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The Global Economic Outlook: Clouded with Uncertainties

Global GDP growth is forecast to slow to 3% in 2015, well below its long-run average. This represents the 5th consecutive year of declining global growth rates in per capita terms. The slowdown reflects the disappointing pace of Europe's economic recovery, weak global trade flows, sluggish real investment and, lately, deteriorating financial conditions in emerging market economies (EMEs). While the gradual recovery in most advanced economies continues, commodity exporters face strong headwinds from falling oil, coal and metal prices. In 2016, global growth is expected to rise to 3.6%, contingent on sustained growth in advanced economies.

Growth in advanced economies has been led by the United States and the United Kingdom. Favourable labour market conditions, lower oil prices, and improving household wealth have underpinned consumption and supported growth. The outlook for Japan remains more subdued: the OECD's growth forecasts for 2015 and 2016 have been revised slightly downwards. Consumption remains weak, and tighter labour market policy has not yet fed into wage increases. Canada's growth prospects have also been downgraded for 2015 and 2016, reflecting lower capital spending from a prolonged decline in oil prices.

Rising European growth rates, particularly in those economies hardest hit by the crisis, are encouraging. However, OECD estimates suggest growth is around one percentage point lower than would be expected given the tailwinds from lower oil prices, a weaker euro and lower long-term interest rates. Unemployment remains high and domestic price pressures are weak. While year-on-year credit growth in the euro area became positive in early 2015, it remains below zero in most euro area countries. Further measures are required to strengthen the financial system and stimulate the flow of new credit to support quantitative easing.

Recorded Chinese GDP growth remains strong, reaching 7% in June 2015 year-on-year. However, China's underlying growth dynamics remain difficult to assess. The government has announced new fiscal stimulus measures to support asset prices, credit and activity. If these measures impede financial reforms or fail to address excess capacity in declining industries, they may undermine government efforts to rebalance the economy and deliver long-term sustainable growth.

Weakening Chinese import growth has catalysed a slowdown in global trade flows. This slowdown, coupled with sharp corrections in Chinese share prices and the anticipation of tighter US monetary policy, has adversely affected the prospects of most EMEs. Currency depreciations from declining terms of trade have raised the costs of servicing foreign-denominated debt and exacerbated underlying inflationary pressures in commodity-exporting EMEs. Portfolio balancing away from EME assets has widened sovereign bond spreads and lowered equity prices by more than 10% since May 2015. Bank lending conditions have continued to tighten in most EMEs. The medium-term prospects for EMEs vary: for example, while the outlook for Brazil and Russia has deteriorated significantly, India remains relatively well-insulated from adverse global developments given strong consumer spending and sustained public investment in infrastructure.

Overall in 2016, global growth will be led by the continuing recovery in advanced economies. Two key uncertainties cloud the medium-term global outlook. First, a larger than expected slowdown in China would adversely affect economies with direct trade and investment links. However, it would not be expected to derail the global recovery unless it coincided with a large and widespread correction in global financial markets. Second, further deterioration in the prospects of key EMEs may generate global financial and economic turbulence that would exert a significant drag on advanced economies.

Macroeconomic and Financial Policy Directions

Continued monetary policy support is required in the major advanced economies, but differences in growth and inflation developments call for increasingly divergent stances. The gradual disappearance of economic slack in the United States, and the associated prospect of inflation eventually moving towards its target require higher policy rates. It is important that this long-awaited normalisation of policy rates moves at a gradual pace however, given that price pressures are still modest and weakness in domestic and global activity still remains. The timing of the first rate rise is of secondary importance compared to the pace of subsequent increases. Clear communication of that pace will help to minimise financial market volatility.

In the euro area and Japan, highly accommodative monetary policies should remain until inflation has shown clear signs of moving durably towards the official target. The focus in the euro area should be on improving the transmission of monetary policy via the credit channel to make quantitative easing more effective. This implies a further strengthening of the financial system, with continued progress towards banking union and supervisory action to improve the quality of bank assets. High debt levels in a number of countries continue to hamper the ability of governments to undertake expansionary fiscal measures. Nonetheless, there is still scope to adjust the composition of public spending to strengthen near-term demand and long-term supply without raising deficits.

Policymakers in China face the challenge of ensuring a smooth rebalancing in the economy, while preventing a sharp reduction in GDP growth and mitigating financial stability risks. Monetary and fiscal policies have been eased already to support the economy throughout the transition. The authorities should use the room they have to provide further policy stimulus and avoid a sharp slowdown. However, it is important that stimulus fosters sustainable growth and not just a further increase of leverage and excess capacity.

