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Global Economic Outlook

The global economy weakened considerably over the summer. Activity has been adversely impacted by the unresolved euro area crisis, but also a marked slowdown in emerging economies. Trade flows have slowed significantly. Business and consumer confidence is waning, particularly in the euro area.

The loss of momentum is likely to persist during the second half of this year. The euro area will remain in recession, the United States is projected to enjoy somewhat stronger growth, and in China growth is expected to pick up modestly. The latest OECD assessment suggests that growth in the G7 countries will weaken from 0.7 percent in the first half of 2012 to 0.3 percent in the second half of the year, with the euro area effectively remaining in recession through the period.

Joblessness remains high, and the recent slowdown in activity is already translating into weaker jobs prospects. Labour market developments are especially troubling in the euro area, where unemployment has recently risen to 11.3 percent and could rise further next year. Most advanced economies run a serious risk of locking in unemployment rates that are already unacceptably high -- more than 15 million persons in the OECD area have been unemployed for one year or more and among them almost 8 million for two years or more.

Risks to the global outlook remain high. The euro area remains at the centre of concern. While the likelihood of tail risks has fallen since recent ECB announcements, there is much uncertainty around the practical implementation of these measures. The global banking and financial system continues to be a major concern. Failure to avoid the "fiscal cliff" in the United States could potentially derail a still weak recovery. Global imbalances also remain high and are expected to widen again once economies begin to recover.

Policy requirements in the current juncture

Weakening economic activity calls for continued macroeconomic policy support. Accommodative monetary policies should continue, including through quantitative easing. However, we should remain alert to the potential unintended consequences and political economy risks regarding the perceived independence of central banks, as well as moral hazard arising from quantative easing. Additional monetary and fiscal measures aimed at boosting demand and lifting confidence should also be taken where policy space is still available, including in some emerging-market economies.

Fiscal consolidation, particularly in the euro area, should continue at a pace consistent with country-specific circumstances; where possible, fiscal space should be used in the short term, while maintaining the medium-term credibility of consolidation. In the short-term the looming fiscal cliff in the US threatens to push the economy into recession. In the longer term, many OECD countries will require consolidation just to stabilise debt levels, let alone reduce debt-to-GDP ratios to manageable levels. We estimate that to bring Japan's debt back to 60 percent of GDP by 2030, the average increase in the underlying primary balance will be close to 14 percent of GDP over

the next twenty years. In the case of the United States the figure is over 6 percent of GDP. While this consolidation will have the double dividend of increased stability, lower interest rates and therefore higher growth, there are still tradeoffs to be made in terms of the composition of the consolidation and its effect on growth. Top priority should be given now to establishing detailed and credible consolidation plans.

It is in the euro area where reforms are most urgent. European Council and ECB announcements over the summer, and more recently the ECB announcement that it stands ready to intervene in sovereign debt markets under certain conditions, helped to provide stability in financial markets, despite ongoing difficulties facing banking systems in several countries. While these measures are welcome, the positive market reactions have partially receded in the face of uncertainty about the capacity to follow through with implementation. We have already seen such a pattern, where policy decisions going in the right direction gave rise to positive market response soon to be disappointed by a lack of clear action. Such a pattern should not be repeated. In particular, the ECB needs the freedom to intervene in struggling sovereign debt markets when the conditions are right.

Measures to shore up the European banking system also need to be implemented. Solvency fears for banks and their sovereigns are feeding on each other. Full recognition of non-performing loans, enforced by common supervision, and the availability of area-wide public funds for recapitalisation are crucial for severing this feedback loop. Further progress towards a full banking union – including euro area wide deposit guarantees and a common bank resolution regime – is crucial. It is important that core countries also commit to deploy the ESM where needed. This would bolster the credibility of the framework.

Reforms to the global financial system

At the global level, financial system reforms need to continue apace. From the onset of this crisis, the OECD has advised against excessive complexity in bank regulations and argued for two complementary reforms that we think would be more effective. First, that a simple leverage ratio is essential to control the problem of banks with too little capital. Second, that the separation of commercial banking from large-scale and complex securities (notably derivatives) businesses is essential to avoid the cross-subsidisation of excessive risk taking linked to the too-big-to-fail phenomenon. The OECD is glad to see that the need for such structural policy measures is increasingly being recognised worldwide, including in major European countries, such as the United Kingdom and Germany, and that the introduction and implementation of such reforms is gaining ground.

However, there are two key obstacles to this approach that will need to be addressed. First, despite the emergence of evidence against complex capital rules, the current leverage ratio remains confined as a ‘backstop’ rule at just 3 percent, well above a safer median level of 5 percent recommended by the OECD. Second, national approaches to bank separation seem to be proceeding in a fragmented way. With more European countries now interested in the issue of bank separation, it is important to support more consistent approaches that deal with the issue in as simple and practical a manner as possible.

