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Interim Economic Outlook

6 March 2019

GLOBAL GROWTH WEAKENING AS SOME RISKS MATERIALISE

Summary

- The global expansion continues to lose momentum. Global growth is projected to ease further to 3.3% in 2019 and 3.4% in 2020, with downside risks continuing to build.
- Growth has been revised downwards in almost all G20 economies, with particularly large revisions in the euro area in both 2019 and 2020.
- High policy uncertainty, ongoing trade tensions, and a further erosion of business and consumer confidence are all contributing to the slowdown.
- Global trade growth has slowed sharply and survey measures of new orders continue to decline in many countries. The trade restrictions introduced last year are a drag on growth, investment and living standards, particularly for low-income households.
- Labour markets remain resilient for now, and wage growth is slowly picking up, supporting household incomes and spending.
- Growth in China is projected to moderate gradually to 6% by 2020, with new policy measures offsetting weak trade developments. A sharper slowdown in China would hit growth and trade prospects around the world.
- Substantial policy uncertainty remains in Europe, including over Brexit. A disorderly exit would raise the costs for European economies substantially.
- Signals of a pause in monetary policy normalisation have helped financial market conditions to recover, both in advanced and emerging-market economies, but this risks a further build-up of financial vulnerabilities.
- Multilateral dialogue should be intensified to avoid new damaging trade restrictions and to take advantage of the opportunities for further liberalisation that could benefit all economies.
- Monetary policy decisions are increasingly data dependent in the advanced economies. If uncertainty fades, scope remains for additional interest rate rises in economies where growth holds up. In other economies, central banks should remain supportive and ensure long-term interest rates stay low.
- Co-ordinated macroeconomic and structural policy actions are required in the euro area to strengthen incentives to invest and overcome the dual challenges of soft near-term demand and weak medium-term growth prospects.
- Lower oil prices and improved financial conditions offer scope to reduce interest rates in emerging-market economies with a robust policy framework and well-anchored inflation close to target.
- Greater structural reform ambition is required in all economies to enhance medium-term living standards and improve opportunities for all.

OECD Interim Economic Outlook Forecasts March 2019

Real GDP growth

Year-on-year % change

	2018	2019		2020	
		Interim EO projections	Difference from Nov EO	Interim EO projections	Difference from Nov EO
World[1]	3.6	3.3	-0.2	3.4	-0.1
G-20[1,2]	3.8	3.5	-0.2	3.7	0.0
Australia	2.9	2.7	-0.2	2.5	-0.1
Canada	1.8	1.5	-0.7	2.0	0.1
Euro area	1.8	1.0	-0.8	1.2	-0.4
Germany	1.4	0.7	-0.9	1.1	-0.3
France	1.5	1.3	-0.3	1.3	-0.2
Italy	0.8	-0.2	-1.1	0.5	-0.4
Japan	0.7	0.8	-0.2	0.7	0.0
Korea	2.7	2.6	-0.2	2.6	-0.3
Mexico	2.1	2.0	-0.5	2.3	-0.5
Turkey	2.9	-1.8	-1.4	3.2	0.5
United Kingdom	1.4	0.8	-0.6	0.9	-0.2
United States	2.9	2.6	-0.1	2.2	0.1
Argentina	-2.5	-1.5	0.4	2.3	0.0
Brazil	1.1	1.9	-0.2	2.4	0.0
China	6.6	6.2	-0.1	6.0	0.0
India[3]	7.0	7.2	-0.1	7.3	-0.1
Indonesia	5.2	5.2	0.0	5.1	0.0
Russia	2.3	1.4	-0.1	1.5	-0.3
Saudi Arabia	2.0	2.1	-0.5	2.0	-0.5
South Africa	0.8	1.7	0.0	2.0	0.2

Note: Difference from November 2018 Economic Outlook in percentage points, based on rounded figures.

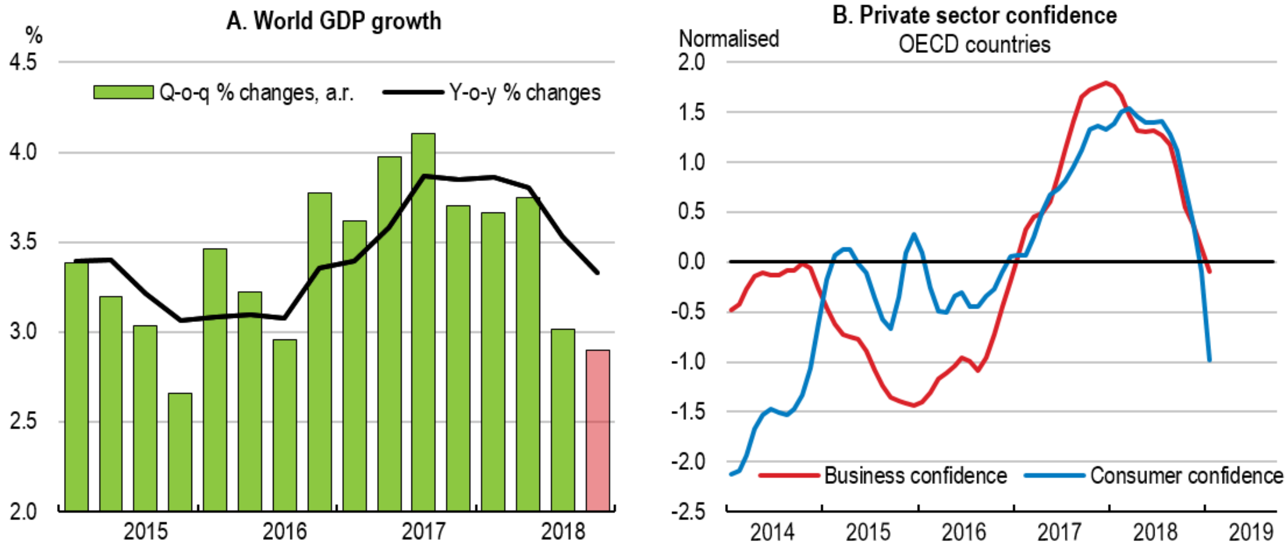
1. Aggregate using moving nominal GDP weights at purchasing power parities.
2. The European Union is a full member of the G-20, but the G-20 aggregate only includes countries that are also members in their own right.
3. Fiscal years, starting in April.