Many other EMEs are experiencing weaker external demand growth and more difficult and volatile financial conditions. Monetary and fiscal policies should be supportive of activity, and due attention should be paid to fiscal choices that support sustainable growth. Exchange rate adjustment should be allowed to take place, but the associated financial risks need to be managed. Macro-prudential measures have a role to play in this regard.

Policymakers across all countries need to promote sustainable and inclusive investment growth. Although monetary policy continues to be very accommodative in most economies, and financial constraints have dissipated considerably, more can be done to eliminate impediments and barriers that firms face in reallocating resources. Authorities will need to address regulatory burdens that limit the ability of businesses to re-adjust their capital stock, and also to undertake multilateral efforts to address sources of global policy uncertainty, including plans to mitigate the negative effects associated with climate change to be discussed at COP21 in Paris this December.

Boosting Employment and Improving Job Quality

The jobs recovery is slowly gathering pace, but employment will remain well below pre-crisis levels in many countries, especially in Europe, through to the end of 2016. Consequently, unemployment will remain high: around 42 million people were without work in May 2015 across the OECD, down from 45 million in 2014 but still 10 million more than just before the crisis. Unemployment in the 34 OECD countries is projected to continue declining over the next 18 months to reach 6.5% in the last quarter of 2016. It will remain above 20% in Greece and Spain. Long-term unemployment remains unacceptably high. More than one in three jobseekers in the OECD have been out of work for 12 months or more, equivalent to 15.7 million people. This is an increase of 77.2% since the end of 2007. More than half of these people have been without work for two years or more, and their chances of finding work again are shrinking. Youth

unemployment also remains very high in some OECD countries raising concerns that he long-term career prospects of many recent school leavers could be permanently compromised.

The scarring effects of the crisis on the hardest hit groups are compounded by longer-run trends that are making it more difficult for low-skilled workers to move out of precarious, low-paid jobs into jobs that offer opportunities for career advancement. Time is running out to prevent the scars of the crisis becoming permanent, with millions of workers trapped at the bottom of the economic ladder. If that happens, the long-run legacy of the crisis would be to ratchet inequality up yet another notch from levels that were already far too high.

Governments need to act now to avoid a permanent increase in the number of workers stuck in chronic joblessness or moving between unemployment and low-paid precarious jobs. Tackling unemployment where it remains high and driving down long-term unemployment, in particular, represent key policy priorities. However, lowering unemployment should be approached as part of a larger challenge to promote upward mobility at the bottom of the earnings ladder. Three types of policy measures are particularly important. First, effective activation measures that connect jobseekers with suitable jobs are required. Second, skill deficits in the workforce must be addressed since one of the strongest predictors of poor career outcomes is a low level of skills. Third, direct measures to raise job quality have an essential role to play, especially in shoring up the earnings of low-paid workers.

Going forward, more attention should be paid not only to the number of job opportunities available, but also to the quality of these jobs and who requires targeted assistance to access them. In order to promote full recovery from the crisis and help workers to thrive in an ever-changing economy, governments must take action to foster stronger employment growth and improve workers' access to productive and rewarding jobs. Doing so will help to repair the broken rungs of the jobs ladder and reverse the long-run increase in inequality, also strengthening the sustainability of economic growth.

Stronger and More Inclusive Productivity Growth

While macroeconomic and labour market policies are necessary to boost growth and promote employment, broader structural reforms continue vital to be vital to achieve strong sustainable and inclusive growth. One key issue to address is the 'slowdown' in productivity growth experienced by many advanced and emerging economies in recent years.

Labour productivity growth, which is a central driver of long-term improvements in economic prospects and broader living standards, has slowed since the early 2000s across all advanced countries. From 2000 up until the global economic crisis began in 2007, a slowdown in total-factor productivity (TFP) growth was the main contributor to weak productivity outcomes. Since the onset of the crisis, the slowdown in productivity growth has also been driven by a decline in the contribution of capital per worker, reflecting persistently low levels of investment growth. Low investment reflects, for the most part, weak demand.

Paradoxically, the productivity 'slowdown' is taking place at a time of unprecedented technological change, where digital innovations in particular are proving increasingly disruptive. There is enormous scope for digital technologies to leverage human brain capacities and cognitive skills. Nonetheless, OECD research suggests that an important feature of the productivity slowdown is not so much a decline in frontier innovations, but rather a slowing of the pace at which innovations spread throughout the economy – a breakdown in the diffusion machine. Reviving the diffusion machine at the macro level depends on a pick-up in investment rates to levels that are more consistent with higher potential growth.

