EDITORIAL
THE POLICY CHALLENGES: NOW AND IN THE LONG TERM

After five years of crisis, the global economy is weakening again. In this we are not facing a new pattern. Over the recent past, signs of emergence from the crisis have more than once given way to a renewed slowdown or even a double-dip recession in some countries. The risk of a new major contraction cannot be ruled out. A recession is ongoing in the euro area. The US economy is growing but performance remains below what was expected earlier this year. A slowdown has surfaced in many emerging market economies, partly reflecting the impact of the recession in Europe.

The weaker outlook has several causes. A significant drop in confidence is a key driver. This takes place against a background of deleveraging, simultaneous fiscal consolidation across countries and a large multiplier, and weakening global trade. High and, in some countries, rising unemployment is further depressing confidence and spending.

Lack of confidence largely reflects insufficient or ineffective policy responses, both in terms of too little short-term action and a lack of credible long-term strategies. This, in turn, seems to be determined not so much by a lack of understanding of the policy requirements, but rather by failure to reach consensus on the policy response. The fiscal cliff and the debt ceiling in the United States, and the management of the euro area crisis are two cases in point. Policy challenges, both macroeconomic and structural, are present in emerging market economies as well, reflecting a range of country-specific conditions.

Failure to take sufficient action now could have significant consequences on the global outlook. If the fiscal cliff is not avoided, a large negative shock could bring the US and the global economy into recession. In the euro area, where the greatest threats to the world economy remain, progress in adjustment and in strengthening institutions has been significant over the recent past. However, challenging fiscal sustainability conditions in some countries risk sparking a chain of events that could considerably harm activity in the monetary union and push the global economy into recession, as described in a downside scenario in this *Economic Outlook*.

The crisis in the euro area is being sustained by three negative feedback loops that amplify shocks and interact. Solvency fears for banks and their sovereigns are feeding on each other due to government guarantees for banks and bank holdings of government bonds. The possibility of exit from monetary union pushes up yields, which in turn reinforces breakup fears. Worries about government debt are also driving up yields, which further weigh on debt dynamics. Against such a fragile background, it is not difficult to imagine a situation in which something goes wrong, for example a programme country is unable to deliver or the new EU rescue mechanisms cannot be deployed in time with sufficient impact. This would precipitate a deterioration in market risk assessments, inverting the positive trend which has emerged over recent months. In addition, rising unemployment could trigger reform fatigue and social resistance. The euro area, which is witnessing significant fragmentation pressures, could be in danger.

A positive policy response, avoiding the downside scenario and securing more sustainable growth, is possible. It should be based on the full use of available policy tools: monetary, fiscal, and structural.

The monetary policy stance should be further eased in many economies. Current policies in the United States are appropriate as the employment outlook is improving only slowly and inflation expectations are well anchored. Additional easing is required in the euro area, Japan and some emerging market economies, including China and India. In a longer-term perspective, however, it should be kept in mind that unconventional monetary stimulus, while necessary in the current situation, involves negative risks. Keeping long-term rates very low for a long period could delay necessary deleveraging and prompt excessive risk-taking and resource misallocation.

Excessive near-term fiscal consolidation should be avoided, given high fiscal multipliers at present. In the United States, budgetary tightening should proceed at a more measured pace than currently legislated, in the context of a detailed medium-term consolidation plan. This framework needs to be established. In the euro area, structural budgetary tightening should be limited to that embedded in current fiscal commitments, with the automatic stabilisers operating freely. To enhance credibility, this policy should be set out and communicated in a coordinated fashion. In the large majority of euro area countries, underlying budget positions by the end of the projection period will be consistent with declining debt-to-GDP ratios with a further positive impact on confidence.

In Japan, given the extraordinarily high sovereign debt ratio, a more detailed and credible medium-term fiscal consolidation programme needs to be established. High indebtedness limits the room for manoeuvre, in the event of a negative shock, to allow automatic stabilisers to work.

