OECD
BETTER POLICIES FOR BETTER LIVES

Interim Economic Outlook

19 September 2019

WARNING: LOW GROWTH AHEAD

Summary

- The global outlook has become increasingly fragile and uncertain. Global growth is projected to slow to 2.9% in 2019 and 3% in 2020. These would be the weakest annual growth rates since the financial crisis, with downside risks continuing to mount.
- Escalating trade policy tensions are taking an increasing toll on confidence and investment, adding to policy uncertainty, weighing on risk sentiment in financial markets, and endangering future growth prospects.
- Growth has been revised down in almost all G20 economies in 2019 and 2020, particularly those most exposed to the decline in global trade and investment that has set in this year.
- The disruption to trade and cross-border supply chains is a drag on demand, but also has longer-term growth costs by reducing productivity and incentives to invest.
- Service sector output has so far held up due to solid consumer demand, but persistent weakness in manufacturing sectors will weaken labour demand, household incomes and spending.
- Growth in China is expected to moderate gradually, but risks of a sharper slowdown and a prolonged period of very weak import demand are intensifying.
- Substantial uncertainty persists about the timing and nature of the withdrawal of the United Kingdom from the European Union. A no-deal exit would be costly in the near-term, potentially pushing the United Kingdom into recession in 2020 and reducing growth in Europe considerably.
- Significant financial market vulnerabilities remain from the tensions between slowing growth, high debt and deteriorating credit quality.
- Collective effort is urgent to halt the build-up of trade-distorting tariffs and subsidies and to restore a transparent and predictable rules-based system that encourages businesses to invest.
- Monetary policy should remain highly accommodative in the advanced economies, but the effectiveness of accommodative monetary policy could be enhanced if accompanied by stronger fiscal and structural policy support.
- Fiscal policy needs to assume a bigger role in supporting growth in the advanced economies. Exceptionally low interest rates provide an opportunity to invest in infrastructure that supports near-term demand and offers benefits for the future.
- Greater structural reform ambition is required in all economies to help offset the impact of the negative supply shocks from rising restrictions on trade and cross-border investment and enhance medium-term living standards and opportunities.
- In the euro area, using fiscal and structural policies alongside monetary policy would be more effective for growth and create fewer financial distortions than continuing to rely mainly on monetary policy.

OECD Interim Economic Outlook Forecasts September 2019
Real GDP growth
Year-on-year % change

	2018	2019		2020	
		Interim EO projections	Difference from May EO	Interim EO projections	Difference from May EO
World[1]	3.6	2.9	-0.3	3.0	-0.4
G20[1,2]	3.8	3.1	-0.3	3.2	-0.4
Australia	2.7	1.7	-0.6	2.0	-0.5
Canada	1.9	1.5	0.2	1.6	-0.4
Euro area	1.9	1.1	-0.1	1.0	-0.4
Germany	1.5	0.5	-0.2	0.6	-0.6
France	1.7	1.3	0.0	1.2	-0.1
Italy	0.7	0.0	0.0	0.4	-0.2
Japan	0.8	1.0	0.3	0.6	0.0
Korea	2.7	2.1	-0.3	2.3	-0.2
Mexico	2.0	0.5	-1.1	1.5	-0.5
Turkey	2.8	-0.3	2.3	1.6	0.0
United Kingdom	1.4	1.0	-0.2	0.9	-0.1
United States	2.9	2.4	-0.4	2.0	-0.3
Argentina	-2.5	-2.7	-0.9	-1.8	-3.9
Brazil	1.1	0.8	-0.6	1.7	-0.6
China	6.6	6.1	-0.1	5.7	-0.3
India[3]	6.8	5.9	-1.3	6.3	-1.1
Indonesia	5.2	5.0	-0.1	5.0	-0.1
Russia	2.3	0.9	-0.5	1.6	-0.5
Saudi Arabia	2.2	1.5	-1.0	1.5	-0.4
South Africa	0.8	0.5	-0.7	1.1	-0.6

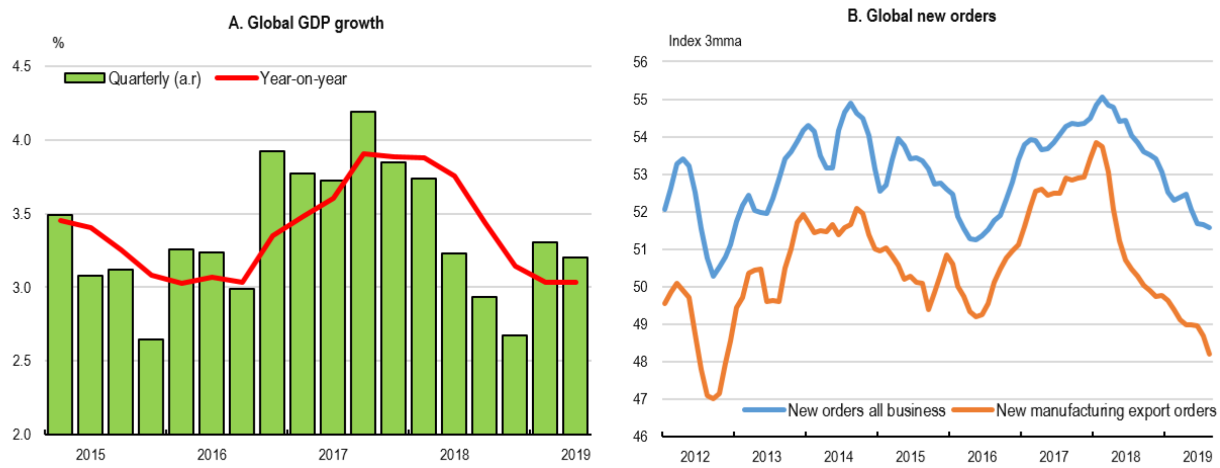
Note: Difference from May 2019 Economic Outlook in percentage points, based on rounded figures.
1. Aggregate using moving nominal GDP weights at purchasing power parities.
2. The European Union is a full member of the G20, but the G20 aggregate only includes countries that are also members in their own right.
3. Fiscal years, starting in April.

Global growth has weakened amidst rising uncertainty

The global outlook has become increasingly fragile and uncertain. GDP growth is subdued and global trade is now contracting. Continued and deepening trade policy tensions are taking an increasing toll on confidence and investment, adding to policy uncertainty, and weighing on risk sentiment in financial markets. A sharp upward spike in oil prices due to rising geopolitical tensions and disruptions to oil supply in Saudi Arabia is also increasing uncertainty and financial volatility.

Global growth slowed to an annual pace of 3% in the first half of 2019 (Figure 1, Panel A). Outcomes held up in the United States, helped by strong consumer spending and fiscal policy support, and Japan, but proved weaker than anticipated in many other advanced economies, especially in Europe. Developments in many emerging-market economies were also softer than projected, including in India, Mexico and many commodity-exporting economies. GDP growth in China eased only gradually, amidst ongoing policy stimulus, but import demand weakened considerably.

Figure 1. Global growth continues to slow

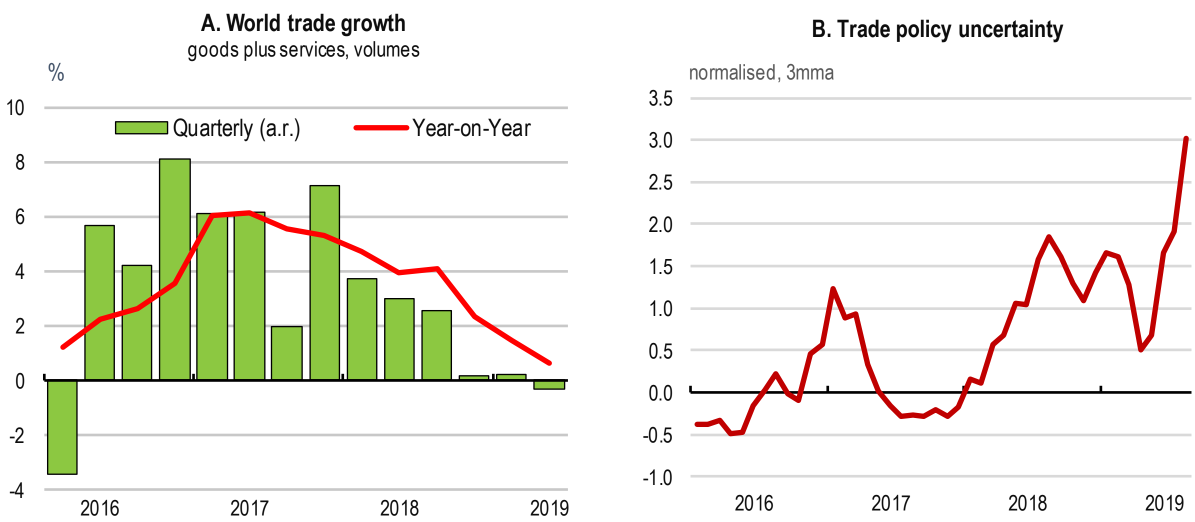


Note: GDP aggregation using PPP weights. Quarterly estimates for 2019 are based on countries with available national accounts data.
Source: OECD Economic Outlook database; Markit; and OECD calculations.