Global growth continues to slow as risks mount

The global expansion continues to lose momentum, amidst heightened policy uncertainty, persistent trade tensions and ongoing declines in business and consumer confidence. Global growth slowed more quickly than anticipated in the latter half of 2018, to around 3% on a quarterly basis. This was the weakest pace since mid-2016 (Figure 1, Panel A), in part reflecting the deep recessions occurring in some emerging-market economies and widespread weakness in industrial sectors.

Confidence indicators have slowed markedly in OECD countries (Figure 1, Panel B), especially in the euro area and the United Kingdom, where growth has disappointed, and also in China, where concerns linger about the extent of the slowdown. One-off factors have contributed to the weakness in Europe, such as the disruption to the car sector following new vehicle-emission tests. However, business investment prospects have also weakened, reflecting declining confidence and continued policy uncertainty.

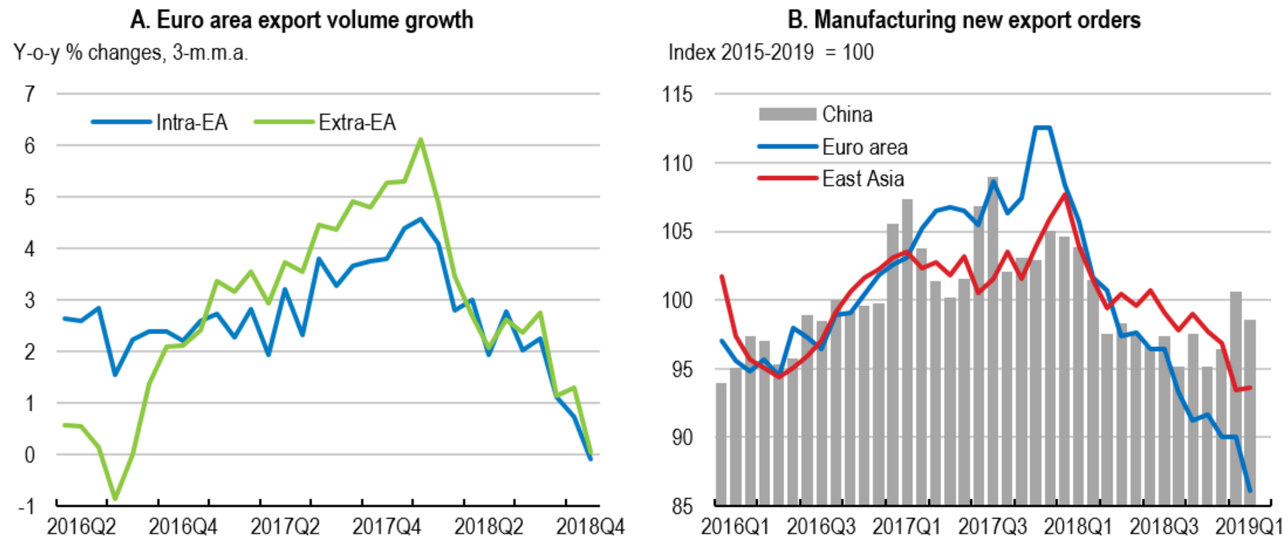
Figure 1. Global growth and confidence are slowing



Note: Global growth in PPP terms. GDP figures for the fourth quarter of 2018 are based on available national accounts data plus estimates for Argentina, Australia, Russia, and Turkey.
Source: OECD Economic Outlook database; OECD Main Economic Indicators database; and calculations.

Trade growth, a key artery in the global economy, has also slowed markedly, to around 4% in 2018 from 5¼ per cent in 2017, with trade restrictions having adverse effects on confidence and investment plans around the world. In Europe, trade growth has stalled, reflecting a slowdown in both external and internal demand (Figure 2, Panel A). Leading indicators suggest that near-term trade prospects are weak. Survey indicators of new export orders remain low in China and continue to decline in Europe and many Asian economies (Figure 2, Panel B).

Figure 2. Trade growth has stalled in Europe and many Asian economies



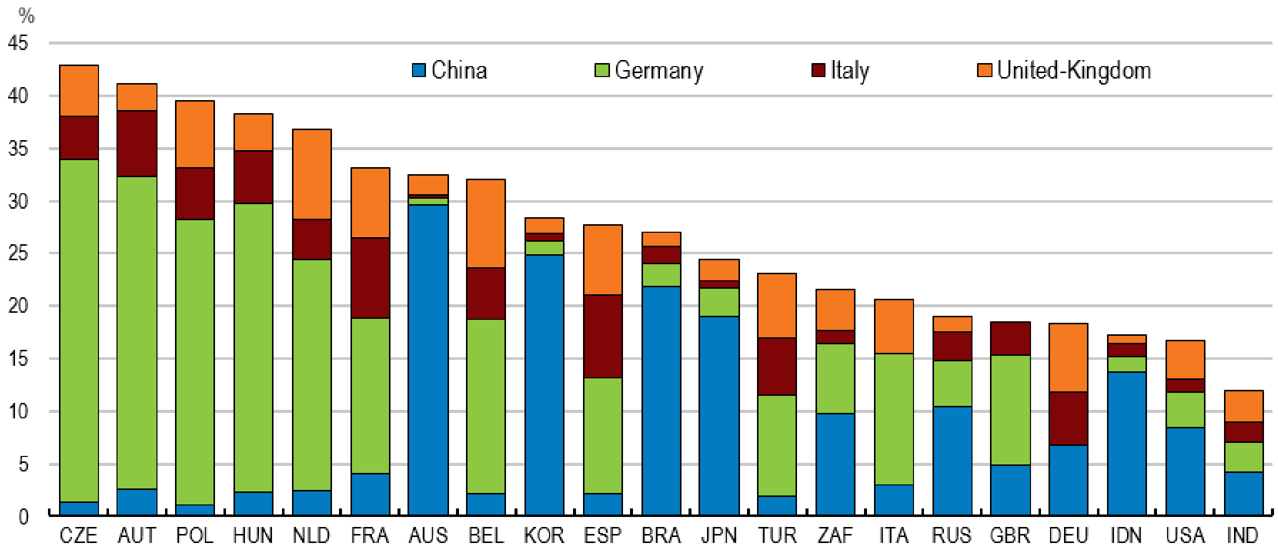
Note: Seasonally and working-day adjusted merchandise export volumes. East Asia export orders are a PPP-weighted average of Japan, Korea, Malaysia, the Philippines, Thailand, Chinese Taipei and Vietnam.

