short-term and long-term growth, without stretching public debt and while averting half of the increase in the price of financial assets over the past five years.

The second lever is to restore the confidence of businesses in their ability to find markets. It is now evident that trade tensions are not a temporary side-show. The international framework which governed trade has been permanently impaired, and the WTO as we know it will not come back.

Public recognition that global trade is experiencing a structural shift, that trade agreements going forward will no longer be global but perhaps more regional and more targeted, and that there is a commitment between like-minded countries to push ahead, would send a clear message to businesses to resume investment.

Growth is languishing, but there is a lot that public policy can do. This includes restoring confidence in the collective ability to establish trade rules which are clearer, more transparent, and afford more protection to citizens; and taking advantage of the predictable rates provided by monetary policies to boost investment, and with it growth and the jobs of tomorrow. It can be done. It urgently needs to be done.

More info: http://www.oecd.org/economy/outlook/