Survey measures of business activity have continued to weaken (Figure 1, Panel B), particularly in manufacturing, where global measures of output and new orders have declined to their lowest level for seven years. Trade tensions have weighed heavily on industrial sectors, especially in the advanced economies, where industrial production declined in the first half of 2019. Service sector output has so far held up, with improved labour market conditions and modest fiscal policy support underpinning household incomes and consumer spending. The unusual dichotomy between manufacturing and services is unlikely to last long. Prolonged weakness in industrial sectors would intensify the downturn in hiring intentions and reduced working hours already underway in some countries, placing downward pressure on household incomes, spending and demand for services.

Global trade remains exceptionally weak. Trade volumes (goods and services) stalled at the end of 2018 and are now declining (Figure 2, Panel A). High-frequency indicators suggest that near-term trade prospects are bleak. Uncertainty about trade policies has reached a new high (Figure 2, Panel B) and new export orders are contracting in around two-thirds of the economies with available survey data. The disruption to trade, cross-border investment and supply chains from rising trade tensions is a direct drag on demand and adds to uncertainty. It also harms supply and weakens medium-term growth prospects, as the induced reallocation of activities across countries and adjustment to supply chains makes firms less productive. Lower expectations of future growth also reduce the incentives to invest at present.

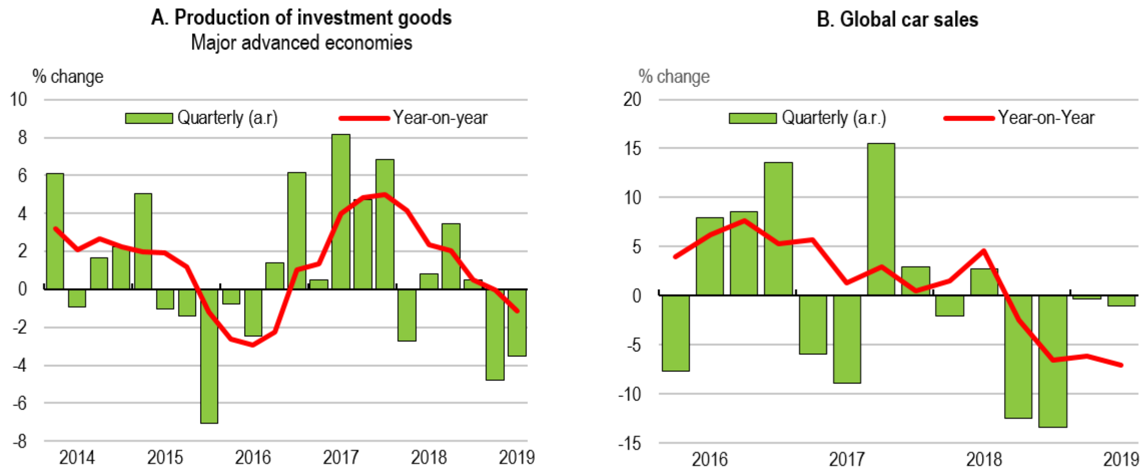
Figure 2. Trade growth has weakened



Note: Trade policy uncertainty is a weighted average for the United States and Japan, normalised over 2011-2019.
Source: OECD Economic Outlook database; policyuncertainty.com; and OECD calculations.

The impact of heightened policy uncertainty on investment is increasingly apparent. Aggregate investment growth has slowed sharply in the G20 economies, from an annual rate of 5% at the start of 2018 to only 1% in the first half of 2019. Production of capital goods in the major advanced economies, a key indicator of business investment, declined sharply throughout the first half of 2019 (Figure 3, Panel A). Demand for consumer durables has also eased, especially for cars (Figure 3, Panel B). Germany is being particularly affected by these developments. This reflects the relative importance of manufacturing for overall activity, a specialisation in capital goods production and the difficulties of adjusting to structural challenges in the car industry.

Figure 3. Demand for investment goods and cars has declined

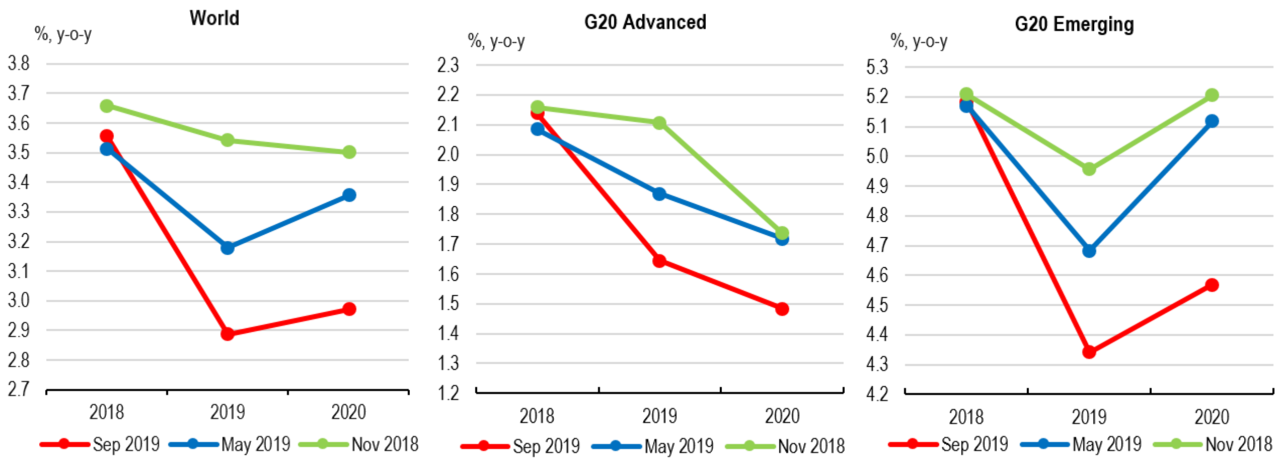


Note: Production of investment goods is a weighted average of output in the euro area, the United States, Japan, Korea and the United Kingdom. Production of business equipment is used for the United States.
Source: OECD Economic Outlook database; US Federal Reserve; Eurostat; Ministry of Trade and Industry, Japan; KOSIS; and OECD calculations.

Global growth is set to remain weak, with downward revisions in most G20 countries

Recent economic and financial developments suggest that the widespread moderation in GDP and trade growth prospects is likely to persist for longer than earlier anticipated, with confidence declining further, policy uncertainty continuing to rise and investment remaining weak. Lower interest rates should help to cushion the extent of the slowdown, although the impact of recent changes in policy interest rates is likely to be modest, especially in the advanced economies. Household spending is holding up, helped by real wage increases and modest macroeconomic policy support, but slowing job creation is likely to weigh on income growth, and persistent weak productivity and investment will check the strength of real wage gains. Global GDP growth is projected to slow from 3.6% in 2018 to 2.9% this year and 3% in 2020, with downward revisions in most G20 economies (Figure 4). These would be the weakest annual global growth rates since the financial crisis.

