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Economic outlook. The global recovery has lost impetus. GDP growth was sub-par in the second quarter in some of the advanced economies and economic areas, such as the United States and the euro area. Growth slowed in the dynamic emerging-market economies, but remains stronger than in most industrialised countries. The expansion of global trade has also hit a soft spot, due in part to disruptions in supply chains after the March 2011 disaster in Japan. Inflation has been in general low in OECD countries due to large and rising economic slack, although robust growth has put upward pressure on underlying inflation in several emerging-market economies.

Among the reasons for sluggish growth are concerns about sovereign debt distress and budget developments in the United States and the euro area to support a weak recovery, which have raised risk awareness and undermined confidence. Pro-cyclical fiscal action in some countries, headwinds related to high commodity prices and disruptions to cross-border supply chains following the earthquake and tsunami in Japan have also weighed on activity growth. In addition, post-crisis balance-sheet adjustment, including fiscal consolidation, may be stronger than previously anticipated. If left unaddressed, heightened risk aversion will continue to bear down on the recovery in the near term.

Turmoil in the financial markets has risen alarmingly in recent weeks as a consequence of a loss of confidence in policy making with respect to the sovereign crisis in Europe. Bank exposure to sovereign debt and the impact of spread widening that reduces collateral values for loans and derivative positions has meant that sovereign spreads and bank spreads have moved in lock-step. Indeed bank and sovereign CDS spreads are now much higher than they were at the worst point of the Lehman crisis. Some major banks within Europe have also had credit rating downgrades, worsening their position. The situation is substantively better for US banks. Nevertheless, in today's world of globalised markets and interconnectedness via derivative counterparty risk the crisis in Europe has materially affected US banks and share prices have suffered accordingly. In addition, continued deleveraging, negative equity in many mortgage loans, uncertainty about regulatory rule writing and litigation issues affecting US banks have all operated to inhibit the traditional financial intermediation functions of banks.

Unemployment remains stubbornly high in many OECD countries, although there are large differences across the board. According to the OECD's latest Employment Outlook, published on 15 September, the number of unemployed people in the OECD area had declined to just over 44 million in mid-2011, still more than 13 million higher than immediately before the crisis. There are increasing risks that high unemployment could become entrenched in some countries, translating in lower output potential. Workers with weakest attachment to the labour force, such as youths, low-skilled women and migrants, are at greatest risk of falling in inactivity after long spells of unemployment. Indeed, the unemployment rate for people aged 15 to 24 was 17.4 percent in the OECD area in the first quarter of 2011, compared with 7 percent for adults (25-65 year olds). Effective labour market policies and institutions can make a difference. Some OECD countries, including Australia, Japan, Korea and the

Netherlands have managed to contain the increase in unemployment. Germany has actually reduced unemployment during the crisis.

Current account imbalances have narrowed from pre-crisis levels but remain wide. Due to still high oil prices, the external surplus of the oil-exporting countries has soared, while the combined external position of the deficit countries has narrowed only modestly in recent months. Global imbalances are unlikely to contract in a sustainable manner in the near term to the extent that oil revenues are saved, rather than re-spent; they are equally unlikely to shrink in the absence of greater exchange-rate flexibility, fiscal consolidation and structural reforms that could encourage domestic demand in surplus countries and stimulate savings in deficit countries.

Policy challenges and requirements. There is considerable uncertainty as to the length of time that sluggish growth may persist and whether or not the downturn in activity may be more pronounced than expected in some of the major economies. But at any rate, the right policies can make the difference in the current juncture. Policy makers have to take into account the current and near-term weakness and put the focus on restoring confidence with a medium and long-term strategy.

Monetary policy should remain accommodative in the face of a weak economic outlook in the advanced economies. Interest rates should be kept on hold in most OECD countries. Further monetary easing would be warranted, if risks intensify that the economy is heading towards a recession or more protracted stagnation. Policy responses would involve interest rate cuts, where there is scope, and unconventional measures, including quantitative easing and renewed asset purchases by central banks. A conditional commitment to maintaining policy rates at exceptionally low levels until a certain date would also be justified. There is room for monetary accommodation in the fast-growing economies outside the OECD area where disinflation in well under way.

