OECD Observer

How to escape from the low-growth trap

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Low growth trap image 1 | First image for How to escape from the low-growth trap, image of author Catherine Mann

Now is an opportune time to deploy effective fiscal initiatives and promote inclusive trade policies.

For the last five years the global economy has been in a low-growth trap, with growth disappointingly low and stuck at around 3% per year. Persistent growth shortfalls have weighed on future output expectations and thereby reduced current spending and potential output gains. Around the world, private investment has been weak, public investment has slowed, and global trade growth has collapsed, all of which have limited the improvements in employment, labour productivity and wages needed to support sustainable gains in living standards. Overall, a slowdown in structural policy ambition and policy incoherence have slowed business dynamism, trapped resources in unproductive firms, weakened financial institutions and undermined productivity growth. In the face of these limited prospects, the OECD has argued in previous Economic Outlooks that fiscal, monetary and structural policies need to be deployed comprehensively and collectively for economies to grow sufficiently to make good on promises to their citizens.

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The projections in the latest Economic Outlook offer the prospect that fiscal initiatives could catalyse private economic activity and push the global economy to the modestly higher growth rate of around 3.5% by 2018. Durable exit from the low-growth trap depends on policy choices beyond those of the monetary authorities–that is, of fiscal and structural, including trade policies– as well as on concerted and effective implementation. Collective fiscal action undertaken by all countries, including a more expansionary stance than planned in many countries in Europe, would support domestic and global growth even for those economies, who by virtue of specific circumstances, need to consolidate their fiscal positions or pursue a more neutral stance.

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Outlook summary

OECD area, % change, unless otherwise indicated

	2016	2017	2018
		%	
Real GDP growth			
World	2.9	3.3	3.6
OECD	1.7	2.0	2.3
US	1.5	2.3	3.0
Euro area	1.7	1.6	1.7
Japan	0.8	1.0	0.8
Non-OECD	4.0	4.5	4.6
China	6.7	6.4	6.1
Output gap (% of potential GDP)	-1.4	-0.9	0.0
Unemployment rate, % of labour force	6.3	6.1	6.0
Inflation	1.0	1.7	2.1
Fiscal balance, % of GDP	-3.1	-3.0	-2.9
World real trade growth	1.9	2.9	3.2

Source: *OECD Economic Outlook* No 100   StatLink http://dx.doi.org/10.1787/888933438659

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Chart for Low Growth Trap, Outlook summary for Real GDP growth of OECD countries
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Some might argue that there is no space for such fiscal initiatives, given the heavy public debt burden in many economies. In fact, following five years of intense fiscal consolidation, debt-to- GDP ratios in most advanced countries have flattened. It is time to focus on expanding the denominator–GDP growth. The latest Economic Outlook argues that the current conjuncture of extraordinarily accommodative monetary policy with very low interest rates opens a window of opportunity to deploy fiscal initiatives. Fiscal space has been created by lower interest payments on rolled-over debt, which also increases gauges of market access and of debt sustainability. On average, OECD economies could deploy deficit-financed fiscal initiatives for three to four years, while still leaving debt-to-GDP ratios unchanged in the long term. A front-loaded effort could allow deficit

finance to taper sooner and put the debt-to-GDP ratio sustainably on a downward path.

The key is to deploy the right kind of fiscal initiatives that support demand in the short run and supply in the long run and address not just growth challenges but also inequality concerns. These include soft investments in education and R&D along with hard investment in public infrastructures. Such fiscal initiatives would improve outcomes for demand and supply potential even more for economies suffering from long-term unemployment, when undertaken collectively, and when fiscal initiatives are complemented by country-specific structural policies put together in a coherent package. The mix is different for different countries.

Against this backdrop of fiscal initiatives, reviving trade growth through better policies would help to push the global economy out of the low-growth trap, as well as support revived productivity growth. In the latest Economic Outlook trade growth is projected to increase from a dismal ratio of global trade-to- GDP growth of around 0.8 to be about on par with global output growth–remaining much less than the multiple of 2 enjoyed over the last few decades. This sluggish trade growth compared to historical experience shaves some 0.2 percentage point from total factor productivity growth–which may seem minor–but is meaningful given the slow productivity growth of some 0.5% per year during the post-crisis period.

Some argue that slowing globalisation would temper the brunt of adjustments to workers and firms. The Economic Outlook suggests that protectionism and inevitable trade retaliation would offset much of the effects of the fiscal initiatives on domestic and global growth, raise prices, harm living standards, and leave countries in a worsened fiscal position. Trade protectionism shelters some jobs, but worsens prospects and lowers well-being for many others. In many OECD countries, more than 25% of jobs depend on foreign demand. Instead, policy makers need to implement the structural policy packages that create more job opportunities, increase business dynamism, promote successful reallocation and enhance policies to ensure that gains from trade are better shared. Fortunately, the country-specific policy packages that make fiscal initiatives more effective in promoting demand growth and supply potential also help to make growth more inclusive. The transition path to a more balanced policy set and higher sustainable growth involves financial risks. But so too does the status quo dependence on extraordinary monetary policy. Pricing distortions in financial markets abound. Yield curves are still fairly flat, with negative interest rates. Pricing of credit risk has narrowed even as issuance of riskier bonds has increased. Real estate prices continue to advance in many markets, even in the face of attempted tempering by macro-prudential measures. Expectations in currency markets are on edge as evidenced by high measures of currency volatility. These financial distortions and risks expose vulnerable balance sheets of firms in emerging markets, and challenge bank profitability and the long-term stability of pension schemes in advanced economies.

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The fiscal initiatives in conjunction with trade and structural policies, as outlined in the scenarios in the Economic Outlook, should revive expectations for faster and more inclusive growth, thus allowing monetary policy to move toward a more neutral stance in the US at least, and possibly other countries as well. The risk of a growing divergence in monetary policy stances in the major economies over the next two years could be a new source of financial market tensions even as growth picks up, thus putting a premium on collective action by countries to revive growth in tandem.

In sum, policy makers should closely examine fiscal space; low interest rates enable many countries to boost hard and soft infrastructure and other growth-enhancing initiatives. Avoiding trade pitfalls, coupled with social measures to better share the gains from globalisation and technological change, are key policy priorities. Using the window of opportunity created by monetary policy and following through on fiscal and structural measures should raise growth expectations and create the necessary momentum for the global economy to escape the low-growth trap.

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