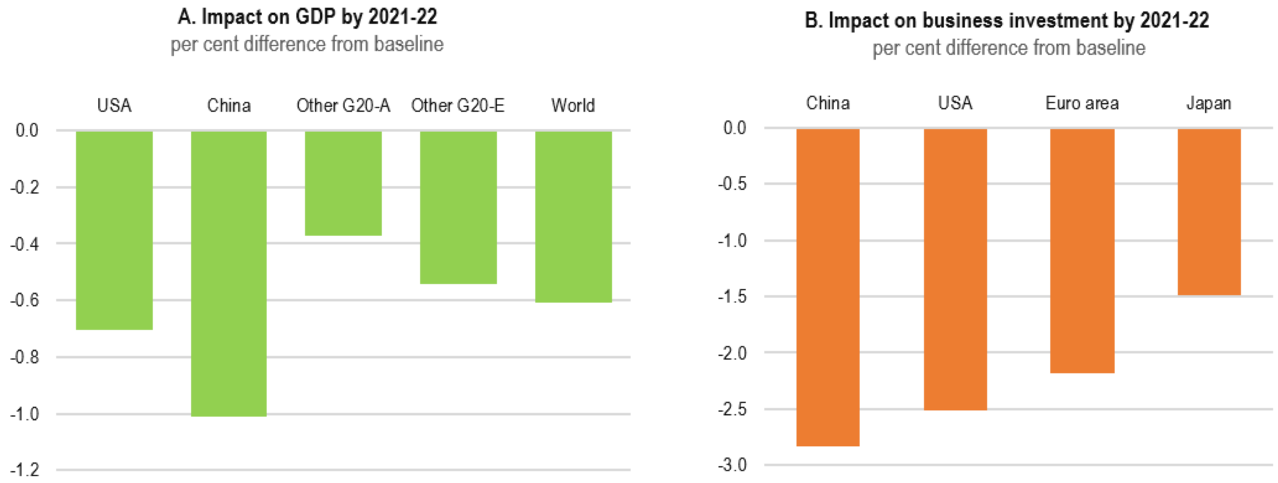
Figure 4. GDP growth prospects are set to remain weak



Note: Projections from current Interim Economic Outlook and the May 2019 and November 2018 OECD Economic Outlooks.
Source: OECD Economic Outlook database.

The bilateral tariff measures introduced by the United States and China since the start of 2018 will continue to exert a significant drag on global activity and trade over the next two years, particularly given the additional uncertainty that they create (Figure 5). All told, the US-China measures could reduce global GDP growth by between 0.3-0.4 percentage points in 2020 and 0.2-0.3 percentage points in 2021. These effects are incorporated in the projections for 2020. China and the United States would be most affected by these shocks, but all economies are adversely affected by rising uncertainty, with business investment impacted severely in the major advanced economies. In the event that tensions ease, global growth could be stronger than projected, although uncertainty could still remain elevated given the greater unpredictability of policies.

Figure 5. The adverse effects from higher US-China tariffs are intensifying and persistent



Note: Other G20-A and Other G20-E refer to other G20 advanced and emerging-market economies respectively. Total investment for China. The simulation shows the combined impact of the changes in bilateral tariffs implemented by the United States and China in 2019 (including those planned for the remainder of the year) and a global rise of 50 basis points in investment risk premia that persists for three years before slowly fading thereafter. All tariff shocks are maintained for six years. Based on simulations on NiGEM in forward-looking mode.
Source: OECD Economic Outlook database.

Country prospects

Key features of the projections in the individual G20 economies are:

- GDP growth in the United States is projected to moderate to around 2% in 2020 as the support from fiscal easing slowly fades. Solid labour market outcomes and supportive financial conditions continue to underpin household spending, but higher tariffs continue to add to business costs, and the growth of business investment and exports has moderated.

- In Japan, GDP growth is set to slow from 1% in 2019 to 0.6% in 2020. Labour shortages and capacity constraints continue to stimulate investment, but confidence has eased and export growth has weakened. Stronger social spending should support demand following the increase in the consumption tax rate in October, but fiscal consolidation efforts are set to resume in 2020.

- GDP growth in the euro area is projected to remain subdued, at around 1% in 2019 and 2020. Wage growth and accommodative macroeconomic policies, including modest fiscal easing, are supporting household spending, but policy uncertainty, weak external demand and low confidence continue to weigh on investment and exports. Outcomes in Germany and Italy are set to remain much weaker than in the rest of the euro area, reflecting their stronger exposure to the downturn in global trade and the relative size of their manufacturing sectors. Growth in France is projected to remain relatively resilient, helped by the support for household incomes from tax cuts and other fiscal measures.

- GDP growth is projected to be around 1% in the United Kingdom in 2019 and 2020, even if the exit from the European Union were to proceed smoothly with a transition period, as assumed. Growth has weakened, reflecting persistent uncertainty and weak investment, but sizeable fiscal easing should help to support demand next year.

- GDP growth is projected to remain close to trend rates in Canada in 2019 and 2020, at around 1½ per cent per annum. Strong job and real wage growth should continue to help support demand, but weak global trade is likely to moderate business investment and exports.
- Growth in Korea and Australia has moderated by more than expected this year, in part due to persistently weak global trade and soft import demand in China. These factors are expected to persist, but recent steps to ease macroeconomic policies should support domestic demand growth in 2020.
- GDP growth in China is projected to continue to moderate to around 5¾ per cent in 2020. Escalating trade tensions are weighing on investment and adding to uncertainty, but new fiscal and quasi-fiscal stimulus measures and the easing of monetary policy should help to cushion credit growth and demand.
- GDP growth in India has proved surprisingly weak in recent quarters, with consumer spending having slowed and tight financial conditions restraining investment. Growth is expected to strengthen from around 6% in FY 2019 to just over 6¼ per cent in FY 2020. Lower interest rates and stronger benefits from reform efforts should all help private sector demand to strengthen.
- A gradual recovery is set to continue in Brazil, with GDP growth projected to pick up from 0.8% this year to around 1¾ per cent in 2020. Lower real interest rates provide support for private consumption, and progress towards implementing reforms should help to support sentiment and investment.
- GDP growth in Indonesia is projected to be around 5% in 2019 and 2020. Trade weakness, especially in Asia, is holding back export growth, but rising incomes, falling poverty rates and recent reductions in policy interest rates should help to ensure that private sector demand remains resilient.
- GDP growth has slowed sharply in Mexico this year, in part due to temporary factors such as strikes and higher policy uncertainty. As these factors fade, lower interest rates, strong remittances and the increase in the minimum wage should help GDP growth to strengthen to 1½ per cent in 2020.
- GDP growth in South Africa is projected to remain soft, at around 0.5% this year and 1% in 2020. Weak global trade, lower metals prices and declining new orders are hampering exports and business investment, but low inflation and monetary policy easing should help support household spending.
- In Turkey, GDP was stronger than expected in the first half of 2019, helped by temporary fiscal and quasi-fiscal spending, and strong tourism exports. However, investment continues to contract and credit growth is still weak. Monetary policy easing should help growth to pick up modestly to just over 1½ per cent in 2020, provided domestic and international confidence is maintained.
- The economic outlook in Argentina has weakened significantly following the renewed depreciation of the peso and the imposition of capital controls. Policy uncertainty is high, and inflation is rising again. Output is projected to contract sharply again in the latter half of 2019 and early 2020. Following the October election, the next government will need to reveal detailed plans for macroeconomic policies to help restore confidence and ensure stability.