The public finances remain in a precarious state in the major economies. For most OECD countries, according to the latest edition of the OECD Economic Outlook (published in May 2011), government debt is poised to continue to rise in relation to GDP in the near term, despite a projected improvement in headline budget balances. By contrast, fiscal positions are in general better in the emerging-market economies outside the OECD area than in the majority of OECD countries.

Strong, credible medium-term frameworks for fiscal consolidation and durable growth are needed to restore confidence in the longer-term sustainability of the public finances and to build budgetary space to deal with short-term economic weakness. Countries with limited fiscal space have restricted scope for fiscal easing and some have to tighten despite cyclical weakness. Countries with sounder public finances can provide additional counter-cyclical stimulus or at least let the automatic stabilisers work unimpeded around the projected consolidation path in view of a fragile near-term outlook. In the United States, a credible medium-term consolidation plan should build on recent agreements and announcements with the aim of first stabilising and then putting the government debt on a downward trajectory in relation to GDP over the longer term. In the euro area, the priority is to find a solution to the debt crisis. Significant more resources and more credible mechanisms are needed to avoid contagion and prevent fiscal duress in individual countries from undermining stability in the area as a whole.

As for the financial markets, the aim of policy must be to break the link between the sovereign and banking crises, to continue to ensure that the crisis is not permitted to spread to other larger European countries, and that banks' short-term and longer term funding can be assured.

To address the tensions in bank term funding markets, renewed calls have been made for the creation of explicit government-supported arrangements for guaranteeing bank debt, such as those temporarily put in place by many governments in 2008. This time, according to some proposals, guarantees would be provided jointly by several sovereigns or via joint facilities, given that some sovereigns on their own would not be able to extend guarantees that would be sufficient to reassure investors of the quality of the underlying bank debt.[1] These initiatives should be supported if confidence deteriorates further and banks face renewed funding difficulties. Final recommendations by the UK Banking (Vickers) Commission, and specifically three of them, are worth highlighting when it comes to the regulation of the banking sector: (i) to ring-fence retail banking from investment banking (and to require that boards of retail and riskier parts of banks be separate and that any transactions across the ring-fenced units be done at arm's-length to ensure reduced cross-subsidisation); (ii) that the loss absorbing capacity of banks depends on equity, and this should be much higher than current Basel standards require; and (iii) measures to improve competition in banking should be encouraged. The OECD welcomes this report. All three of these messages have been the main strategy advocated by the OECD for more than 2 years as a response to the crisis.[2] It is to be hoped that other countries too will look more closely at these same issues.

"Going structural": policies to facilitate fiscal consolidation, risk sharing and global growth rebalancing. Well-designed and well-implemented structural reforms yield a triple dividend: they enhance longer-term growth potential and lift employment; they strengthen public budgets and can affect the cost of government borrowing by enhancing confidence that budgetary positions are sustainable in the longer term; they rebalance global demand.

In view of weak growth in the near term and impaired fiscal positions in most OECD countries, priority should be given to reforms that offer comparatively strong short-term gains and facilitate fiscal consolidation.

A full range of growth-friendly structural reforms could help to achieve medium-term fiscal sustainability. For example, OECD analysis shows that reforms in health care and education can raise efficiency, allowing spending to be cut without undermining provision, and, in turn, contributing to fiscal consolidation. Judicious tax reform, combined with measures to enhance compliance, can facilitate adjustment without jeopardising growth. Reforms

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1 The upfront fiscal costs associated with guarantees are also limited or nil. But care needs to be taken, as guarantees are not costless. In fact, one of the key lessons from the experience with the policies put in place in response to the global financial crisis of 2008/09 is that mispriced guarantees create distortions to completion and incentives and produced moral hazard.