If serious downside risks were to materialise, further policy support would be essential. Lower interest rates, where possible, and much stronger additional quantitative easing would be warranted in major OECD economies. Temporary fiscal stimulus should be provided by countries with robust fiscal positions (including Germany and China). Most other economies should either slow planned budgetary consolidation or, in the case of those with very high debt levels or under intense market pressure, allow the automatic stabilisers to operate fully.

Structural policies have already been activated in many countries. These reforms should be fully implemented. They could begin delivering fruit sooner than expected in terms of higher growth, better employment performance, and sustainable current account rebalancing, especially in the euro area where ongoing rebalancing reflects cyclical weakness more than underlying structural adjustment. Ambitious reforms are needed in all countries to boost growth potential and make the adjustment more symmetric.

Strong institutions, such as independent fiscal councils or credible fiscal rules, can provide additional support. Indeed, the ongoing sovereign debt crisis suggests that countries with strong institutions can enjoy market confidence beyond what would be warranted by their fiscal policy performance alone.

Institution building is very relevant in the euro area, where the progress has been remarkable over the past two years. The establishment of a crisis management mechanism based on the OMT/ESM buys time, but also shows the resolve to address major weaknesses in the structure of monetary union. Markets have reacted positively to its establishment. Its effectiveness, however, will ultimately depend on the progress in reform implementation in countries that require assistance, as well as the willingness of creditor countries to agree on the use of common resources.

Progress towards a fully fledged banking union is essential to complete the architecture of the euro area and to facilitate disentangling sovereign and banking sector fragilities. This will involve supervision at euro area level, effective cross-border crisis resolution procedures, a common deposit guarantee mechanism, and a euro area fiscal backstop. Delays in putting the banking union in place could have negative consequences on the sustainability of the euro area. Furthermore, it remains essential to address in the coming years the capital shortage of euro area banks.

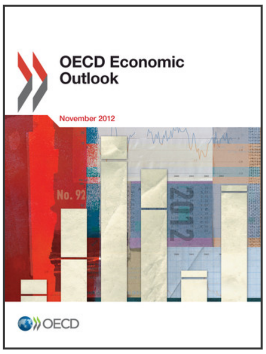
At the global level, stronger confidence and more sustained growth will require taking international spillovers more into account. This concern is at the heart of the G20 agenda, a key policy institution on issues such as global imbalances and the impact of monetary policies on capital flows and exchange rates. Indeed, the global nature of the current slowdown reminds us, once again, of the need to take interdependence and channels of transmission into serious consideration and shape the policy response accordingly.

Decisive policy action to deal with the immediate challenges is a necessary condition to lengthen the horizon for policy. Looking beyond the forecast interval presented in this *Economic Outlook*, the policy challenge is to guide the global economy forward towards a new long-term path. This requires a departure from the pre-crisis business as usual. In addition to repairing the financial system, policy will need to find ways to ensure environmental sustainability and to tackle rising inequality. New sources of growth, such as green growth and innovation in intangible assets, will have to play an increasingly important role.

Potential trade-offs between growth and equity, growth and sustainability, growth and environmental sustainability will have to be addressed. For example, as this *Economic Outlook* shows, the impact on inequality of fiscal consolidation can be significantly different according to the specific consolidation strategies that are put in place. Well-designed structural reform packages, together with credible fiscal consolidation, are key both in dealing with such trade-offs and in addressing imbalances that may be associated with long-term growth. Even as policy deals with the immediate challenges, there is no need to wait any longer for such long-term strategies that can and should be activated now.

27 November 2012

Pier Carlo Padoan
Deputy Secretary-General and Chief Economist



From:

OECD Economic Outlook, Volume 2012 Issue 2

Access the complete publication at:

https://doi.org/10.1787/eco_outlook-v2012-2-en

Please cite this chapter as:

OECD (2012), “Editorial: The policy challenges: now and in the long term”, in *OECD Economic Outlook, Volume 2012 Issue 2*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/eco_outlook-v2012-2-1-en

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to rights@oecd.org. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at info@copyright.com or the Centre français d’exploitation du droit de copie (CFC) at contact@cfcopies.com.

OECD