Significant downside risks could further weaken growth

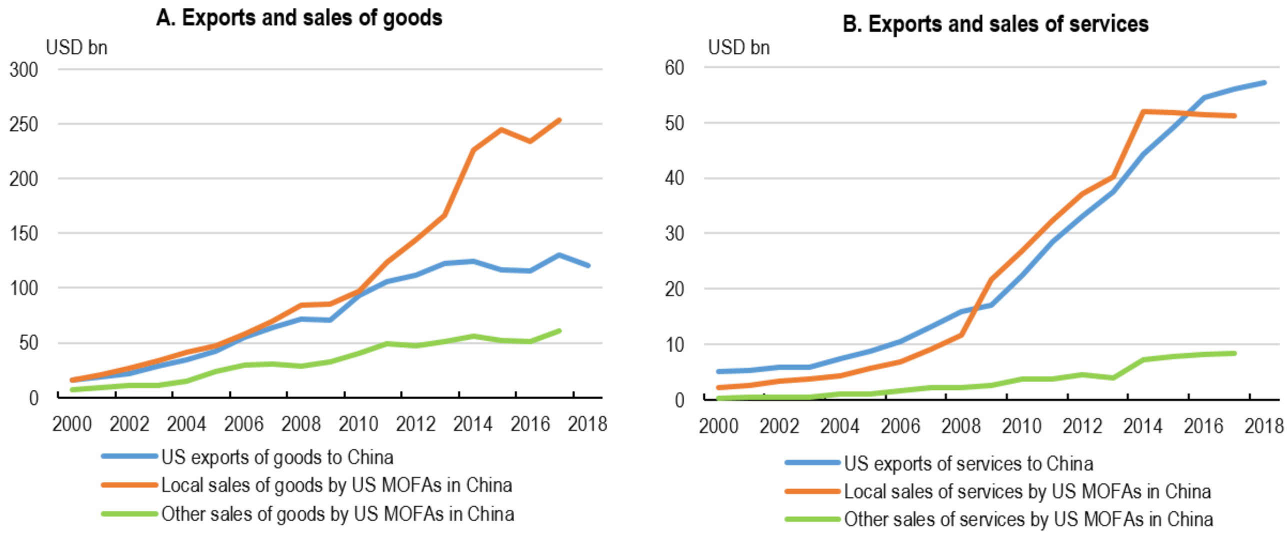
Growth outcomes could be weaker still if additional downside risks materialise or interact, including from further use of trade and investment policy instruments that impede business choices, a no-deal Brexit and persisting policy uncertainty in Europe, a failure of policy stimulus to prevent a sharper slowdown in China, and financial vulnerabilities from the tensions between slowing growth, high debt and deteriorating credit quality. A persistent upward spike in oil prices due to supply disruptions would also weaken growth prospects. On the upside, decisive actions by policymakers to reduce policy-related uncertainty and geopolitical tensions and strengthen medium-term growth prospects, including measures that reduce barriers to trade, would improve confidence and investment around the world.

Trade tensions continue to rise and could intensify further

Risks remain that US-China trade tensions will intensify and spill into new areas, further disrupting supply networks, reducing and distorting trade, and weighing on confidence, growth and jobs. Even if most of US-China merchandise trade will have become subject to new tariffs by end-2019, tariff rates could be raised further. Moreover, given the breadth of their economic relationship, other bilateral US-China relationships could become affected: the renminbi could continue to depreciate; services trade, notably related to tourism and foreign students, might be restrained; and affiliates of US companies operating in China, which sell more in their host country than total US exports to China (Figure 6), and Chinese companies established in the United States could come under pressure.

Bilateral trade tensions could also spread to other US trade partners, notably the European Union, with a decision by the US authorities scheduled in the coming months on whether to impose tariffs on imports of motor vehicles and parts from countries outside North America. If US-EU trade tensions were to escalate in the near term, it would add to the challenges for both economies.

Figure 6. The sales of US-owned affiliates in China are larger than US exports to China



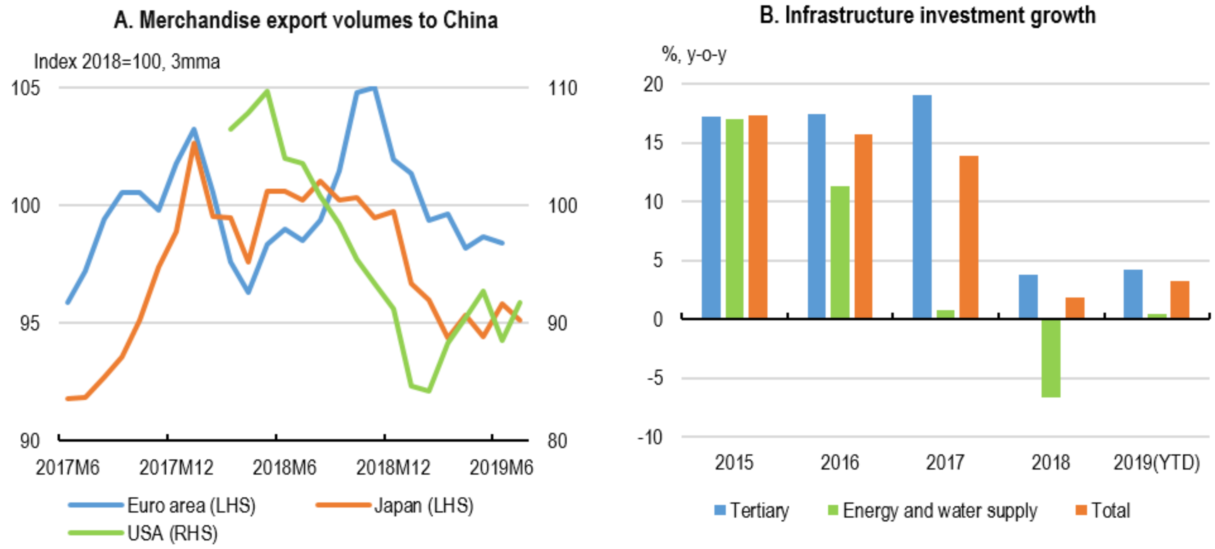
Note: MOFAs denotes majority-owned foreign affiliates of US companies in China.
Source: Bureau of Economic Analysis; OECD Economic Outlook database; and OECD calculations.

Growth in China could slow more sharply than expected

Exports to China from the major advanced economies have declined sharply over the past year (Figure 7, Panel A), adversely affecting trade and growth in the rest of the world. Import weakness in China is related to structural changes in the Chinese economy, but also raises concerns about the effectiveness of the macroeconomic policy stimulus measures that have been announced over the past year, and the gains from further action if needed. The fiscal support this year of at least 1% of GDP involves tax reductions and increases in the special bond quota for local governments to finance infrastructure spending. However, household tax reductions may take time to feed through to consumer spending, and investment in infrastructure has picked up only modestly following the sharp moderation in 2018 (Figure 7, Panel B). Recent further reductions in reserve requirement ratios may however help to support the flow of credit to businesses.

OECD estimates suggest that a sustained decline in domestic demand growth of 2 percentage points per year in China would result in a significant slowdown in global growth, particularly if accompanied by a deterioration in global financial conditions and heightened uncertainty, as in the previous slowdown in China in 2015-16. In such circumstances, global GDP growth could be lowered by 0.7 percentage point per year on average in the first two years of the shock and global trade growth by close to 1½ per cent per year, with the strongest effects being felt in neighbouring economies in Asia. The effects would be larger still if macroeconomic policies were not able to respond fully to offset the shocks due to limited policy space.

Figure 7. Import demand is weak in China and infrastructure investment growth remains modest



Note: Export volume data for the United States calculated using seasonally unadjusted data on nominal exports to China and the price of exports to China. Infrastructure investment in the tertiary sector includes investment in transport and communications, plus investment in water management and environmental conservation. Estimates for 2019 are for the first seven months relative to the first seven months of 2018.

Source: OECD Economic Outlook database; Eurostat; Bank of Japan; Census Bureau; Bureau of Labor Statistics; National Bureau of Statistics of China; and OECD calculations.

A no-deal Brexit would be costly

Substantial uncertainty persists about the timing and nature of the withdrawal of the United Kingdom from the European Union (Brexit), as well as the future UK-EU trading relationship. The possibility that withdrawal will occur without a formal deal is a serious downside risk, and a major source of uncertainty. If the United Kingdom were to leave the European Union without an agreement, the outlook would be significantly weaker and more volatile than otherwise, particularly in the short term. Such effects could be stronger still if a lack of adequate border infrastructure or a loss of market access were to cause serious bottlenecks in integrated cross-border supply chains, or disruptions in financial markets.

Even a relatively smooth no-deal exit, with fully operational border infrastructure, would have large costs. In this event, UK GDP could be 2% lower than otherwise in 2020-21, potentially pushing the economy into recession (Box 1, Figure 8). These effects would add to weaker-than-expected growth in the UK economy since the referendum in 2016. UK exports would be reduced due to higher tariff and non-tariff barriers with the European Union and elsewhere, higher uncertainty would weigh on investment, and the longer-term supply-side costs of exit would slowly start to emerge. In such a scenario, there would also be sizeable negative spillovers in other EU economies, with euro area GDP over ½ per cent lower than otherwise in 2020-21.

