PROSPECTS FOR GROWTH AND IMBALANCES BEYOND THE SHORT TERM

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Introduction

The global financial and economic crisis and the ensuing recession left many OECD countries with a legacy of lower potential output, high unemployment and unsustainable government finances.

While long-term growth rates may well have been unaffected by the crisis, the level of potential output is expected to have fallen by close to 3% in the OECD area as a whole. At the same time, a combination of fiscal stimulus measures, a loss of previous extraordinary revenue buoyancy, and cyclical revenue losses and expenditure hikes, has led to sharp increases in budget deficits, which are projected at almost 8% of GDP in 2011 on average in OECD countries. The global crisis has also contributed to a temporary narrowing of global current account imbalances. Having reached over 5% of world GDP in 2008, the combined current account surpluses and deficits of the world's major countries and economic areas almost halved in 2009. These imbalances are beginning to widen again, with the notable exception of China's current account surplus, which has continued to fall in relation to GDP.

Repairing the damage wrought by the downturn and getting economies back onto the path of strong, sustainable and balanced growth will require concerted efforts in a number of policy domains, including fiscal consolidation targeted at reducing government debt over the medium-to-longer term, some realignment of exchange rates and structural reforms that will boost growth and welfare while at the same time rebalancing the sources of world demand.

On the basis of policy simulations, this note reports different scenarios for the world economy to identify what combination of policies is likely to be most successful in delivering strong, balanced growth, sound public finances and sustainable current account positions.[1]

Scenarios for the world economy

The OECD Global Model can be used to simulate the effects of three policy scenarios on growth, public finances and global imbalances for the period 2012-25. The assumptions underpinning each scenario are reported in Box 1. In summary:

- A **business-as-usual scenario** is characterised by the closure of output gaps from their current levels and relatively unambitious fiscal policy in OECD countries focused on stabilising government indebtedness in relation to GDP. This scenario can be considered as a baseline against which alternative scenarios can be assessed.

- A **fiscal consolidation scenario** involves sufficient fiscal consolidation starting in 2011 to reduce government debt in relation to GDP by 2025 to the pre-crisis levels prevailing in each OECD region, except Japan (see Box 1). This scenario focuses on efforts to restore the longer-term sustainability of OECD public finances, with some consequent depreciation of OECD currencies vis-à-vis their non-OECD counterparts.

[1] The note draws on the analysis presented in the most recent edition of the *OECD Economic Outlook* (May 2010).

- A **structural reform scenario** includes, in addition to fiscal consolidation, the impacts of a stylised set of reforms that are desirable in their own right and would gradually reduce savings in countries with large current account surpluses and discourage consumption in deficit countries. Such reforms include:

  – In the United States, an improvement of financial market regulation, the elimination of distortionary tax incentives and the pricing of environmental externalities of fossil fuel use.

  – In the euro area, pro-competition product and labour market reforms that would boost potential growth and reduce structural unemployment.

  – In Japan, an easing of product market regulations and reforms to deepen financial markets.

  – In China and other non-OECD Asian economies, a combination of policy reforms to improve social safety nets and expand the provision of health care, facilitate access of households to credit and strengthen the business and financial environments.

Box 1. The assumption behind the different policy scenarios

The business-as-usual scenario

- **Fiscal policy**. In each country, the underlying primary budget deficit is reduced by 0.5% of GDP per year for as long as needed to stabilise the ratio of government debt to GDP. The effects on public budgets from population ageing and continued upward pressures on health care spending are assumed to be addressed by separate measures and therefore not taken into account. Long-term interest rates are assumed to increase by 4 basis points (1 basis point for Japan) for every additional percentage point increase in the government debt-to-GDP ratio above 75% of GDP.

- **GDP growth and unemployment**. GDP grows at its potential rate after 2015, when the output gap is closed in all OECD countries. Adjustments to potential output (capital, structural unemployment, labour force participation) resulting from the crisis are completed by 2015. Between 2015-25 OECD countries experience a slow convergence to annual labour productivity growth of 1¾ per cent per year. Post-crisis hysteresis abates and structural unemployment rates return to their pre-crisis levels by 2015 in those countries with more flexible labour markets and by 2025 in all other countries. After 2011, the emerging-market economies outside the OECD area show a slow convergence to US growth rates in per capita income (measured at purchasing power parity).

- **Prices and exchange rates**. Oil and other commodity prices rise by 1% per year in real terms after 2011. Bilateral exchange rates remain unchanged in nominal terms within the OECD area. For other countries an estimated Balassa-Samuelson effect is used as a basis for assumed currency appreciation between 2011 and 2025. The renminbi appreciates gradually by about 20% in real terms against all currencies through 2025, with about half of this appreciation being associated with the convergence in GDP per capita over the period.