Source: Eurostat; Markit; and OECD calculations.

Even in the absence of further trade restrictions, the slowdown in many key trading economies - such as Germany, China, the United Kingdom and Italy - is acting to weaken growth in their trading partners in Europe and in Asia given their importance as export markets and in regional supply chains (Figure 3).

Figure 3. Weak growth in the major economies will hit export prospects around the world

Share of partner countries in exports of goods, 2017



Source: World Bank; and OECD calculations.

A number of factors have cushioned the slowdown in growth. Improving labour market conditions continue to support household incomes and spending in many economies. Macroeconomic policies also generally remain supportive. Financial market conditions have improved and commodity prices are lower. The significant repricing of risk in financial markets seen at the end of last year has been partially reversed, amidst signals by major central banks that monetary policy may remain more accommodative than previously expected. Oil prices have also eased, despite continued supply restrictions by OPEC and Russia, helping to lower headline inflation around the world, and boost household real income growth.

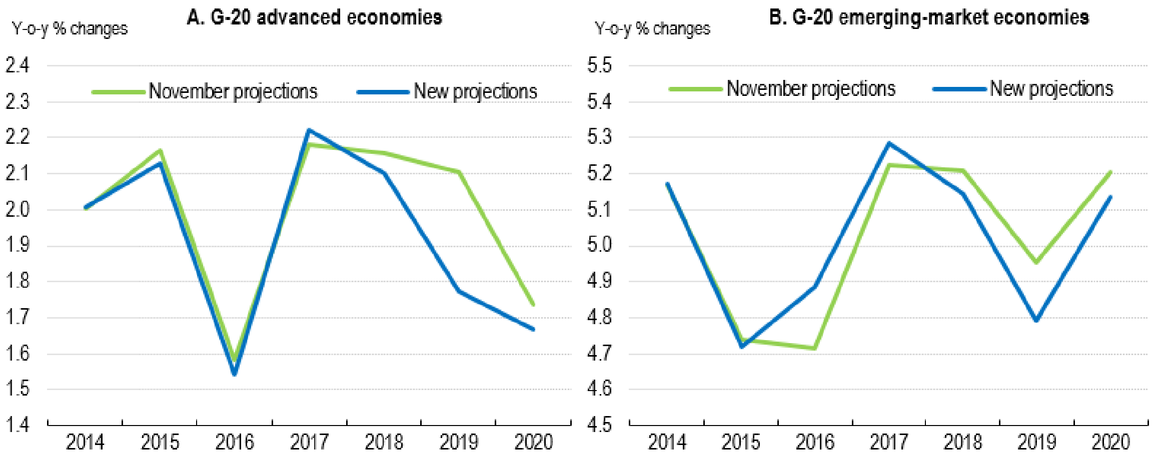
Global growth is set to slow further this year, with downward revisions in most G20 countries

Overall, recent economic and financial developments, and the materialisation of some downside risks, suggest that global growth prospects have eased since the November *Economic Outlook*, especially in Europe. Global GDP growth is projected to slow from 3.6% in 2018 to below-trend rates of 3.3% this year and 3.4% in 2020, with downward revisions in most G20 economies.

In the advanced economies, improved labour market conditions, lower headline inflation and supportive fiscal measures targeted at lower-income households in some countries, including France and Italy, should help to support real income growth and household spending. Monetary policy support also continues to underpin activity. However, continued policy uncertainty and declining confidence are set to weigh further on business investment and trade prospects.

Growth prospects in the emerging-market economies are collectively projected to be steady over 2019-20, but this masks diverging developments in the major economies. A gradual slowdown appears set to persist in China, despite renewed policy support, and substantial adjustment challenges are continuing in those economies hard hit by the financial market stress seen last year. In other countries, including India and Indonesia, downside risks from financial market tensions have eased, and strong investment, improving income growth and past reforms are helping to support domestic demand.

Figure 4. Growth prospects have weakened further



Source: OECD Economic Outlook database.

Country prospects

Key features of the projections in the G20 economies are:

- GDP growth in the United States is projected to moderate to around 2½ per cent in 2019 and a little over 2% in 2020 as the support from fiscal easing slowly fades. Solid labour market outcomes and supportive financial conditions continue to underpin household incomes and spending, but higher tariffs have begun to add to business costs and prices, and the growth of business investment and exports has moderated. The partial Federal government shutdown is likely to slow growth in the first quarter of 2019 but this effect will be reversed in the following quarters.

- GDP growth in Japan is set to be around ¾ per cent in 2019 and 2020. High corporate profits and severe labour shortages continue to stimulate investment, but confidence has eased and recent industrial production and export data have been very weak. Stronger social spending, the FY2018 supplementary budget, and temporary spending increases and tax cuts in the FY2019 budget will cushion part of the short-term impact of the scheduled increase in the consumption tax rate in October 2019.

- GDP growth in the euro area slowed sharply through 2018 and is projected to remain soft, at 1% in 2019 and 1.2% in 2020. Industrial output has been especially weak. Softening external demand and one-off factors contributed to the slowdown last year, but fading intra-area trade growth, high political uncertainty and moderating confidence point to an underlying demand slowdown that may persist. Wage growth and accommodative macroeconomic policies provide support for household spending, but policy uncertainty, weaker external demand and lower confidence are likely to weigh on investment. Despite the stimulus that fiscal easing will provide this year, growth has been revised down particularly sharply in Germany and Italy, reflecting their relatively high share of exports in GDP compared with that of France.

- Growth is projected to remain weak in the United Kingdom, at under 1% in both 2019 and 2020. The still-strong labour market continues to support household spending, but persisting uncertainty about Brexit and the ongoing growth slowdown in the euro area are weighing on business confidence, investment and export prospects.

- GDP growth in Canada is projected to ease to around 1½ per cent this year, before stabilising at 2% in 2020. Lower oil prices and production cutbacks have hit energy sector output, and higher mortgage rates have added to debt-service burdens for households. But labour market conditions remain firm, and business investment should strengthen, given capacity constraints.

- In Korea, GDP growth is set to remain moderate, at between 2½-2¾ per cent in 2019 and 2020. Continued fiscal easing and low inflation should support demand, but exports have slowed sharply, especially to Asian markets.