Policy responses could cushion part of these short-term costs. In the United Kingdom, the Bank of England could face a difficult choice if inflation were to be pushed up by a sterling depreciation, but should look through this given the need to react to a much weaker growth outlook, and reduce policy interest rates or buy bonds. Fiscal policy could also be eased further from what is already planned, although a no-deal exit would already add to pressures on the public finances.

In European economies, faced with a deflationary shock, monetary policy could become more accommodative. A more effective approach would be to implement targeted and temporary fiscal measures to support investment in some sectors, and to assist with the retraining of displaced workers and new job creation in those countries most affected. The European Union has announced that support is available from funds set up to provide assistance, such as the European Globalisation Adjustment Fund and the European Union Solidarity Fund. While important, the available funds are modest relative to GDP, suggesting that other measures may be needed. It might also prove possible to adapt temporarily the state aid framework to provide broader support, as was done at the height of the financial crisis in 2008-09, or to allow more leeway within the EU fiscal rules to affected economies, in recognition of the exceptional circumstances. Should the situation be substantially worse, a more broad-based fiscal stimulus by EU member states, particularly ones that trade relatively intensively with the United Kingdom, could offer a timely and larger support for demand.

Box 1. The potential near-term impact of a no-deal Brexit

This box sets out one possible illustrative scenario for the short-term impact following United Kingdom exit from the European Union (EU) without a deal. Adjustment is assumed to occur relatively smoothly, helped by the preparations made by the UK government, national governments in Europe and the European Commission to limit the immediate disruptions to trade, financial markets and passenger movements following exit. If preparations to border infrastructure fail to prevent significant delays, or if financial market conditions were to deteriorate considerably, or if consumer confidence were to decline sharply, the near-term impact of a no deal Brexit could be much more costly.

The analysis builds on past work by the OECD that has looked at the short and longer-term effects of Brexit on the UK economy, and the implications for Ireland, the Netherlands and Denmark of trade with the United Kingdom on WTO terms. In the short-run, the impact will reflect a number of different factors, including the impact on trade, the implications for supply, the degree of uncertainty that arises, and policy choices.

Trade

Trade between the United Kingdom and the rest of the world is assumed to be governed by the WTO Most-Favoured Nation (MFN) rules. In event of exit without a deal, there are three different additional costs that UK exporters may face in EU and non-EU markets, and EU exporters may face in the UK market:

- UK exporters would face tariffs set at the MFN bound rates in importing economies, including EU economies. EU exporters to the United Kingdom would also be subject to UK tariffs.
- Once the United Kingdom leaves the customs union, administrative rules, such as customs declarations, possible border checks and health or technical compliance reviews, could increase the cost of trade. These costs would occur on both sides of UK-EU trade.
- Services trade, while not subject to tariffs, is affected by rules, regulations and other non-tariff measures. The restrictiveness of these on UK-EU trade is likely to change following Brexit.
- The UK government announced in March that it intends to implement lower temporary rates of customs duty (tariffs) on imports in the first year if the United Kingdom leaves the EU without a deal. These would reduce the additional costs faced by some exporters to the United Kingdom in 2020, but also reduce the revenue from customs duties accruing to the UK government.

The additional costs faced by exporters can be expected to build up over time. Some changes, such as higher tariffs and additional border checks, start to take effect immediately. Others, such as additional NTMs, will gradually accumulate as regulations diverge between the United Kingdom and the European Union. In the medium-to-longer term, UK export volumes could decline by between 15 and 20%, based on OECD estimates using the METRO model and separate gravity models of trade.

The trade shocks considered in the near-term scenario are as follows:

- Total UK export volumes are assumed to immediately decline by 8% upon exit, as in the earlier OECD study of Brexit in 2016, with this decline rising steadily thereafter.
- In the near-term, part of the adjustment to the adverse export shock is absorbed by the exchange rate, with sterling assumed to depreciate by a further 5% on exit.
- Exports from the other EU economies to the United Kingdom are estimated to decline by around 16% as a result of higher trade costs, with the largest effects being felt in Ireland. The impact on individual countries will depend on the extent of their direct trade with the United Kingdom, their role in supply chains for exports to the United Kingdom and, over time, the extent to which they may be able to fill markets in which UK exporters have become less competitive. In the illustrative scenarios below, total export volumes (to all economies) are assumed to decline by 1¼ per cent in the EU economies as a whole in the near-term, with the largest declines occurring in Ireland, the Netherlands, Belgium, Germany and Spain, reflecting the relative importance of the UK in their export markets.
- Import volumes are allowed to adjust freely to these shocks in all economies. Given weaker domestic demand and export volumes in the scenario set out here, import volumes also decline sharply.

Other sources of shocks

A gradual reduction in UK trade openness would start to adversely affect the overall economic dynamism of the UK economy, reducing competition, the inflow of new ideas and productivity. OECD estimates imply that a four percentage points decline in trade openness reduces total factor productivity by 0.8% after five years (and by 1.2% after ten years). In the scenario below, the impact on productivity of the sharp fall in trade was modelled as a decline in labour-augmenting technical progress of 1.6% by 2024.

Withdrawal from the EU could also provide scope for the United Kingdom to impose tighter controls on net inward migration, which was 226 000 people in the year to March 2019. This would reinforce the endogenous effects on economic migration coming from a weaker UK economy and labour market. As in the OECD study of Brexit in 2016, net inward migration is assumed to decline by 84 000 per year from 2020 onwards, with around 75% of this reflected in the labour force. This is offset by a corresponding increase in net inward migration in the rest of the EU, assumed to be distributed across countries according to their share in EU27 GDP.

The adverse effects on long-term supply could be expected to raise the term premium on UK government debt, at least temporarily, reflecting market uncertainty about future growth prospects and policies. In the scenario, a 25 basis point rise in the term premium is assumed initially. The term premium on government debt is also raised by 25 basis points in Ireland and 10 basis points in other EU countries.

Departure from the EU without a deal could also be expected to add to already-high policy uncertainty in both the United Kingdom and the European Union, at least temporarily. UK investment risk premia are assumed to be raised by 100 basis points in 2020, with the equity risk premium rising by 25 basis points, before slowly fading thereafter. The initial investment risk premia shock broadly corresponds to a two standard deviation increase in policy uncertainty, based on historical relationships between corporate bond spreads and uncertainty. Small mirror shocks are assumed in EU economies, with the investment and equity premia rising by 25 basis points for a period.

Results

In the near term, given considerable uncertainty, businesses and households would be unlikely to behave as if the future was known with certainty, making spending choices more heavily dependent on current conditions rather than future expectations.[1] Monetary policy is initially left exogenous (although the depreciation of sterling changes monetary conditions), and budgetary objectives are left unchanged in all countries, implying that governments react to the various shocks by attempting to maintain an announced budget path. The consequences of relaxing these assumptions are discussed below and in the main text.

Key features of the respective scenarios are summarised in Figure 8.

- The no-deal exit generates a large negative shock to the UK economy. GDP declines by close to 2% in 2020, pushing the economy into recession given the baseline projection, with the near-term costs continuing to rise in 2021-22. In the first year, the decline is driven largely by the trade and uncertainty shocks, but over time the adverse supply-side costs begin to emerge.[2] Business investment is particularly affected, declining by close to 9% in 2020, reflecting the headwinds to trade and higher uncertainty. Consumer price inflation is pushed up by close to ¾ percentage point in 2020, driven by higher import prices.

- In the euro area and also the EU27 as a whole, GDP declines by around 0.5% in the near-term. The fall in GDP is marginally smaller than this in Germany, France and Italy, but between ½-¾ per cent in Spain and Denmark, somewhat larger in the Netherlands and Belgium, at between ¾-1 per cent, and in Ireland, where GDP drops by around 1½ per cent in the near term. In the euro area overall, business investment is particularly affected, declining by around 2% in 2020-21. Consumer price inflation also declines, by around 0.2 percentage point per annum in 2020 and 2021.