- **Monetary policy**. Interest rates are normalised through the period to 2015 in order to bring inflation in line with medium-term objectives. For Japan it is assumed that once the output gap has closed and inflation returns to 1% in 2015, the target rate of inflation for monetary policy will be fixed at 2%.

The fiscal consolidation scenario

- **Fiscal policy**. Accelerated fiscal consolidation starts in 2011 and reduces government debt-to-GDP ratios by 2025 to the pre-crisis levels. In Japan, due to its high level of indebtedness, only half of the increase in debt in the aftermath of the crisis is reversed by 2025. Critically, fiscal consolidation is seen as credible and the fall in bond yields associated with lower debt (than the business-as-usual scenario) is therefore front-loaded.

- **Exchange rates.** OECD currencies fall by 10% relative to their non-OECD counterparts immediately and by a further 10% over the following ten years in response to the announcement of consolidation.

The structural reform scenario

- **Savings**. A mix of policies are modeled that affect government and household savings. As a consequence, private and public savings are lowered by 3% of GDP in China and other non-OECD Asian economies, private demand is raised by 2% of GDP in Japan and private savings are raised by 1% of GDP in the United States. These reforms are phased in over eight years beginning from 2011.

- **Unemployment**. The structural unemployment rate is reduced in the euro area by 2 percentage points over the next eight years with structural reforms bringing it more into line with the average across other OECD countries.

- **Exchange rates**. Exchange rates adjust to changes in domestic saving. In particular, the renminbi appreciates by 20% and the US dollar depreciates by 10% over two years (other bilateral exchange rates remain unchanged compared to the business-as-usual scenario). These adjustments allow for the impact on GDP of lower (higher) private savings in China (United States) to be compensated by lower (higher) net exports.

The implications of business-as-usual policies

The policy simulations show that, in the baseline scenario characterised by only gradual fiscal consolidation, high government indebtedness would dampen medium-term growth prospects. In particular:

- **Government indebtedness would continue to rise** in relation to GDP before stabilising at close to 120% of GDP in the OECD area in the longer term, about 20 percentage points above the current level and nearly 50 percentage points above the pre-crisis level (**Table 1**).

- **Rising indebtedness would dampen longer-term growth prospects**. Long-term interest rates would likely increase due to rising indebtedness, which would undermine long-term growth and pose risks to future stability.[2] Higher interest rates are also likely to flow through to higher costs for corporate borrowing, which would discourage business investment.

- **Global imbalances would re-emerge** over the medium term as global demand recovers and output gaps close, while remaining below the levels prevailing immediately before the crisis. The current account deficit of the United States would stabilise at around 4% of GDP through 2025, while the Chinese surplus would widen to some 5-5½ per cent of GDP in 2025.

[2] Rising longer-term interest rates can lead to unstable debt-dynamics. Under the baseline scenario, by 2025 10 countries would have gross debt above 100% of GDP, from only 3 countries before the crisis, including Japan (at 220% of GDP in 2025) and United States and the United Kingdom (at close to 130% of GDP).

Table 1. A baseline scenario

	Period averages		
	2011-15	**2016-2020**	**2021-2025**
GDP growth (% pa)			
United States	2.7	2.5	2.3
Japan	1.5	1.0	0.9
Euro area	2.2	1.7	1.6
OECD total	2.6	2.1	2.0
China	9.5	8.0	6.4
Fiscal balance (% of GDP)			
United States	-8.2	-6.7	-4.7
Japan	-6.9	-4.6	-2.7
Euro area	-4.2	-2.4	-2.3
OECD total	-5.5	-4.0	-3.0
Gross government debt (% of GDP)			
United States	105	122	129
Japan	212	221	222
Euro area	100	102	101
OECD total	106	115	117
Current balance (% of GDP)			
United States	-4.0	-4.1	-4.2
Japan	3.3	2.8	2.2
Euro area	1.0	1.1	1.3
OECD total	-0.7	-0.8	-0.8
China	3.7	4.5	5.3

Source: OECD Economic Outlook 87.

The effects of fiscal consolidation without structural reform

Fiscal consolidation that reduces the ratio of government indebtedness to GDP by 2025 to pre-crisis levels would only have a limited impact on external imbalances, in part because all OECD economies would engage in consolidation simultaneously. In particular:

- **The positive impact of generalised consolidation efforts on interest rates would lead to a substantial improvement in medium-term growth outcomes.** The level of OECD and global GDP would be 2% higher by 2025 under this scenario compared to the business-as-usual baseline due to the lower interest rates associated with the fall in government indebtedness (Table 2). Fiscal consolidation would nevertheless sap demand in the short term and, hence, lower GDP growth in 2011-12, depending on the extent of the required adjustment in individual countries.