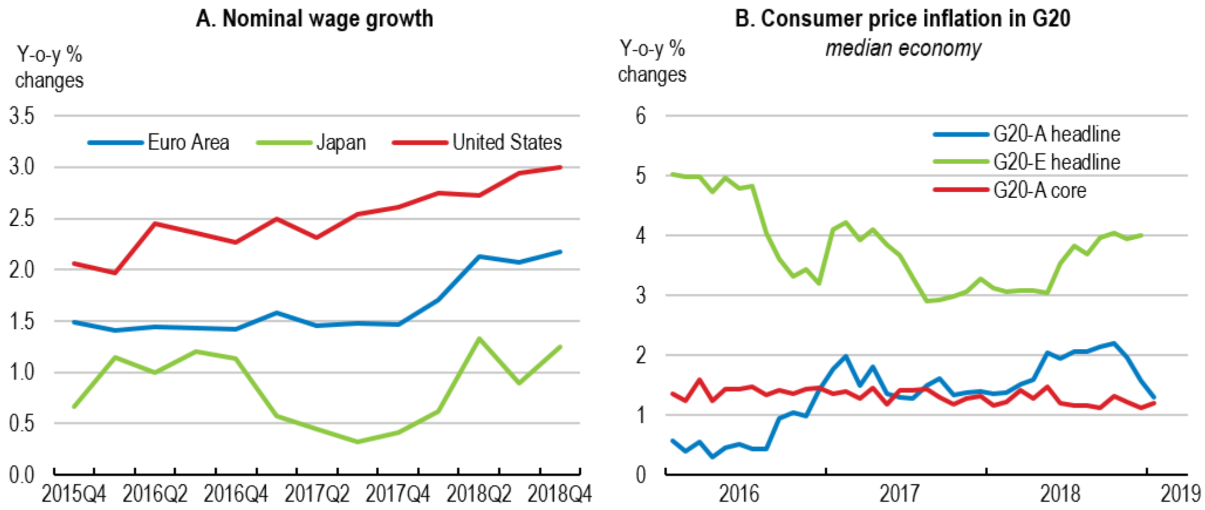
- GDP growth remains resilient in Australia, but is projected to moderate slowly to around 2¾ per cent in 2019 and 2½ per cent in 2020. Continued labour market improvements, higher public infrastructure spending and accommodative financial conditions should all support domestic demand, but headwinds have started to appear from the housing market slowdown and export market growth is set to slow.
- Growth in Mexico is projected to be 2% in 2019 before picking up to 2¼ per cent in 2020. Strong remittances, a rise in the minimum wage and government plans to boost infrastructure investment and revive energy production should all lift domestic demand. Further declines in inflation would offer scope for monetary policy easing.
- Growth prospects remain weak in Turkey. Output and domestic demand have declined sharply since mid-2018, following severe financial market pressures and tighter macroeconomic policies. Financial markets have stabilised and external competitiveness has improved, but weak confidence, high corporate debt service burdens, tight monetary policy and soft demand in euro area markets still weigh on domestic and external demand.
- GDP growth in China is projected to moderate gradually, to 6% by 2020. New fiscal policy stimulus is being implemented, although the extent and effectiveness of some measures is difficult to gauge, and monetary policy has eased. Scope remains for further policy support if required, but this would further delay the necessary deleveraging of the corporate sector and aggravate risks to financial stability. Recent monthly trade value data have been very erratic, in part reflecting the frontloading of some trade in 2018, but generally suggest that underlying growth has weakened, with trade tensions weighing increasingly on exports and industrial production.
- GDP growth in India has eased, but is projected to be around 7¼ per cent in FY 2019 and FY 2020. Business confidence and investment remain strong, and activity should benefit from easing financial conditions, lower oil prices, accommodative fiscal policy and recent structural reforms.
- A moderate recovery is underway in Brazil, with GDP growth projected to strengthen to around 2% this year and close to 2½ per cent in 2020. Stronger business confidence, reduced policy uncertainty, disinflation and improving labour markets will all underpin domestic demand. Successful implementation of the new government's reform agenda, particularly the pension reform, remains key for a stronger revival in growth.
- Solid GDP growth is projected to continue in Indonesia, at a little above 5% per annum on average in 2019-20. Strong income growth will support private consumption, and ongoing infrastructure projects continue to underpin investment. The impact of tighter financial conditions has been mild to date and financial market conditions have improved markedly since late-2018, but slowing external demand in Asia will check export growth.
- Growth is projected to pick up slowly in South Africa, to around 1¾ per cent in 2019 and 2% in 2020. Business confidence is improving slowly, albeit from a low level, and higher international metals prices offer support for exports. Employment and private investment growth remain modest but should strengthen if policy uncertainty and electricity supply disruptions ease.
- Output continues to contract in Argentina, following the financial market turmoil experienced last year and the subsequent tightening of fiscal and monetary policies. Export prospects are improving, helped by the peso depreciation and stronger agricultural production, and should help a gentle recovery to set in through the course of 2019 despite soft domestic demand.

Wage and inflation developments

Labour market conditions are now improving in most OECD economies, despite moderate output growth, with continuing declines in unemployment. Nonetheless, in the median OECD economy, aggregate participation and employment rates are only just back to their levels prior to the financial crisis, and the quality of new job creation has not always matched the quantity. Involuntary part-time work rates also remain high in some countries, especially in Europe. Such factors have held back wage growth in recent years in many economies. Nonetheless, nominal wage growth is now starting to strengthen in the major advanced economies as signs of labour shortages continue to emerge (Figure 5, Panel A). Real wage growth remains moderate, in part due to still-modest labour productivity growth, but recent declines in headline inflation should boost household purchasing power in the near term.

Inflation is set to remain benign. Lower oil prices have contributed to sharp falls in headline consumer price inflation in the advanced economies in recent months (Figure 5, Panel B). Underlying inflation also remains low and stable in most of these economies, especially in Japan and the euro area. Headline consumer price inflation was rising in the median emerging-market economy at the end of 2018, reflecting the impact of past currency depreciation and higher commodity prices last year, but is likely to moderate as the impact of tighter monetary policy is felt and the recent declines in oil prices feed through. Inflationary pressures have already fallen sharply in China and India.

