Focus Note 4: Global policy co-operation is needed in the event of a deeper downturn

Global economic growth has slowed substantially over the past eighteen months. If downside risks materialise, and growth weakens further than currently projected, governments will be faced with the challenge of having to respond to significant weakness at a time when domestic policy space is limited. The analysis reported in this note looks at the impact of an illustrative set of co-ordinated policies across the G20 economies, as was undertaken following the Washington and London G20 Leaders Summits in 2008 and 2009 at the height of the global financial crisis.

The results suggest that co-ordinated action, involving timely fiscal and monetary policy support and renewed structural reform efforts in all countries, offers a better prospect for restoring growth and improving living standards over time in all countries. A well-designed package of mutually supporting macroeconomic and structural policies can reinforce the benefits of each policy measure and mitigate the short-term side effects of others, to the benefit of the G20 economies as a whole. This is because co-ordinated action creates positive spillover effects through trade and improved confidence, resulting in a larger overall output gain in each country than if they acted alone.

Policy choices

A continued weakening of output growth could be expected to add to uncertainty and raise concern about the effectiveness of the policy tools available to national governments and central banks to respond. Indeed, this concern may already be contributing to uncertainty at present, even with GDP growth stuck at a subdued but stable below-trend pace in many countries. An effective response to a further slowdown in growth requires both timely and well-targeted measures to lift demand in the near term and actions that durably improve the prospects for living standards in the medium-to-longer term. A balanced policy package of this kind will help the potential synergies from complementary actions across different policy areas to be realised.

Illustrative scenarios using the NiGEM global macroeconomic model highlight the benefits that can be obtained from all of the G20 economies collectively undertaking co-ordinated supportive macroeconomic and structural policy actions. The different policy measures considered are:

- Each country undertakes additional debt-financed public expenditure of 0.5% of GDP for three years. In the advanced economies, this is assumed to occur via an increase in the volume of government investment. In the emerging-market economies, this occurs via an *ex ante* rise in nominal government expenditure of 0.5% of nominal GDP (reflecting smaller and less detailed country models). This contributes to slightly smaller multiplier effects in many emerging-market economies, as higher inflation from the initial demand stimulus reduces the real value of the additional nominal government expenditure.
- Monetary policy is allowed to become more accommodative in those economies with sufficient policy space.
    - Policy interest rates are lowered by 100 basis points for three years in all economies apart from Japan and the euro area, where interest rates are held unchanged at their baseline values for three years, and the United Kingdom, where the policy rate is lowered by 50 basis points for three years.

  - Thereafter, monetary policy is set to operate in a way that takes into account the longer-term supply-side gains that arise from enhanced structural reforms discussed below. In effect, this means that forward guidance is being used to help interest rates stay low for longer, inducing private sector investment to strengthen more quickly than it otherwise might have.
- Productivity enhancing structural reforms are assumed to occur in all economies.
  - In the advanced economies, these consist of measures that raise labour-augmenting technical progress (TFP) growth by 0.2 percentage point per annum for five years, with the 1% higher level of TFP being maintained permanently thereafter. In the emerging-market economies, the reforms consist of measures that raise potential output by 1% over a decade, with the increase accumulating gradually over time.
  - Stronger structural reforms may help emerging-market economies to both expand their own productivity and to catch-up to the productivity frontier. The latter mechanism is not embodied directly in the scenario set out here, potentially underestimating the long-term impact on these economies.

Significant co-ordinated policy actions by all G20 economies at a time when growth is slowing rapidly will also help to improve the confidence of consumers and investors and reduce uncertainty. In the scenario below, this effect is modelled by a 50-basis-point reduction in investment risk premia for two years that fades slowly thereafter. This approach is the mirror image of the shock to uncertainty incorporated in the simulations of US-China trade tensions reported in Chapter 1.