The slowdown has also occurred against a backdrop of rising inequalities that over the last three decades has seen widespread increases in income disparities between individuals (or households) accompanied by increasing divergence in outcomes across a broad range of well-being dimensions (from educational and

skills outcomes, to job opportunities, and health status). To date, insufficient attention has been paid to how multidimensional inequalities interact with productivity performance. But there is good reason to believe that adopting a multi-dimensional setting, against which to assess productivity growth and its distribution, is an indispensable feature of the debate on productivity. For instance, physical and mental health affects productivity and income and is in turn affected by productivity. Similarly, skills and human capital are important determinants of productivity growth and themselves dependent on the quality and productivity of educational and training systems.

The trend slowdown in productivity and widening inequalities show that harnessing the potential of digital technologies for the benefits of the whole population is by no means straightforward. One benefit from more recent technological advances is that a whole new range of tasks (in areas such as complex communication and advanced pattern recognition) are now amenable to automation with a capability that was deemed unimaginable even only 10-15 years ago. The replacement of workers by machines and software to perform specific tasks is clearly not a new phenomenon but post-crisis labour market developments suggest that the pace of job creation in new – often complementary – areas may no longer be sufficient to make up for the jobs displaced by digital technologies. The consequence is scores of low- and medium-skilled workers left behind and ill-equipped to adapt. At the same time, the deeper penetration of digital technologies across industries brings innovations that, short of being radical, are nonetheless breaking old models of businesses and reshaping the landscape in ways that challenge conventional policies in areas of competition, taxation, social protection as well as intellectual property.

In this context it is no longer possible for governments to assume that technological advances, and the related innovations in processes and business models, will translate into genuine productivity gains and, more importantly, that such gains will be broadly shared across firms and the population. Responding to this requires governments to adopt a more holistic approach and to take a hard and comprehensive look at policy settings ex-ante, to assess how they interact to affect innovation outcomes, the dispersion of incomes across individuals (or households), firms, regions and countries, as well as key non-income dimensions that matter to the population. In short, this is about making *Inclusive Productivity* the cornerstone of a policy agenda to promote well-being.

A new approach is needed to boost productivity at the **individual, firm, regional and country level**. At the level of the individual, the first step is to respond to the recognition that educational qualifications do not automatically translate into skills. The second is to focus much more attention on skills mismatches. Around one-quarter of workers in the OECD area are estimated to suffer a mismatch between their skills and those required to do their job. The third area which has been neglected in the traditional approach to enhancing productivity is the health of the population. For example, poor mental health affects up to 1 in 5 of the working-age population, and between a third and a half of all people who are without work. Yet, health policies underinvest in influencing unhealthy lifestyles and employers, employment, health, education and social services neglect many mental health disorders, reducing the productivity of those affected.

At the firm level, diffusion of innovation is shaped by global connectedness, experimentation, investment in knowledge based capital and the efficiency of reallocation, which are all heavily influenced by policies. Product market reforms and bankruptcy laws that do not excessively penalise failure can facilitate diffusion by enhancing firms' incentives to experiment, by facilitating the efficient allocation of skills and other resources, and enhancing the potential benefits of participation in global value chains. The aggregate benefits of diffusion are magnified by policies that foster the growth of the most productive firms. While the most advanced firms often have productivity levels close to the global frontier, their aggregate impact can be muted if they are small. It is also crucial that young firms grow and become more productive, while inefficient firms are allowed to exit.

At the regional level, urbanisation boosts productivity through the promotion of skills-enhancing interactions, the diffusion of tacit knowledge and the realisation of increasing returns to scale in the delivery of services. However, aside from congestion issues, it may also have adverse distributional implications across regions and within cities, including through housing prices. Urban planning and housing policies thus play a key role in facilitating labour and jobs mobility, as well as allowing access to affordable housing and services to lower-income households. The high levels of air pollution and road congestion prevailing in many large cities in both advanced and emerging-market economies underscore the need for better provision of public transport infrastructure, along with a more widespread use of environmental taxation as a privileged source of funding.

Ultimately, policies having an influence on firms, individuals and regions are often designed and legislated by national governments. They also play an important role in ensuring that the promotion of productivity is not pursued at the cost of widening inequalities across households, regions and countries, but that it does lead to higher well-being. Widening inequality itself can affect productivity, through reducing investment in human capital, and causing differences in the quality of public services such as education and health across social groups and geographical areas. If only for that reason, an approach which consists of pushing for strong productivity first and then relying on ex-post redistribution mechanisms to distribute the gains more broadly is no longer sustainable. Only national governments can develop a coherent policy package that addresses inequality and productivity jointly. The OECD is here to support governments in this important endeavour.