Figure 5. Wage growth is starting to strengthen but inflation remains modest



Note: Employment Cost Index: wages and salaries for all civilian workers in the United States; negotiated wages in the euro area; and compensation per employee in Japan. G20-A denotes the G-20 advanced economies, G20-E denotes the G-20 emerging-market economies. Based on monthly data for consumer price inflation. Core consumer price inflation excludes food and energy. Data for Australia and Argentina are not included.

Source: OECD Economic Outlook database; OECD Consumer Price database; Statistics Canada; Bureau of Labour Statistics; ECB; and OECD calculations.

Downside risks remain

Growth outcomes could be weaker still if downside risks materialise or interact, including from further steps to raise trade barriers, persisting policy uncertainty and prolonged sub-par growth in Europe, a disorderly Brexit, a sharper slowdown in China, and renewed financial market repricing. On the upside, decisive actions by policymakers to reduce policy-related uncertainty and strengthen medium-term growth prospects, including measures that reduce barriers to trade, would improve confidence and investment around the world.

An intensification of trade restrictions would have significant costs

Continued uncertainty about trade policies remains a significant source of downside risk to global investment, jobs and living standards. Higher trade restrictions reduce living standards for consumers, particularly lower-income households, and add to production costs for businesses. The bilateral tariffs already imposed by the United States and China last year are slowing growth in these economies and adding to inflation, albeit to a moderate extent, with mild but negative impacts on other economies.

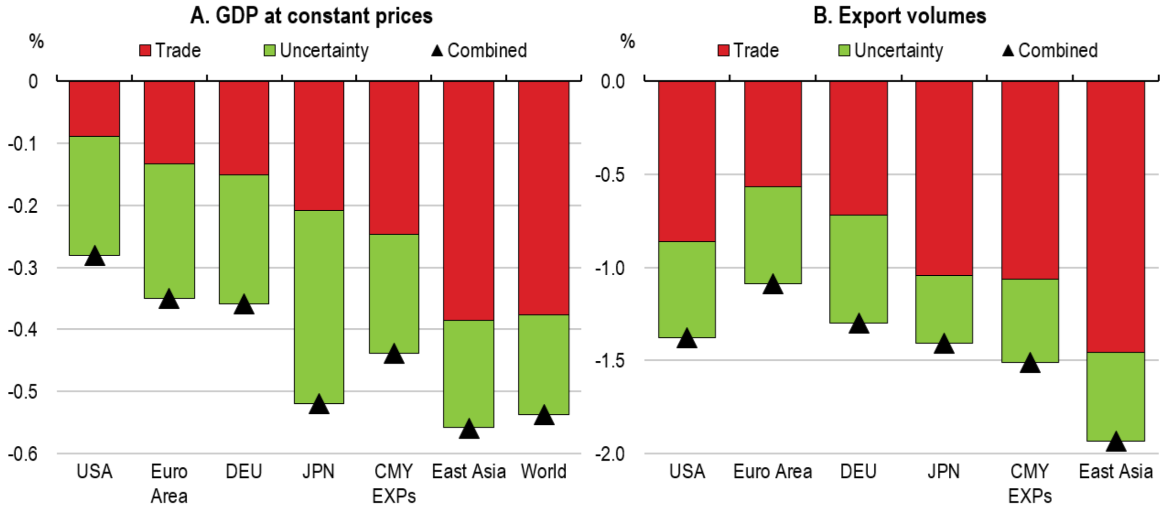
Even if the United States and China conclude a trade agreement in the near term, risks still remain that other restrictive measures could be implemented later in 2019, including new restrictions in specific trade-sensitive sectors such as cars and car parts, with discussions about US-EU trade underway. This would hit Europe particularly, where motor vehicle exports represent around one-tenth of total EU merchandise exports to the United States and there are significant supply-chain linkages that spread the impact widely across countries and sectors. Such measures would add considerably to the costs of the tariff increases imposed so far and adversely affect business investment plans around the world.

Growth in China could slow more sharply than projected

In China, recent monthly trade value data remain very erratic, but generally suggest underlying trade growth is slowing, with adverse effects on key trading partners in Asia and Europe. A much sharper slowdown in Chinese GDP growth than in the current projections would have significant adverse consequences for global growth and trade given the strong linkages China now has around the world. A decline of 2 percentage points in the growth rate of domestic demand in China for two years would lower global GDP growth by close to 0.4 percentage point in the first year, with the impact on Japan, commodity-producing economies and other economies in East Asia being higher than elsewhere (Figure 6, Panel A). Export volumes would also fall relatively sharply in these economies, by over 1% in the first year (Figure 6, Panel B), as well as in Germany. Greater uncertainty could add to these costs significantly, particularly in the advanced economies, by raising investment risk premia in financial markets and the cost of capital for companies. Spillovers from the slowdown from China would be larger still if monetary policymakers around the world were not able to react.

Figure 6. A sharper slowdown in China would hit growth and trade around the world

Differences from baseline



Note: Simulated impact of a two-year decline of 2 percentage points per annum in domestic demand growth in China and a rise of 50 basis points in investment risk premia in all economies. The red bars show the contribution from the direct slowdown in trade; the green bars show the additional contribution from adding higher uncertainty. Commodity exporting economies (CMY EXPs) include Argentina, Brazil, Chile, Indonesia, Russia, South Africa and other non-OECD oil-producing economies. East Asia includes Korea and the Dynamic Asian Economies.

Source: OECD calculations using NiGEM.

Brexit-related uncertainties persist

Uncertainty persists about the timing of UK withdrawal from the European Union (Brexit) and the nature of the UK-EU trading relationship in the short and medium-term. The possibility that a withdrawal agreement will not be reached before the exit date remains a serious downside risk and source of uncertainty in the near term. The current projections for UK GDP growth are conditional on the assumption of a smooth Brexit, with a transition period lasting until the end of 2020.

If the United Kingdom and the European Union were to separate without an agreement, the outlook would be significantly weaker. OECD analysis suggests that the increase in tariffs between the two economies as a result of WTO rules coming into effect would reduce GDP by around 2% (relative to baseline) in the United Kingdom in the next two years. This would add to the adverse effects on GDP and business investment already seen relative to expectations prior to the vote in 2016.

The effects could be stronger still if a lack of adequate border infrastructure and a loss of access to EU trade arrangements with third countries were to cause serious bottlenecks in integrated cross-border supply chains. The costs would also be magnified if this also induced a further decline in business and financial market confidence and disruptions in financial markets. In such a scenario, the likely near-term recession in the United

Kingdom would generate sizeable negative spillovers on growth in other countries. Although contingency measures to soften the impact of a no-deal outcome are being taken by both sides, UK-EU separation without an agreement would still be a major adverse shock for Europe and possibly elsewhere in the world, given that the United Kingdom is an important trading partner for many countries.