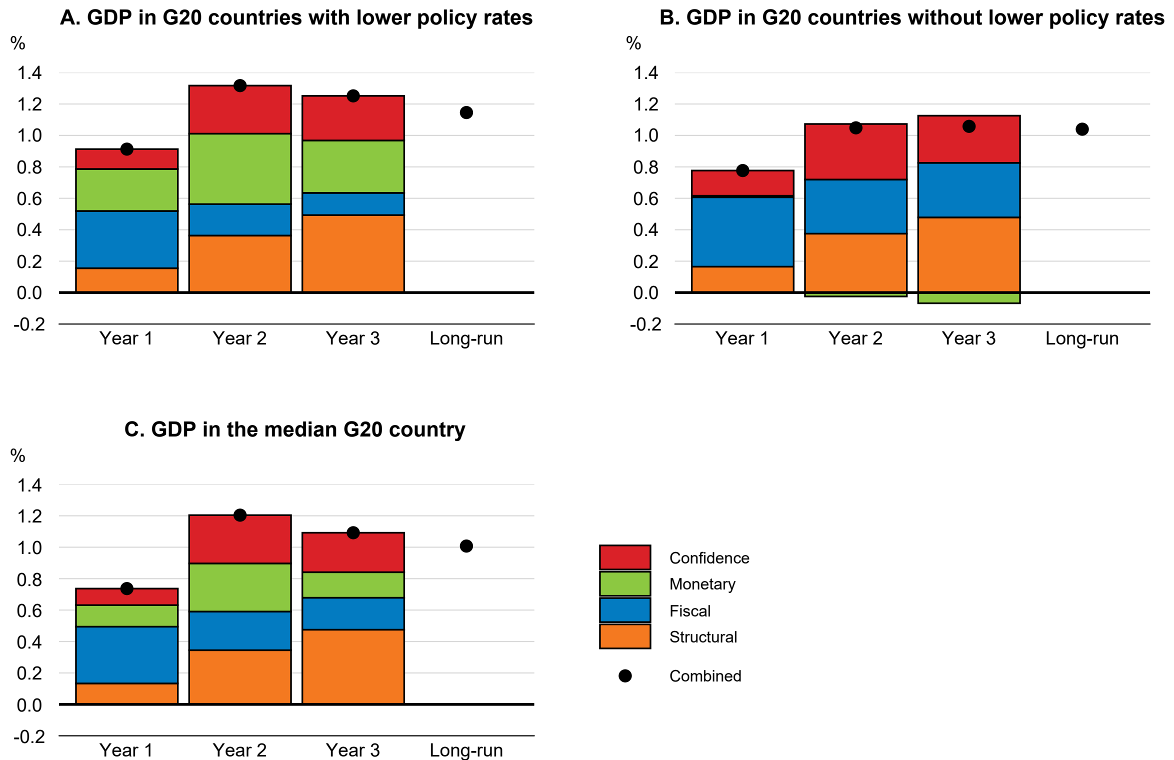
Results

Key features of the scenario in which all G20 countries simultaneously undertake policy measures (Figure 2.7) include:

- The short-term impact of the co-ordinated actions raises the level of G20 GDP by over ¾ per cent in the first year of the shock and by 1¼ per cent in the second year. In the longer term (after 15 years), the level of GDP is just over 1% higher in the median G20 economy (Figure 2.7, Panel C).
- The near-term boost to output primarily results from the collective gains from more supportive macroeconomic policies, but the structural reform measures also raise G20 GDP growth by between 0.15-0.2 percentage point in both the first and second years in the median economy. Thereafter, the impact of structural reforms on output continues to build over time, even as the impact of the macroeconomic stimulus measures wanes, with investment and real wages responding to the improvement in labour efficiency and the capital stock rising gradually. There are also additional small positive effects on long-run output from a higher public sector capital stock.
- The near-term impact on GDP is higher in those G20 economies that have space to reduce policy interest rates (Figure 2.7, Panels A and B). In addition to the positive effects on demand and investment, these economies also benefit slightly from an exchange rate depreciation relative to those economies in which policy interest rates remain unchanged. Nonetheless, there are strong output gains in the economies without policy rate reductions, reflecting the direct impact of stronger public investment and the benefits from improved confidence that stem from joint action across countries.
- The smaller impact of fiscal policy in the countries that lower policy interest rates reflects the lower *ex post* real stimulus in the emerging-market economies.