2 See for example: The Financial Crisis: Reform and Exit Strategies, OECD 2009. In particular the OECD Secretariat has argued for some time now that the combining of traditional commercial and modern investment banking activities under one roof creates tensions and gives rise to the wrong kind of competition between banks.

to pension and social benefit systems that promote participation could contribute to raise the effective labour supply and this would in turn improve fiscal positions by generating revenue to the budget and/or lowering public spending. Other structural fiscal reforms that facilitate growth and contribute to fiscal adjustment while at the same time improving welfare include reductions in tax expenditures and subsidies, as well as the introduction of pollution-pricing mechanisms, such as carbon taxes or the auctioning of emission permits.

"Going social": policies to strengthen the job content of the recovery. Effective labour market policies can make a difference. Some OECD countries have managed to contain the increase in unemployment, while others have experienced large hikes in joblessness. Structural labour market policies can also do much to prevent currently high unemployment from becoming structural in many advanced economies and at the same time would help avoid the associated long-term damage to the public finances.

With public resources limited, policy responses should focus on cost-effective measures - such as well-designed hiring subsidies. Moreover, income support for the unemployed should be maintained or even reinforced where assistance is relatively low, difficult to access and where the long-term unemployed face a serious risk of falling into poverty and exclusion. But it is essential to combine income support with effective re-employment programmes to avoid benefit dependence. In emerging-market economies, income support should be targeted to those who most need it and be better integrated in broader social protection programmes.

Helping young people must be a priority. Policies involving job-search assistance, hiring subsidies and remedial assistance should focus on the most disadvantaged youth, including those at high risk of exclusion. In a number of countries, there is also a need to expand opportunities for "study and work" programmes, such as apprenticeships and other dual vocational education and training programmes.

Structural policies for global rebalancing. In combination with appropriate macroeconomic policies, there is much scope for achieving a sustained reduction in global imbalances through structural reform, as increasingly recognised by G20 countries in the context of the G20's *Framework for Strong, Balanced and Sustainable Growth*.

Investment-friendly structural reforms in product markets, such as initiatives to enhance competition in sheltered sectors, would help to rebalance growth towards domestic demand in some advanced surplus economies and reduce their reliance on external sources of growth. In the case of emerging-market economies with large external surpluses, structural reforms that are already desirable on efficiency and/or equity grounds, such as a strengthening of social welfare systems and financial deepening, have the potential for stimulating domestic demand. Policy action that aligns movements of real exchange rates with economic fundamentals in individual countries would facilitate adjustment at the global level. The G20's *Framework for Strong, Balanced and Sustainable Growth* has to be used a real policy tool and its recommendations should be guide the policy implementation on national and international level.

Keeping markets open, a crucial precondition for economic recovery. Keeping markets open to international trade and investment remains a crucial precondition for economic recovery, fiscal consolidation and job creation. Investment policy monitoring at the OECD shows that, over the past year, investment liberalisation has continued, albeit slowly and that governments have begun unwinding assets accumulated under earlier crisis response programmes. Governments should further reduce their involvement in business investment processes and communicate clearly that, henceforth, investment decisions need to be made on the basis of market risk and returns unaltered by taxpayer-financed programmes.

Sticking to internationally-agreed disciplines in the realm of capital flows management is of critical importance too. Monetary easing in the advanced economies influence cross-border capital flows. Several countries facing strong inflows have recently taken capital flow management measures. Adoption of such measures by individual countries, however, can lead to negative collective outcomes. Discussions on capital flow management measures have taken place in the G20 context. This discussion has renewed the experience gained with the OECD Codes of liberalization that commits 34 member countries to a free capital flow regime while maintaining the necessary flexibility to take national measures subject to rules of transparency and multilateral dialogue. The Organisation recently decided to open the Capital Movements Code to adherence by non-members to extend the benefits of the codes to any interested countries.