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Economic outlook

The global economic recovery is taking hold, even if short-term prospects are relatively weak. Output growth in the major OECD economies slowed in aggregate through the first half of the year, with sluggish outturns in the United States and Japan only partially offset by buoyancy in the euro area, led by developments in Germany. This slowdown was expected, but it was more pronounced than foreseen earlier this year. The second half of 2010 is also expected to be weak in the OECD area as a whole.

This growth pause does not signal a greater underlying weakness. The global economic recovery is taking hold and growth is likely to pick up next year. The OECD draws comfort from the large corrections that have already occurred – in balance sheets, residential construction activity, and inventory levels.

That said, a less favourable scenario cannot be ruled out and policy actors need to stand ready to respond if necessary. A renewed decline in housing prices in the United States, for instance, could provoke a negative feedback onto private demand, with possible spill-over effects on global demand and growth. In this adverse scenario, financial conditions could worsen if economic weakness led to new losses for banks, possibly amplified by heightened concern over sovereign debt in fiscally weak countries.

Requirements for monetary and macroeconomic policies

Policymakers have little room to manoeuver on the macroeconomic front and they have to find the right balance between supporting a fragile recovery and moving to a more sustainable fiscal path. In this context, one of the main roles of policy is to strengthen confidence and stabilize long term expectations.

On the monetary side, the exceptional crisis mitigation measures have started to be withdrawn across the globe, albeit at different speeds across economies. The Federal Reserve closed its special liquidity window, but put the exit from extraordinary long-term asset holdings on hold. Likewise, the Bank of England has completed its asset purchase programme while committing for now to keep the stock of assets purchased unchanged. Meanwhile, the Bank of Japan continues to purchase government bonds and also expanded its credit facilities. Similarly, the European Central Bank rescheduled its exit from emergency liquidity measures and launched a new programme of purchases of government and private securities.

With subdued inflation, a temporary weakening in growth and a somewhat stronger fiscal consolidation than looked likely before the summer, central banks can generally afford to maintain their very accommodative policy stances somewhat longer. If, however, the slowdown proves protracted, they may need to consider further quantitative easing or strengthened commitments to keep policy rates close to zero for an extended period. Slower exit or reversals of policy by central banks should be used sparingly, however. Keeping the cost of finance artificially low may lead to a host of problems: "ossifying" money markets, undermining traditional banking models, creating important difficulties for funding of long-term liabilities of pension funds and insurance companies, and more broadly, affecting future saving behaviour and asset allocation, thus misallocating resources.

On the fiscal side, the global crisis has wreaked havoc in the public finances and the sovereign debt markets of several G20 countries. This is related to the impact on the budget of fiscal stimulus measures, cyclical revenue losses and expenditure hikes, and the disappearance of revenue buoyancy driven by asset bubbles. Government indebtedness is set to reach all time highs in many OECD countries.

In some countries, particularly in Europe, deterioration in public finances calls for consolidation to restore long-term fiscal sustainability. The consolidation should be faster, the weaker the state of public finances, the greater the difficulties to fund debt, the stronger the economy, the lower the short-term multiplier effects, the greater the scope for monetary policy to offset these multiplier effects and the larger the adverse long-term growth effects from delaying consolidation. With regard to the mix of fiscal consolidation measures, past experience suggests that budget consolidation concentrated on spending cuts is likely to be more durable and have a more positive impact on potential growth. Tax hikes may be unavoidable, and should be concentrated on the elimination of distortive tax expenditures and consumption, while environmental levies may bolster budgets and welfare.

Fiscal rules and institutions can play an important role in consolidation. In the current circumstances, employing a debt rule that specifies the path to stabilise and reduce debt-to-GDP ratios would be particularly useful. It could be supplemented with spending and/or deficit rules. That said, automatic fiscal stabilisers should be allowed to operate around the planned consolidation paths except in countries where market pressures are a prospective concern. In addition, independent fiscal watchdogs can play an important role in monitoring the compliance with rules, helping to boost credibility and thereby reduce funding costs for the government and the economy at large.

If the slowdown proves protracted, the leeway for additional fiscal stimulus is limited. In the OECD's view, governments should only consider reducing the speed at which they consolidate their budgets in those countries that have less impaired fiscal positions and/or modest debt-to-GDP ratios.

Structural policies to tackle post-crisis vulnerabilities

OECD analysis has shown that a judicious mix across countries of structural reform, fiscal consolidation and exchange rate changes can bring about stronger medium-term growth with healthier public budgets and smaller international imbalances. Over the near term, though, there is a risk that unilateral resistance to exchange rate changes can not only weaken the necessary international rebalancing but also lead to greater pressure on countries that allow their exchange rates to vary and may trigger trade tensions and protectionist sentiments.