Figure 2.7. The impact of G20 policy co-ordination

Differences from baseline, collective policy simulation



Note: Scenario with all G20 economies simultaneously undertaking changes to fiscal, monetary and structural policies. See text for details of the shocks applied. PPP weighted averages in Panels A and B. The countries without lower policy rates are Japan, France, Germany and Italy.
Source: OECD calculations using the NiGEM global macroeconomic model.

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In all G20 countries, there are clear gains from collective action relative to those from each country acting by itself (Figure 2.8). These positive spillovers arise from two sources:

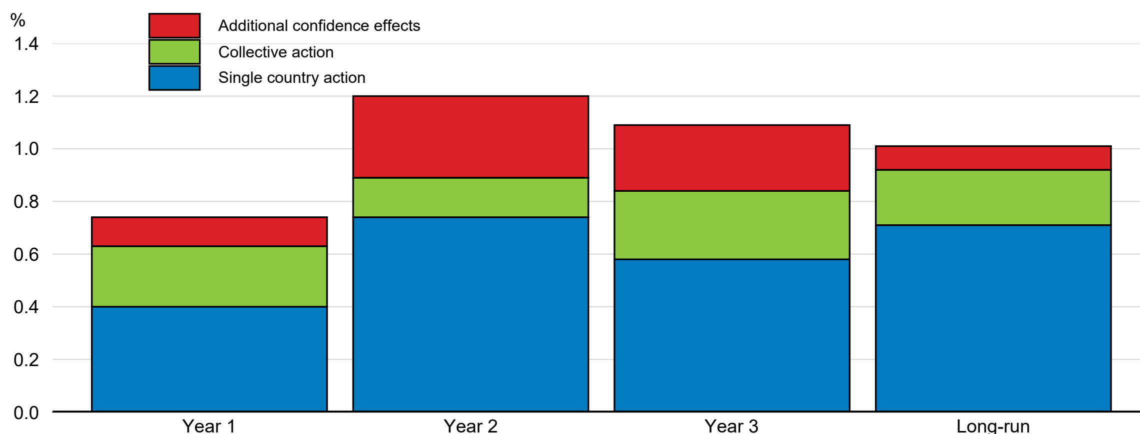
- First, each country is better off in the co-ordinated scenario above than if they are the only country to undertake policy measures, even in the absence of the gains from improved confidence. Acting together enhances the spillovers through stronger trade growth and higher financial asset prices. In the median G20 economy, the output gains in the first three years are significantly higher when all countries act together than when only one country acts by itself, reflecting the boost to exports and incentives to invest that result from stronger external demand (Figure 2.8). Acting together also raises the pace at which economies achieve the longer-term boost to output from structural reforms; in the typical economy, the longer-term impact on output is around one-quarter higher when all countries undertake co-ordinated action. This is because domestic investment is stronger, helping the capital stock adjust more quickly to a new and higher long-run equilibrium.

- Second, there are additional gains for each country from the boost to global confidence and reduction in uncertainty that comes from acting together to tackle a common problem. In the co-ordinated scenario above (Figure 2.7), enhanced confidence contributes significantly to the near-term output gains from collective action. This adds one-sixth and one-third respectively to the output gains in the median G20 economy in the first and second year of the co-ordinated scenario across countries (Figure 2.8). It also has a positive impact on the longer-term outcome, as there is a permanent (though small) additional boost to the capital stock due to stronger business investment.

These results suggest that co-ordinated policy action across countries would provide the most effective and timely counterweight in the event of an even sharper or more protracted global growth slowdown than currently projected. In practice, it may either not be possible for all countries to undertake the same actions, or countries may simply choose to undertake a different mix of fiscal, monetary and structural responses. Nonetheless, it is important that all countries participate in a co-ordinated effort to support growth, as this will maximise the collective gains and the benefits for each economy.

Figure 2.8. There are sizeable spillovers from co-operative actions

GDP in the median G20 economy, differences from baseline



Note: The blue panel shows the impact on GDP in the median G20 country from undertaking the package of fiscal, monetary and structural measures by itself. The green panel shows the additional boost to GDP if all G20 countries undertake these policy measures at the same time. The red panel shows the additional gains from an improvement in confidence when all countries undertake actions at the same time.
Source: OECD calculations using the NiGEM global macroeconomic model.

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