- **Despite the improved growth outcomes, fiscal consolidation has only limited impact on external imbalances**, in part because all OECD economies would engage in consolidation simultaneously. This is despite the fact that fiscal consolidation would affect OECD currencies, which would likely depreciate relative to the currencies of non-OECD countries. Taken together. the adjustment would reduce the current account surpluses of China and other non-OECD Asian countries by about ¾ percentage point of GDP and reduce the US deficit by about ½ percentage point relative to the business-as-usual scenario. This improvement would in part be offset by a further widening of surpluses in Japan and the euro area.

Table 2. A fiscal consolidation scenario

	Growth		Fiscal balance		Gross government indebtedness		Current balance	
	% per annum		% of GDP		% of GDP		% of GDP	
	2021-25	Difference[1]	2021-25	Difference[1]	2025	Difference[1]	2021-25	Difference[1]
United States	2.6	0.2	0.9	5.6	74	-54	-3.5	0.7
Japan	1.5	0.6	0.9	3.5	185	-35	3.7	1.5
Euro area	1.6	0.0	0.0	2.3	78	-24	1.6	0.3
OECD total	2.2	0.2	0.5	3.5	86	-30	-0.1	0.6
China	6.4	0.0	-	-	-	-	4.3	-1.0

1. Difference in percentage points from the baseline scenario.

Source: OECD Economic Outlook 87.

A combination of fiscal consolidation and structural reform

The fiscal consolidation scenario can be augmented with structural reforms to reduce (raise) savings in surplus (deficit) countries, especially China, dynamic non-OECD countries in Asia and the United States, and reduce unemployment in the euro area. This scenario suggests that:

- **Over the longer term global output would be higher than in the baseline scenario**. This is due to a combination of lower long-term interest rates and a removal of distortions that constrain consumption and investment in surplus countries and savings in deficit countries. Set against that, welfare enhancing social reforms in China and other non-OECD economies would lower savings and increase interest rates.

- **Global imbalances would also improve (Table 3)**. In particular, the external deficit of the United States and the Chinese surplus would be reduced significantly, not only relative to the baseline scenario, but also relative to the fiscal consolidation scenario (**Figure 1**).

Table 3. A scenario of fiscal consolidation with structural reform

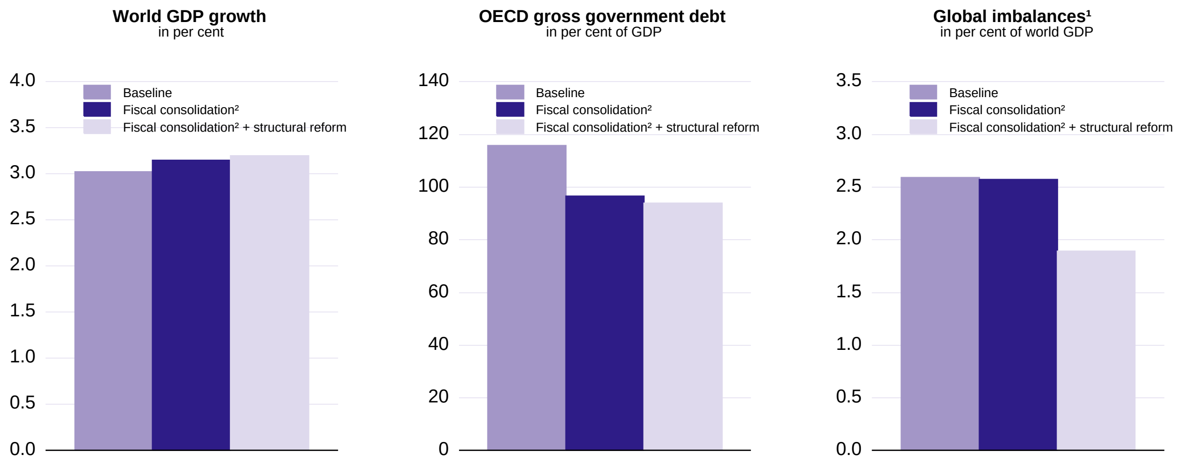
	Growth		Fiscal balance		Gross government indebtedness		Current balance	
	% per annum		% of GDP		% of GDP		% of GDP	
	2021-25	Difference[1]	2021-25	Difference[1]	2025	Difference[1]	2021-25	Difference[1]
United States	2.5	0.2	1.1	5.8	75	-54	-1.2	3.0
Japan	1.3	0.4	1.1	3.7	170	-50	3.2	1.0
Euro area	1.8	0.2	0.3	2.7	76	-26	1.6	0.3
OECD total	2.2	0.3	0.7	3.7	83	-33	0.7	1.4
China	6.3	-0.2	-	-	-	-	2.7	-2.6

1. Difference in percentage points from the baseline scenario.

Source: OECD Economic Outlook 87.

Figure 1. Structural reform can do much to sustain growth and reduce global imbalances

Policy simulations, 2016-25 average



1. A summary measure of global current account imbalances is constructed as the absolute sum of current balances in each of the main trading countries or regions.
2. Fiscal consolidation including exchange rate response.

Source: OECD calculations.