Widespread resort to capital controls represents another danger to the multilateral system. OECD members today are now almost entirely free of controls on capital movements. They are also committed under the OECD Code of Liberalisation of Capital Movements to maintain this openness unless exceptional circumstances can be invoked to justify temporary recourse to restrictive measures under conditions of transparency and consultation with OECD partners. The disciplines of the Codes provide an important safeguard for a key element of a well functioning international system.

Given the limited room for manoeuvre with macroeconomic policies, governments need to boost potential output and address imbalances. The role of structural reform in shaping longer-term economic prospects has become even more prominent in the aftermath of the financial and economic crisis. Broad agreement has emerged that structural reform is needed to recover the output losses associated with the global crisis, to put public finances back on a sustainable track and avoid large external imbalances from re-emerging as the global recovery gathers pace. It is also essential to equip economies to tap into new sources of growth, such as the knowledge-based and the green economies.

The OECD has identified a number of structural policy measures that could increase potential growth. These include further opening; increased competition in product markets remains a priority; notably in network industries, retail trade and professional services; actions to improve educational outcomes; and tax reforms that strengthen the incentives for investing, saving and innovating. Moreover, a number of countries could lower excessively high marginal tax rates on labour incomes, reduce the duration and replacement rates of unemployment benefits, strengthen job-search and broaden access to childcare and parental leave to encourage labour force participation. Labour utilisation could also be improved through reforms of labour market regulations, wage setting and housing policies.

At the same time, such structural measures that enhance potential growth could also facilitate the necessary fiscal consolidation. Structural policy measures may have a direct favourable impact on fiscal positions, by reducing government spending on items such as pensions and unemployment benefits. By the same token, certain product market reforms, such as privatisation or the removal of public subsidies for agriculture, energy and housing could also contribute to improving fiscal positions. Reforms can also have an indirect positive impact on fiscal positions by boosting productivity and employment and the associated tax take. OECD analysis shows that a 1 % reduction in structural unemployment would improve the fiscal position by ¼ to ½ a percentage point of GDP on average.

In a similar vein, structural reforms can help narrow the gaps between savings and investment in many countries. These gaps are at the root of the global imbalances which have played such a prominent role in exacerbating, if not partly causing, the financial and economic crisis. While the imbalances have receded somewhat with the global recession, they are largely structural in nature and have begun to widen again in the recovery. Structural reform can have effects on both savings and investment. Their balance depends on the types of reforms implemented and the initial conditions prevailing in individual countries. It is therefore important to carefully map the mix of structural reform measures and their impact on saving and investment decisions.

Specifically, in countries running excessive external surpluses, easing product market regulation that stifles competition could stimulate greater entry of new firms and investment. Reform in sheltered sectors may lead to a shift of resources to these sectors and thereby further contribute to narrow the current account surplus. Stronger social security programmes and pension systems, where these are presently underdeveloped, could reduce the need for precautionary saving. Structural reform can boost expected future income growth and induce household saving to decline if consumers frontload some of these benefits by raising consumption – provided financial markets are sufficiently developed and competitive. This highlights the role of financial market reforms in current-account surplus countries. Similarly, improvements in the sophistication and depth of financial markets should foster investment.

In countries running excessive external deficits, exposing heavily investing companies to stronger competition can lower the incentives for over-investment. Similarly, tax reforms can affect investment and saving decisions, notably in deficit countries where the tax treatment of interest payments on loans is particularly generous. Phasing out this special treatment could contribute to a reduction in global current-account imbalances.

Financial market reform

Financial market reforms should also be vigorously pursued and implemented, as they are essential to improve the functioning and stability of financial markets. In this context, the planned increase in bank capital requirements is welcome. Their implementation, however, has effectively been weakened, particularly as concerns the definition of capital, netting of derivative exposures and the nature of the leverage ratio that is under consideration.

As legislators act – in the United States, Europe and elsewhere -- the challenge of achieving global consistency of regulation becomes more pressing. Consistent global rules across financial markets – both geographically and across sectors – are essential to prevent regulatory arbitrage and business migration that will likely create new distortions and systemic risks. The OECD emphasises that financial ‘promises’ should be treated in the same way—wherever they are made and to wherever they are shifted—if we are to avoid crises in the future. Further progress in this direction is still sorely needed.

In the specific case of Europe, the lack of liquid trading in the interbank market and the pricing of sovereign default in the bond markets of some countries, despite aggressive central bank liquidity policies, suggests that there is still work to be done to allay market concerns. The EU stress tests gave banks a two-year clean bill of health. But markets are also focussed on what might happen in the period when government support packages are no longer in place. Any bank resolution would need to involve not only the trading books, but also the banking books, where most sovereign debt is held. Balancing fiscal consolidation, dealing with substantial debt refinancings and managing the use of the European Financial Stability Facility without generating adverse market reactions will be important challenges going forward. But above all, markets have to be convinced that structural reforms will be pursued so as to rebalance competitiveness across EU regions.