In the European Union, the impact of any scenario that resulted in trade between the United Kingdom and the European Union being undertaken on WTO terms would vary across member states. Some smaller countries, including Ireland, the Netherlands and Denmark with strong trade and investment links with the United Kingdom, would be relatively exposed, resulting in significant adjustment costs in particular regions or sectors. OECD estimates suggest that their bilateral exports to the UK could decline by around 15% in the medium-term in the event of trade being undertaken on WTO terms, with the strongest impacts being in the agri-food and machinery and equipment sectors.

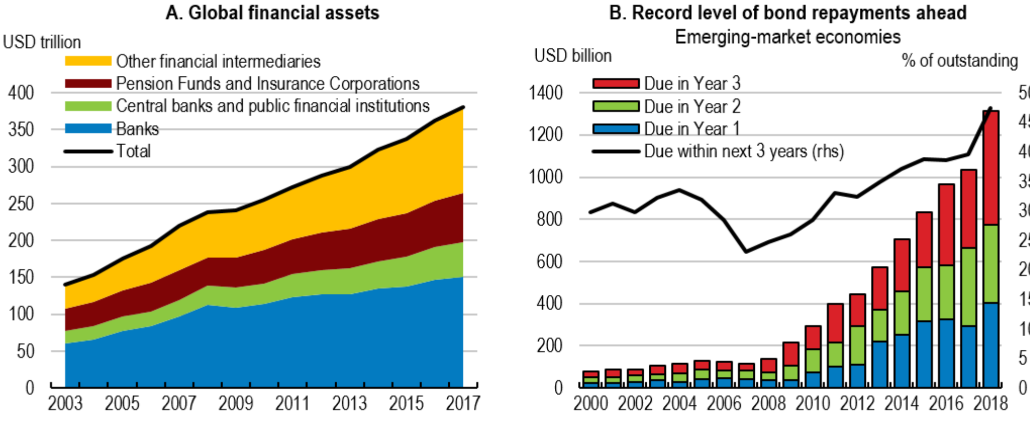
Significant financial vulnerabilities remain

A prolonged period of very low interest rates since the financial crisis has resulted in an accumulation of financial vulnerabilities. Asset valuations are still stretched in some markets and debt levels are high in both public and private sectors. The recent reversion in financial market conditions, offsetting part of the repricing that occurred in 2018, reflects expectations that very low rates will continue for some time to come, potentially resulting in a further build-up of financial vulnerabilities. Rising downside economic risks create the potential for rapid market adjustments to unexpected events.

One risk is that a sharper-than-expected slowdown in global growth will substantially enhance the challenges of servicing elevated debt burdens, even if interest rates remain lower for longer than previously expected. This is particularly the case in global corporate bond markets, where the outstanding stock of debt at the end of 2018 (USD 13 trillion) was twice that in 2008 in real terms, 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 due in emerging-market economies in the next three years, especially in China (Figure 7). The outstanding stock of leveraged loans, which now exceed USD 1 trillion, are also particularly exposed to downturns in cash flow, and could trigger significant repricing via fire sales and losses for investors.

The strength and resilience of banking systems have improved significantly since the financial crisis, with regulations raising minimum capital and liquidity requirements. The use of macro-prudential policies has also increased somewhat after the global financial crisis in the advanced economies. Some risks have, however, shifted to more lightly regulated non-bank financial institutions. In total, such institutions now account for just under one-half of total global financial assets (Figure 7). The resilience of non-bank financial institutions remains a concern and needs to be monitored on an on-going basis, with minimum prudential standards established and enforced to safeguard financial stability.

Figure 7. Financial vulnerabilities remain



Note: Assets in reporting jurisdictions in Panel A. Non-bank financial institutions comprise pension funds, insurance companies and other financial intermediaries. Repayments due on corporate bonds in Panel B.

Source: Çelik, S., G. Demirtaş and M. Isaksson (2019), "Corporate Bond Markets in a Time of Unconventional Monetary Policy", *OECD Capital Market Series*; Financial Stability Board; and OECD calculations.

Policy requirements

Policymakers need to act to ensure sufficient support for demand, prevent downside risks from materialising, and enhance resilience. Supportive macroeconomic policies and ambitious supply-side policy reforms are required to strengthen medium-term growth prospects and improve opportunities for all. Enhanced multilateral dialogue to halt the slide towards protectionism and reinforce the global rules-based international trade system is needed to reduce policy-related uncertainties. Closer supervision of non-bank financial institutions and macro-prudential measures for highly-leveraged borrowers would help to minimise the build-up of financial vulnerabilities.

In the event of an even sharper global growth slowdown than projected, co-ordinated policy action within countries and across countries would provide the most effective and timely counterweight. Preparing for such an eventuality now by planning growth-enhancing measures, including additional structural reforms, that can be rolled out rapidly would increase the effectiveness of any co-ordinated policy response.

Macroeconomic policy requirements in advanced economies

The pause in monetary policy normalisation is appropriate

Monetary policy normalisation has been paused in the main advanced economies, as appropriate given rising uncertainty, contained inflation and weaker growth prospects. Heightened uncertainty means the future direction and extent of further changes in monetary policy are increasingly dependent on incoming data. If tensions and policy uncertainty gradually fade, as assumed in the current projections, there is scope for a further gradual reduction in monetary policy accommodation in those economies in which growth remains at or above trend rates, including the United States, Canada and Australia. However, in economies where growth remains persistently weak, and downside risks continue to build, further steps to enhance accommodation are likely to be required. In the euro area, the priority for the ECB should be to ensure that long-term interest rates remain low for an extended period and that financial markets continue to function smoothly. This calls for enhanced forward guidance to signal that policy rates will remain low for longer, and, if necessary, well-designed new measures to improve long-term funding for the banking sector. The ECB and the Bank of England will need to be ready to intervene in event of a disruptive UK exit from the European Union. In Japan, where inflation remains very low, current policy should be continued. Fiscal and structural measures, including policies that foster stronger wage growth, could help monetary policy to overcome still-low inflation expectations.

