Editorial: A fragile global economy needs urgent cooperative action

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 1¾ per cent per 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 everywhere 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 1⅓% 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 bilateral 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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