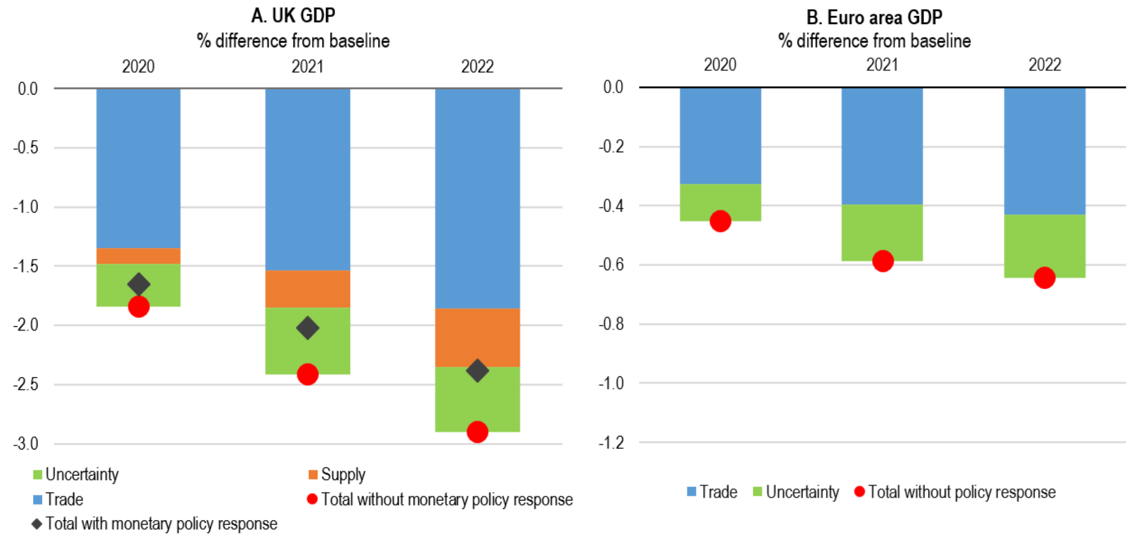
Macroeconomic policy responses can help to cushion these sizeable shocks.

- In the United Kingdom, policy interest rates could be lowered. If any exchange rate depreciation is small and contained, the Bank of England should look through the initial price increase and focus on the longer-term implications of the adverse supply-side shock. A decline in UK policy interest rates of 50 basis points could mitigate around one-quarter of the near-term impact on GDP by 2022 (Figure 8, Panel A). The Bank of England might also purchase bonds, as it did after the 2016 referendum, or reduce the countercyclical capital buffer rate for the banking sector.

- Part of the overall shock to the UK economy could also be absorbed if the UK government chose to adopt a more expansionary fiscal policy. In the particular scenario considered, the UK budget deficit would rise by around ¾ per cent of GDP in 2020 if the budget was allowed to adjust freely, largely reflecting the impact of the automatic stabilisers. This would add to government debt but also serve to cushion part of the decline in output that would otherwise arise from the need to meet prior budgetary objectives.

In such a scenario, central banks in Europe would normally be expected to adopt a more accommodative policy stance and mitigate the impact of the trade and uncertainty shocks, with policy rates reduced by 25 basis points in 2020 in most economies. However, a cut of this magnitude could be difficult to implement in those economies in which policy interest rates are already negative. Although central banks remain the first line of defence, greater use could be made of targeted fiscal measures to cushion the shock, as discussed in the main text, either via funds available at the EU level or through specific national policies.

Figure 8. The potential impact of a no-deal Brexit



Note: See text for details of the shocks applied. The impact of the depreciation of sterling is included in the trade effects.
Source: OECD calculations using the NiGEM global macroeconomic model.

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1. To capture such effects, the near-term scenario is undertaken on the NiGEM model in backward-looking mode.

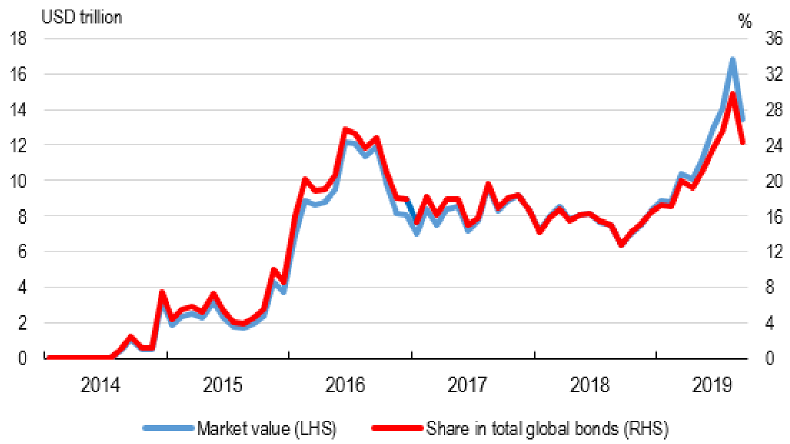
2. If the decline in UK net inward migration was smaller than assumed here, at around 56 000 people per annum (broadly in line with current net inward migration from EU countries), the adverse impact on GDP could be reduced by around 0.1% by 2022.

Significant financial vulnerabilities continue to accumulate

The further escalation of trade conflicts between China and the United States and idiosyncratic geopolitical risks have increased global financial market volatility and prompted a flight to safety by investors in recent weeks. Government bond yields have fallen, with 10-year yields declining by around 30-60 basis points in the United States, the euro area and the United Kingdom since May. As a consequence, the global value of government and corporate bonds trading at negative yields is estimated to have risen to a record high of USD 17 trillion (30% of the total stock of global bonds) in August, exceeding the previous peak in mid-2016 (Figure 9). The yield curve has also flattened or inverted, with the negative gap between short and long-term rates particularly large in the United States. While the US yield curve inversion has previously signalled heightened late-cycle risks of a recession when policy interest rates are being raised, the present signal might be distorted by unconventional monetary policy.

Concerns remain about the high debt of non-financial corporations and its deteriorating quality. This could amplify a recession or a further sharp growth slowdown. A marked reduction in revenue growth could cause corporate stress, triggering a change in investors’ risk appetite and a widespread sell-off of corporate bonds. Even a limited market shock would have the potential to produce large price corrections because non-investment-grade corporate debt is typically much less liquid. The current composition of corporate bonds may also increase the risk of fire sales, as a high share of corporate bonds is rated just above non-investment grade. If these bonds were downgraded to non-investment grade following a negative economic shock, institutional investors who are bound by rating-based regulatory requirements would be obliged to sell.

Figure 9. Negative yielding debt has risen



Note: Bloomberg Barclays global aggregate negative yielding debt is the market capitalisation of corporate and government bonds. The last data point is 13 September 2019.

Source: Bloomberg; and OECD calculations.

Policy changes are required to reduce uncertainty and improve growth prospects

The subdued economic outlook and the risks of intensified policy uncertainty call for policy responses that strengthen confidence, stimulate investment and boost potential growth. There is a rising risk that the manufacturing slowdown may have a long-lasting impact on economy-wide growth prospects. Confidence-building measures that calm trade policy tensions and address other sources of uncertainty are urgently required, and the need for additional macroeconomic policy support has risen in most economies. Monetary policy has already moved in this direction, but the effectiveness of accommodative monetary policy could be enhanced in many advanced economies if accompanied by stronger fiscal and structural policy support. Fiscal policy needs to help lift near-term growth by taking advantage of exceptionally low interest rates, particularly through spending measures such as stronger investments in infrastructure that raise near-term demand and also benefit long-term growth. Structural policy measures need to be stepped up, given the adverse implications for medium-term growth from the disruptions to cross-border trade and investment.

In the event of an even sharper global growth slowdown than projected, co-ordinated policy action within and across all the major economies 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.

Monetary policy accommodation needs to be supplemented by fiscal support in advanced economies

Against the background of slowing growth and the prospect of inflation remaining below target for a prolonged period, central banks in the main advanced economies have eased monetary policy or communicated their readiness to act if the outlook were to deteriorate further. The actual measures implemented or announced are likely to provide some modest support to aggregate demand and help to ensure that inflation expectations do not drift down further. These changes also boost already-high asset prices.

The scope and need for additional monetary policy easing differs across the main advanced economies:

- The United States has more scope but less need than other economies to ease monetary policy. Growth is projected to still be around trend next year, the unemployment rate is at record low levels and core inflation (on some measures) is close to target. There would seem to be little need for further cuts in interest rates, unless a reduction in interest rates as an insurance is warranted due to an elevated risk of growth being significantly lower than projected.
- The euro area and Japan have limited scope to ease monetary policy further but may face a renewed need to do so, if sub-par growth weakens further or if inflation remains persistently well below target.