Fiscal policy and structural reforms should combine to improve economic prospects

Fiscal policy priorities differ across economies, reflecting differences in macroeconomic conditions and imbalances and in policy needs. In the near term, policy measures are continuing to support growth in the United States, Korea and some euro area economies, but policy is set to be broadly neutral in many other advanced economies.

In euro area countries, the limited scope for substantial monetary policy support highlights the important role that co-ordinated fiscal and structural policies could play in lifting growth. In countries with fiscal space, some additional easing and support for investment is merited and would support demand. This would help the benefits of structural reforms to appear more quickly, allow monetary policy to remain accommodative for longer, and ultimately deliver higher output in the short and medium term (see Box). Public debt levels generally remain high, but low long-term interest rates provide scope for well-designed supportive measures without impairing debt dynamics.

Co-ordinated reforms are needed in Europe to strengthen growth prospects

Weak growth is now projected to persist in the euro area for a longer period than first thought. This adds to the challenges facing policymakers from the low rate of potential output growth, estimated to be around 1¼ per cent per annum as of 2018. Short-term demand weakness, the slump in business confidence and poor medium-term prospects all act as disincentives to invest, raising the risk that the current downturn in the euro area becomes entrenched and that current expectations of weak medium term growth become self-fulfilling. New policy measures are thus required to strengthen short-term demand in the euro area and to enhance area-wide growth prospects in the medium term.

Co-ordinated action, involving fiscal support and renewed structural reform efforts, along with low interest rates, offers the best prospects for restoring growth and improving living standards over time. A well-designed package of mutually-supporting fiscal and structural measures, accompanied by monetary policy keeping interest rates low for a longer period, can reinforce the benefits of each policy measure and mitigate the short-term side effects of others, to the benefit of the euro area as a whole.

- In those countries with fiscal space, a temporary additional fiscal stimulus provides a clear means to offset the current shortfall in demand. This would offer positive short-term spillovers for other euro area countries. However, other member states that have already undertaken measures targeted at lower-income households, and in which fiscal space is currently limited, should refrain from additional stimulus measures that could increase sovereign risk premia.

- Additional structural reforms are needed in all member states to improve medium-term productivity and living standards. For instance, further liberalisation of product markets, especially in services, would help to improve the diffusion of new ideas and technologies between firms and across countries and boost total factor productivity (TFP) growth. Stronger competitive pressures would also encourage firms to expand and upgrade the quality of their capital stock and innovate, thereby helping to revive growth. Such reforms take time to have their full effect. New fiscal measures focused on investment in countries with policy space could help to bring forward some of the medium-term benefits of reforms, with firms encouraged to spend because of stronger aggregate demand pressures and improved confidence, and help to compensate workers and households displaced by the impact of stronger competitive pressures on less efficient companies.

- Limited additional monetary policy measures by the ECB could also provide support for demand in the near-term but cannot provide much offset to weak medium-term growth prospects. Keeping interest rates low for a longer period can nonetheless provide important synergies at times when fiscal and structural actions are being undertaken. In particular, forward guidance that recognises the likely positive medium-term effects of new structural reforms on output can help to hold down long-term interest rates and thereby allow investment to strengthen more quickly than it otherwise might have.

Illustrative scenarios starting in 2019 and using the NiGEM global macro model highlight the benefits that can be obtained from co-ordinated action across euro area countries and policies. The different policy measures considered are:

- A three-year debt-financed increase in government investment of 0.5% of GDP per annum in the euro area countries with ample fiscal space. These include Germany, the Netherlands, Austria, Ireland, Finland, the Slovak Republic, Slovenia and the Baltic States. In almost all of these economies, public debt levels are relatively modest, and budget and current account surpluses point to an excess of saving relative to investment. No fiscal measures are implemented in the remaining euro area economies.

- Productivity-enhancing structural reforms are undertaken in all euro area economies. These are assumed to consist of measures that raise TFP growth by 0.2 percentage point per annum for five years, beginning in 2019, with the 1% higher level of TFP being maintained permanently thereafter. This offsets part of the slowdown in TFP growth experienced since the crisis. In the euro area as a whole, OECD estimates suggest that the annual average contribution of TFP to potential output growth in the decade from 2007 to 2017 was around 0.2 percentage point weaker than in the pre-crisis decade, at 0.3 percentage point.[1]

- Monetary policy is assumed to be set in a way that takes into account the longer-term supply-side gains that arise from enhanced structural reforms. In effect, this means forward guidance is being used to help interest rates stay low for longer, recognising that area-wide inflationary pressures will be somewhat lower in the medium-term at any given level of demand.[2]

The short-term impact of the co-ordinated actions considered is to raise euro area GDP growth by around ¼ percentage point in 2019 and 2020; in the longer term, the level of GDP is around 1% higher. The impact of stronger structural reforms gradually builds over time, offsetting the waning influence of the fiscal stimulus measures.

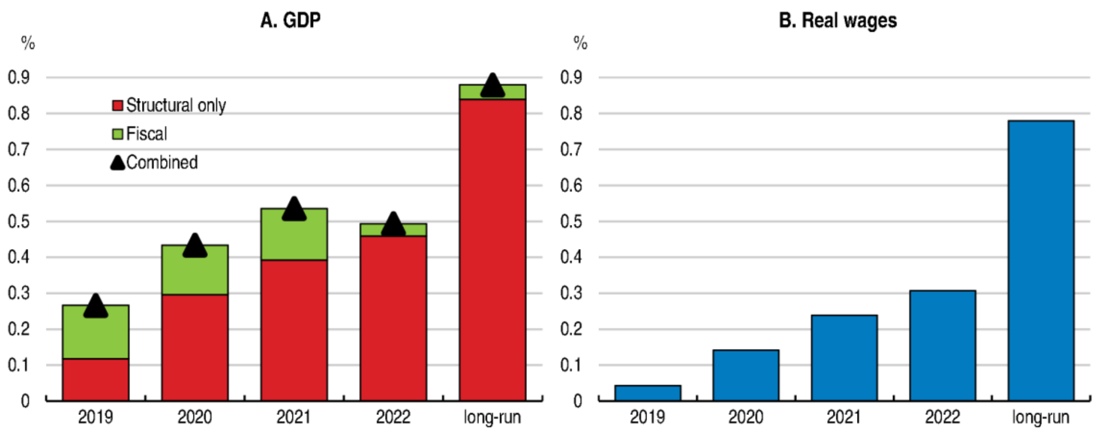
- Business investment rises relatively rapidly, by around over 1% in the first year in the economies undertaking fiscal stimulus and 0.8% in the euro area as a whole, helped by expectations of higher future output and somewhat lower long-term interest rates, and the capital stock continues to accumulate over time.