Special focus on jobs

The size of the employment challenge is daunting. G20 countries today suffer from a jobs gap of over 21 million. Long-term unemployment is high and carries high risks of permanent labour market exclusion. This represents a tremendous waste of human potential. Labour market developments are especially troubling in the euro area, where unemployment has recently risen to above 11 percent and close to 25 percent in Greece and Spain. Moreover, there are 7.8 million young people aged 15 to 24 years in the EU alone who are not in employment or in education and training. These youth risk having their job and earnings prospects permanently scarred.

Governments can become smarter in designing labour market policies and allocating labour market support to maximise the resulting benefits. For example, hiring subsidies should be targeted at helping the most disadvantaged groups back into jobs, while avoiding subsidising jobs that would have been created anyway. Increased flexibilisation of labour markets should be combined with the provision of effective social safety nets, particularly in emerging-market economies.

It is also urgent to improve the employment prospects for youth. This requires actions on different fronts, such as targeted labour market programmes, including effective counselling, job-search assistance and temporary hiring subsidies for low-skilled youth. These can make a difference in facilitating the transition to productive and rewarding jobs. But it also requires re-doubling our efforts to address the challenge of young people that are neither at school nor on the labour market.

More must also be done to tackle long-term unemployment. A well-designed policy package can minimise the long-term costs of unemployment and lay the foundations required to put people back to work. We must provide effective re-employment services and ensure that the unemployed stay connected to the labour market. Assisting those unemployed that are "job ready" should remain the first line of support. Targeted job subsidies for new hires and publically subsidised work-experience programmes can help.

More generally, governments must take measures to help workers during this difficult economic period, including by continuing to pursue labour market reforms. In developing and emerging-market economies, the priority is to make gradual progress towards constructing a comprehensive social protection system. In developed countries there is more often a need to reform existing protective institutions; for example, by reducing the gap in employment protection between permanent and temporary workers. OECD research shows that this type of reform will boost job creation and improve the ability of the labour market to weather adverse economic shocks. The good news is that several European countries, notably Greece, Italy, Portugal and Spain, have passed ambitious labour market reforms recently.

Structural policies to address rebalancing and support growth

More broadly, longer-term challenges associated with the crisis have yet to be addressed. In some cases, lower potential output, higher overall and long-term unemployment, vast debt overhangs and disrupted capital markets could lead to permanently lower growth in advanced economies. While emerging-market economies continue to exploit their catch-up potential, advanced economies, which are closer to or at the technological frontier, will be able to grow only to the extent they can push the frontier itself, which requires tapping into new sources of growth. In addition, imbalances, both within and between countries, have been a contributing factor to the financial crisis, and need to be tackled.

For these challenges to be addressed continued progress on structural reforms is critical. Structural reforms don't take generations to materialise. Our analysis finds that well-targeted and packaged structural reforms can deliver results faster and more efficiently than generally expected. And reforms are not necessarily painful. If properly designed, short-term pain can be minimised by exploiting synergies amongst complementary policies. For example, a comprehensive strategy that maximises complementarities across mutually reinforcing policy domains, such as, labour and product market reforms, enables governments to minimise or even alleviate the transitional costs that may be associated with individual reforms when adopted in isolation.

In the euro area, some adjustment in euro area imbalances is underway, with intra-area trade imbalances continuing to narrow, and with sharp declines in domestic absorption. However, this predominantly reflects the contraction in activity in the periphery, and more is needed to boost productivity and restore competitiveness durably in those countries. Some countries are already making significant progress to implement structural reforms. For example, in Italy legislation has been introduced covering a wide range of areas of competition and regulatory policy, which according to recent OECD estimations could add up to 4 percent to the level of national income over 10 years. The political and social challenges involved in these adjustments could be smoothed if they could take place against a background of stronger area-wide growth. For this to happen decisive action to deepen the euro area's internal market will be key. Spain is also taking key decisions on this score.

While structural reforms in the euro area would have strong positive spillovers for the rest of the world, not least through confidence channels, all countries have room to upgrade their economies and there remain substantial global imbalances to address. Significant challenges include demographic changes, such as ageing, and the effects of economic convergence which will lead to large shifts in the composition of global activity. In the context of these long-term trends structural reforms can have an important role to play. As recent OECD analysis shows, convergence toward best practice in product market regulation would significantly speed up convergence. Likewise, deeper labour market reforms can partly counteract the negative effects of demographic changes, while ambitious structural and fiscal reforms can lift growth and reduce current account imbalances.