There is room in many advanced economies to allow the automatic budgetary stabilisers to operate fully and to implement discretionary fiscal stimulus where needed. The effective nominal interest rates paid on public debt are expected to remain below nominal GDP growth rates for some time, and projected budget balances are higher than those necessary to stabilise debt. A number of G20 economies have already announced a sizeable fiscal expansion for 2020, including Korea and the United Kingdom. Low or negative yields on long-dated government bonds also offer a low-risk opportunity for many countries to address serious infrastructure shortages and strengthen longer-term sustainable growth. In the United States, Japan, France and Italy, where high budget deficits are set to add to already elevated public debt, and where public debt is expected to increase further with unchanged policies, there is a need to enhance the effectiveness of fiscal policy by reviewing the efficacy of public spending and the size of the automatic stabilisers. That said, additional fiscal policy support would be needed in event of a recession, given the limits on monetary policy.

In the euro area, where growth has dropped below trend rates, a joint programme of fiscal support where space exists and renewed reform efforts to strengthen medium and long-term growth is needed alongside continued accommodative monetary policy (Box 2).

Box 2. The euro area needs an integrated policy mix rather than relying mostly on monetary policy

This box summarises the outcomes of simulations that contrast the impact of an extended period of quantitative easing in the euro area with that from an alternative policy mix that combines a more active use of fiscal policy, greater structural policy ambition and a more modest increase in monetary policy accommodation. The simulations reflect the possible policy choices that the euro area could have made in 2014, but also offer lessons for current policy. A balanced policy mix could have been implemented in the euro area back in 2014, but instead the burden of macroeconomic adjustment was left primarily to monetary policy.

In the QE scenario, the term premium on 10-year government debt in the euro area is lowered for an extended period, calibrated on ECB estimates of the impact of the Asset Purchase Programme (APP) introduced in 2015. At its peak, in years 3 to 5 of the simulation, the term premium is reduced by 100 basis points relative to baseline, with this effect fading slowly thereafter. Euro area policy interest rates are also held fixed for five years. An (imperfect) allowance is also made for the impact of the TLTROs that were implemented alongside the APP, with the interest rates on borrowing for house purchases being lowered by an additional 100 basis points for five years, over and above the impact of the term premia shock on private borrowing rates.

The different policy measures considered in the combined policy scenario are:

- All euro area countries raise public investment by ¾ per cent of GDP for five years – offsetting the reductions in investment by a similar amount after the financial crisis. Even in 2014, countries such as Germany, the Netherlands, Austria and the Baltic States had scope to implement this type of policy through additional debt issuance. Their headline budget deficits were below 3% of GDP and on a declining trajectory, and debt levels were well contained. Other countries, including France, Italy and Spain, had less space available for fiscal easing, with budget deficits at or above 3% of GDP and rising government debt-to-GDP ratios. In these countries, the additional public investment spending is assumed to be offset fully by higher direct taxes, so that the ex-ante budget impact is neutral.

- All countries are assumed to undertake productivity-enhancing structural reforms that raise total factor productivity (TFP) growth by 0.2 percentage point per annum over five years, with the 1% higher level of TFP being maintained permanently thereafter. Such reforms offset part of the slowdown in euro area TFP and potential output growth experienced since the crisis, in part due to the fading of reform ambition.

- A smaller QE programme is undertaken, reducing the term premium on 10-year government bonds by 50 basis points at its peak, with the profile of the shock over time similar to that in the QE-only scenario. Policy interest rates are again held fixed for five years. Further ahead, 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, forward guidance is being used to help interest rates stay low for longer.

The simulations are undertaken on the NiGEM global macroeconomic model. Key features of the respective scenarios include:

- After five years, the impact on output and the price level in both scenarios is close. The level of GDP is raised by around 1¾ per cent relative to baseline (Figure 10, Panel A), and the consumer price level is pushed up by between 1.7-1.9% (Figure 10, Panel B), with marginally stronger effects from the combined policy mix.

- In the near term, the impact of the combined policy mix is noticeably stronger, reflecting the direct effect of higher public investment on GDP, the normal lags for monetary policy to take full effect (even in a model with forward-looking behaviour), and the extent to which accommodative macroeconomic policies help to bring forward some of the effects from structural reforms.

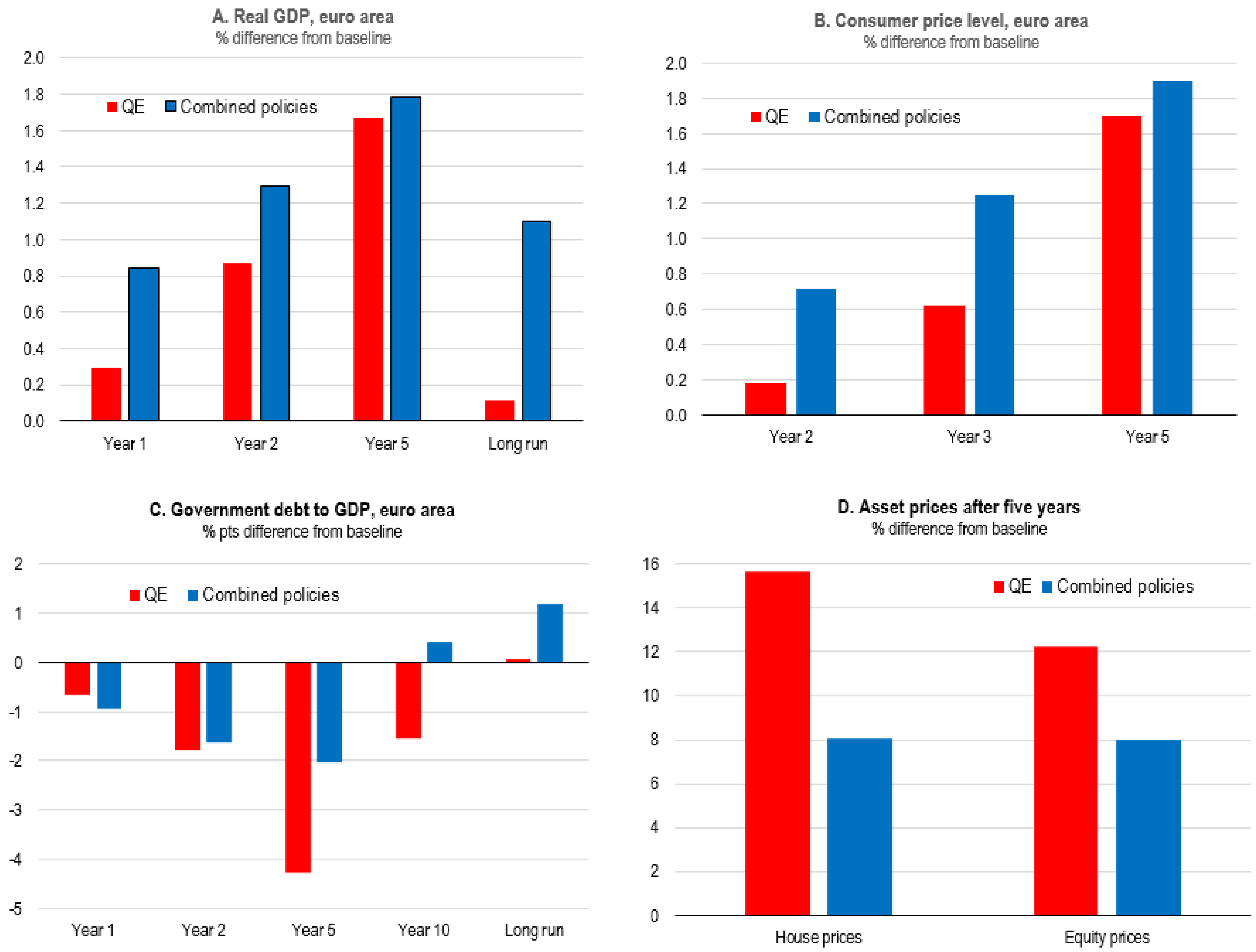
- Over time, the QE impact on output gradually fades, whereas area-wide GDP is up by just over 1% in the longer term (after 15 years) with the combined policy mix, reflecting the higher TFP level and a small boost to the capital stock.