- Co-ordinated action also offers benefits for workers. Nominal and real wages also rise gradually over time, as they adjust towards the higher level of labour productivity. In turn, this helps to strengthen consumer spending.

There are clear synergies from taking complementary actions across different policy areas. Accommodative monetary policy helps to raise the longer-term output gains from structural reforms. After a decade, the impact of reforms on GDP is higher when accompanied by more accommodative monetary policy. The initial stimulus from public investment provides a further boost, helping to bring forward the medium-term gains to output and wages produced by structural reforms. All told, the impact of reforms on GDP after a decade is close to one-quarter higher when co-ordinated action is taken than if reforms are undertaken without macroeconomic policy support.

The impact of co-ordinated policy support in the euro area

Differences from baseline



Source: OECD calculations using NiGEM.

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1. There are a number of ways in which an increase of 1% in the level of TFP over five years can be achieved, especially if a collection of reforms are undertaken simultaneously in a number of different policy areas, as is necessary for many countries. The synergies from a set of well-designed incremental reforms might also augment the benefits from each reform taken in isolation. The policy priorities set out for each euro area country in the forthcoming *OECD Going for Growth* report are different, but frequently include steps to: streamline permits and licenses; improve the transparency of regulation; reduce barriers to entry in network industries, professional services and retail sector; and strengthen collaboration between research institutes, universities and industry. EU-wide reforms could reinforce such efforts, particularly if renewed progress is made in completing the Single Market. Stronger government investment in physical and digital infrastructure can also enhance potential output in the longer-term by raising the capital stock.

2. Monetary policy in NiGEM follows a two-pillar rule, responding to both the deviation of inflation from target and the deviation of nominal GDP from (its baseline) target. In this case, the nominal GDP target was raised by 1%, reflecting the positive long-term supply shock.

Macroeconomic policy requirements in emerging-market economies

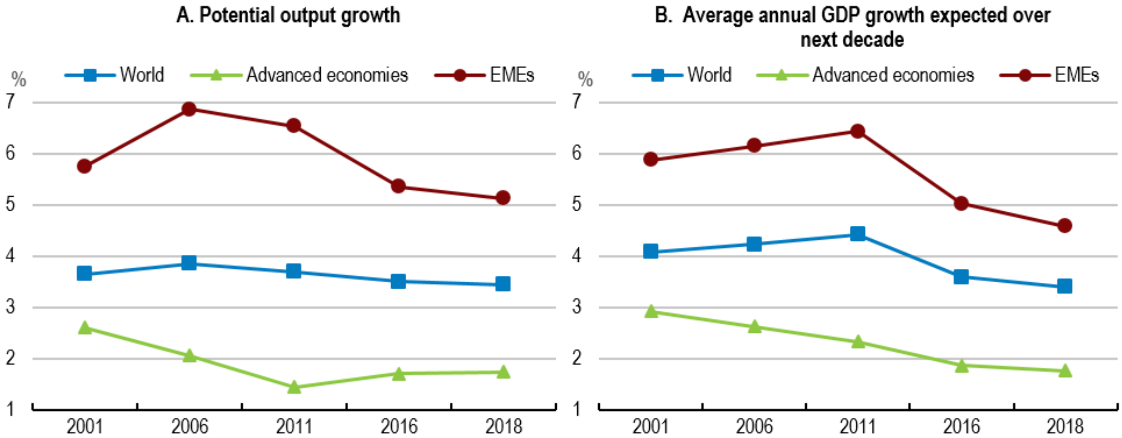
Financial stress has eased in most emerging-market economies, but underlying vulnerabilities persist. The pause in monetary policy normalisation in the advanced economies, particularly the United States, and lower oil prices have reduced near-term risks, but weak global trade, financial stability risks and significant adjustment challenges from past financial market tensions continue to impede growth in many countries.

Policy requirements accordingly differ across countries. In China, policy has been eased, as appropriate given demand weakness, and scope remains for further measures if required. However, careful targeting is needed to avoid adding to high corporate sector indebtedness and medium-term deleveraging challenges. Other emerging-market economies, such as India and Mexico, with a robust macroeconomic policy framework, flexible exchange rate, and manageable exposures to foreign-currency-denominated debt, also have scope to ease monetary policy as inflation declines, while taking the opportunity to improve their fiscal positions if needed. A tighter policy stance remains necessary in those emerging-market economies, such as Argentina and Turkey, where concerns persist about the sustainability of fiscal or external positions, in order to retain investors' confidence. Nominal interest rates can go down as inflation moderates from its current high rates, but there is little scope for lower real interest rates. The priority in these economies is to undertake reforms that enhance the prospects for fiscal and financial sustainability in the medium term.

Structural policy ambition needs to be improved in all economies

The prospects for strong and sustained improvements in living standards and incomes in the medium and long term remain weaker than prior to the crisis in all economies. This reflects the consequences of a decade of sub-par investment and productivity outcomes in the wake of the financial crisis, and less favourable demographic prospects, despite rising labour force participation of older workers in some economies. As a result, estimates of potential output growth have declined (Figure 8, Panel A). Consensus expectations of longer-term growth prospects have also declined (Figure 8, Panel B), reducing incentives to invest.

Figure 8. Medium-term growth prospects have weakened



Note: Based on OECD estimates of potential output growth for 46 economies (Panel A) and consensus forecasts in April for 2001 to 2016, and October 2018 (Panel B). The countries covered account for around 84% (Panel A) and 88% (Panel B) of global GDP in PPP terms.

Source: OECD Economic Outlook 104 database; Consensus Economics; and OECD calculations.

Structural reform efforts have recently stabilised in both advanced and emerging-market economies but remain at a pace below that achieved in the aftermath of the financial crisis. Improved reform ambition in both advanced and emerging-market economies would help to enhance living standards, strengthen the medium-term prospects for investment and productivity, and allow the benefits of growth to be distributed more widely. New liberalisation initiatives by governments to reduce the unnecessary costs of non-tariff measures or to tackle barriers to cross-border services trade would also bring benefits to all economies, enhancing growth and household incomes.