- Even with a sustained fiscal expansion over five years in the combined policy simulation, the area-wide government debt stock remains close to its baseline level (Figure 10, Panel C), helped by stronger nominal GDP as well as lower debt-servicing costs for some years. However, the larger decline in bond yields in the QE-only scenario results in stronger reductions in debt servicing costs.

- Asset prices are substantially lower with the combined policy mix than with sole reliance on monetary policy (Figure 10, Panel D), reducing potential financial stability risks. Both scenarios raise household and corporate incomes, but the asset price responses are stronger in the QE-only scenario due to the larger decline in long-term interest rates.

Figure 10. The impact of alternative policy approaches in the euro area

Differences from baseline



Note: See text for details of the shocks applied in the QE and combined policy scenarios.
Source: OECD calculations using the NiGEM global macroeconomic model.

Overall, these results suggest that an alternative policy approach could have been followed back in 2014-15 that might have been even more effective for macroeconomic stabilisation than relying solely on monetary policy. A combined policy mix, using fiscal and structural policies as well as monetary policy, would also have mitigated some of the stimulus provided to asset prices by a very accommodative monetary policy stance over a sustained period without adding substantially to public debt, and also enhanced longer-term living standards, something beyond the scope of monetary policy.

These issues are even more relevant in the current juncture. Thus, a well-designed combination of country-specific fiscal and structural policy actions, along with continued low interest rates, is needed in the euro area if growth prospects are to be strengthened durably.

Macroeconomic policy requirements differ across emerging-market economies

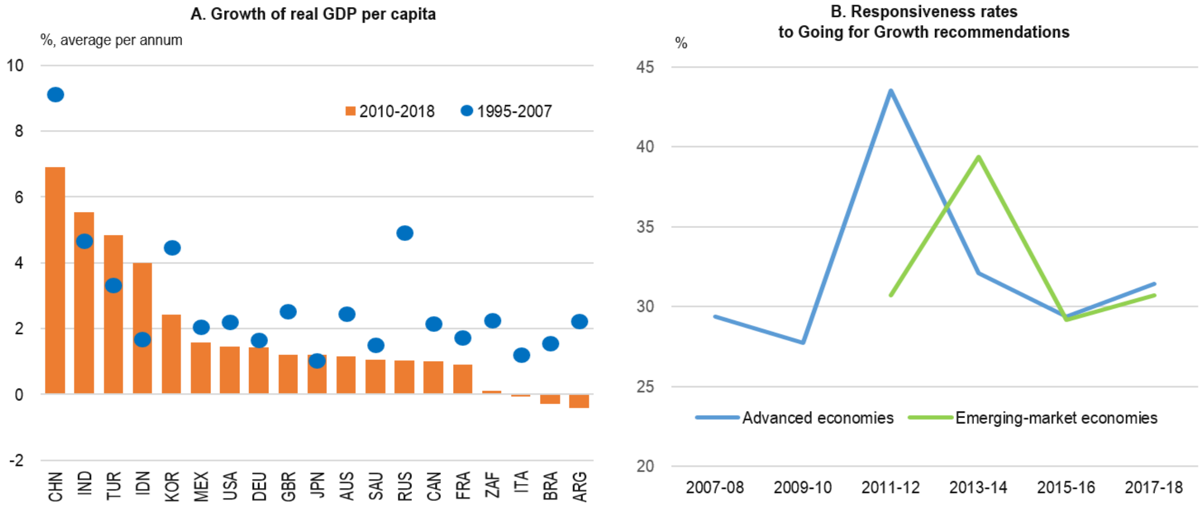
The recent reduction in US interest rates, weaker-than-expected growth, and diminishing inflationary pressures, have provided scope for many emerging-market economies to lower policy interest rates. Even so, weak global trade exacerbates persistent vulnerabilities in many countries. Policy requirements differ across the individual economies depending on their situation.

- In China, both fiscal (including quasi-fiscal) and monetary policies have continued to be eased, as appropriate given demand weakness. Scope remains for further measures if the underlying strength of the economy is weaker than anticipated or if policy instruments are less effective than in the past. However, careful choices are needed to avoid adding to high indebtedness of non-financial corporations and medium-term deleveraging challenges.
- Other emerging-market economies, such as India, Mexico, Brazil, Russia and Indonesia, with flexible exchange rate frameworks and manageable exposures to foreign currency denominated debt, also have scope to further ease monetary policy as inflation declines, while taking the opportunity to improve their fiscal positions if needed.
- A tight policy stance remains necessary in those emerging-market economies where concerns persist about the sustainability of fiscal or external positions, or the health of the banking sector, in order to retain investors' confidence. In Turkey, extraordinary fiscal and quasi-fiscal support and large cuts in policy interest rates have helped to temporarily cushion activity, but continued use of such measures may risk undermining financial and price stability. In Argentina, restoring investors' confidence is the main priority against the background of a sharp currency depreciation, spiralling inflation and the imposition of capital controls.

Greater structural policy ambition is called for in all economies

The prospects for strong and sustained improvement in living standards and incomes in the medium term remain weaker than prior to the crisis, and real per capita growth in recent years has been well below pre-crisis norms in most economies (Figure 11, Panel A). As set out in the latest OECD *Going for Growth*, structural reform efforts have stabilised in both advanced and emerging-market economies in recent years, but at a level below that achieved in the aftermath of the crisis (Figure 11, Panel B). Greater reform ambition in both advanced and emerging-market economies would help to enhance living standards, strengthen medium-term prospects for investment and productivity, and allow the benefits of growth to be distributed more widely.

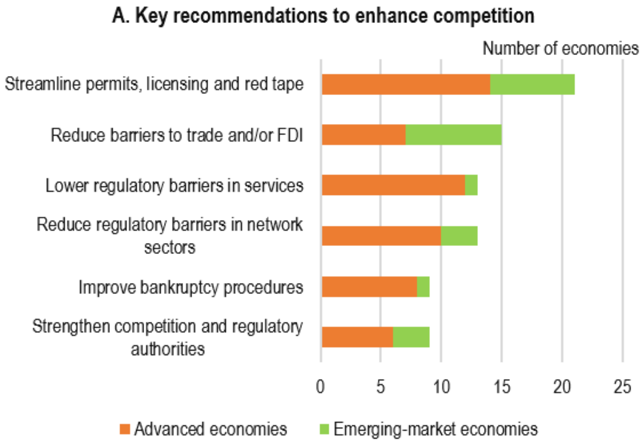
Figure 11. A lack of structural reform ambition is holding back growth

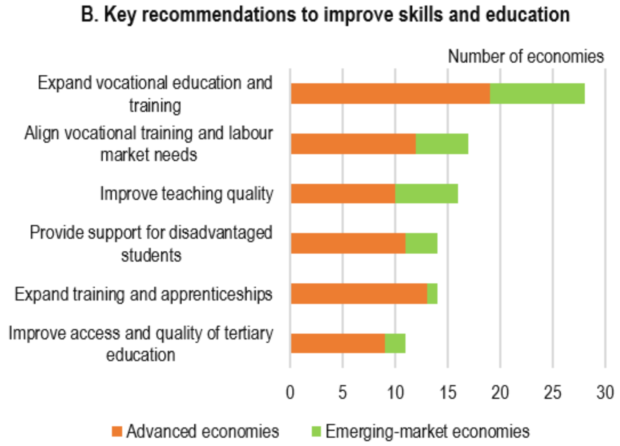


Source: OECD Economic Outlook database; and OECD Going for Growth.

In both advanced and emerging-market economies, the most frequent priorities to be addressed by reforms are in the areas of skills and education and product market regulation (Figure 12). At a time of weak global growth, there is also a case for prioritising and packaging reforms that help to support short-term demand, and ensuring that these are implemented with supportive macroeconomic policies. Part of this package should be a rapid move to reduce restrictions and distortions on cross-border activities and return to collective action on trade policy issues. This would help to reduce trade policy tensions and resulting uncertainty, which is undermining growth in the short and medium term.

Figure 12. Key structural reform priorities





Note: Going for Growth contains structural reform recommendations for 45 economies, plus the European Union.
Source: OECD Going for Growth.