Session 1:

GLOBAL ECONOMIC OUTLOOK

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THE GLOBAL ECONOMY AT A TURNING POINT[1]

1. INTRODUCTION

According to the *OECD Economic Outlook* of November 2011 (No. 90), the recovery in the OECD area has slowed to a crawl, despite a technical rebound in activity following the disaster in Japan. In most economies business and consumer sentiments have plummeted since the summer, in the wake of a renewed bout of financial market turbulence, especially for banks in the euro area (Figure 1). Trade indicators point towards weak global activity in the near future (Figure 2). While widening of sovereign yield spreads has become generalised beyond the euro area programme countries (Figure 3), the flipside has been a substantial decrease in the yields of "safe-haven" government bonds and top-rated corporate bonds, in some cases to historic lows. Financial conditions have been tightening overall in the OECD area (Figure 4), and have become less supportive of growth in the emerging markets. In some countries the household balance sheets have begun to weaken once more, due to lower equity prices and persistent housing market weakness. In addition, a widespread slack in labour markets and a pick-up in

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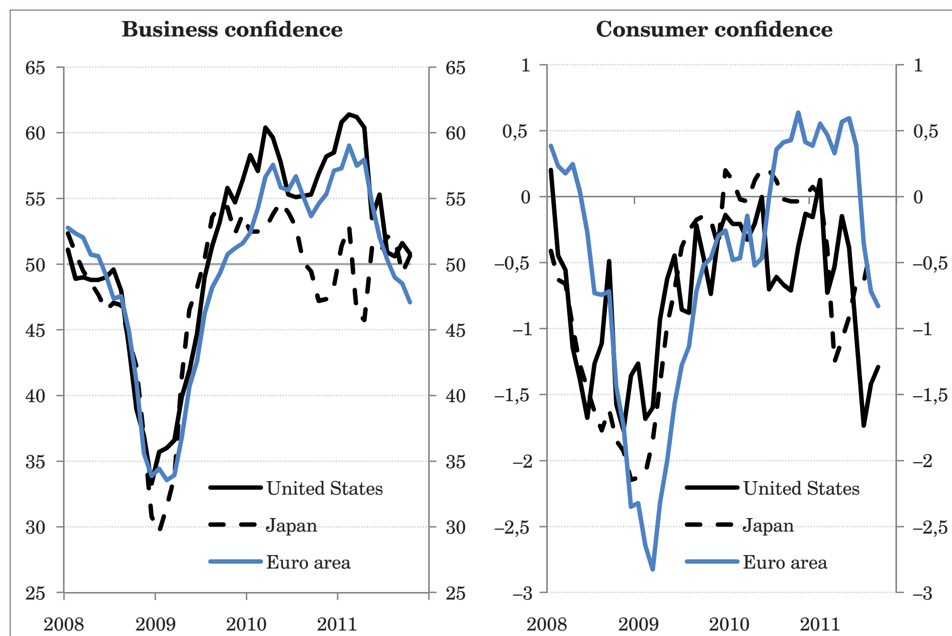
1 This paper is an updated version of an address delivered at the IADI Annual Conference on 19 October, 2011 in Warsaw, Poland. It is based on the *OECD Economic Outlook* No. 90, parts of which were first released on 31 October 2011, with a full release on 28 November 2011.

inflation, alongside the recent declines in consumer confidence are holding back household consumption.

Figure 1. Confidence is weakening

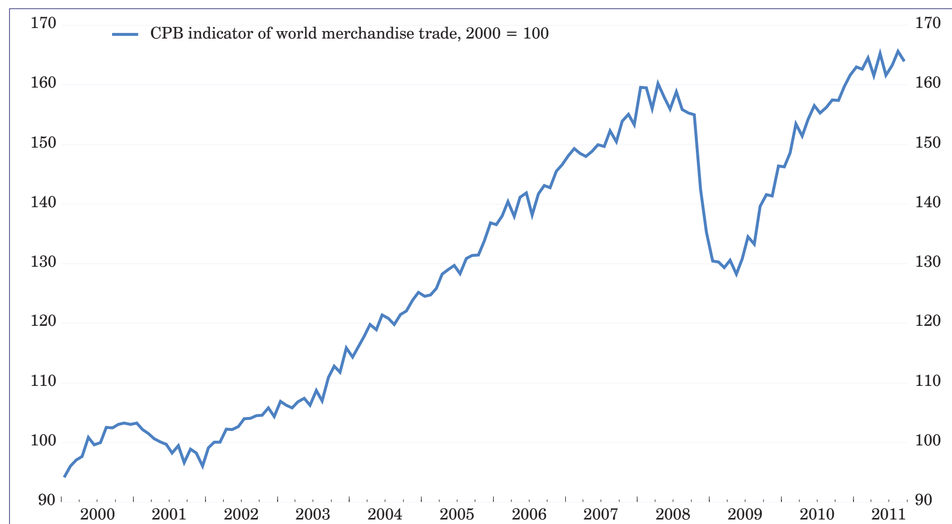


Note: Business confidence: manufacturing sector; values greater than 50 signify an improvement in economic activity. Consumer confidence: values below zero signify levels of consumer confidence below the period average.

Sources: Markit Economics Limited, OECD Main Economic Indicators.

Where will we go from here? In view of very large uncertainties, instead of presenting a "central" projection qualified by upside and downside risk, the *Economic Outlook* presents three scenarios: a baseline scenario, a downside scenario and an upside scenario. The *baseline scenario* is one of "muddling through", in which no major (credit) events happen but also no decisive policy moves towards a resolution of the current predicaments materialise. In this scenario, growth will be weak, although no deep recession is envisaged. The *downside scenario* features an acute confidence crisis and an ensuing deep recession, if not depression, triggered by a major adverse event such as a disorderly sovereign default in the euro area and/or excessive fiscal tightening in the United States. The *upside scenario*, in which the recovery resumes as confidence is restored, is based on the assumption that credible and effective resolution measures are taken to avert such events.

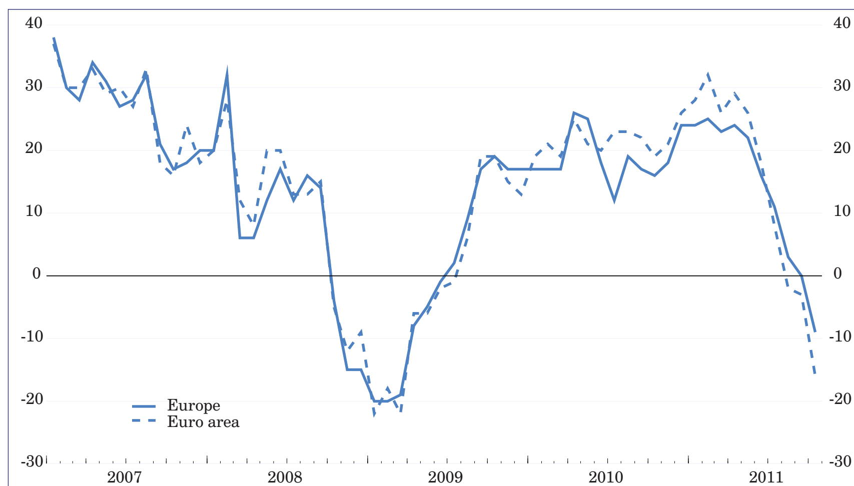
Figure 2. World trade is stagnant



Source: *CPB, OECD Economic Outlook 90 database; and Markit Economics Limited.*

Figure 3. European financial sector confidence has plummeted

Financial services confidence indicator, balances, in percentage points

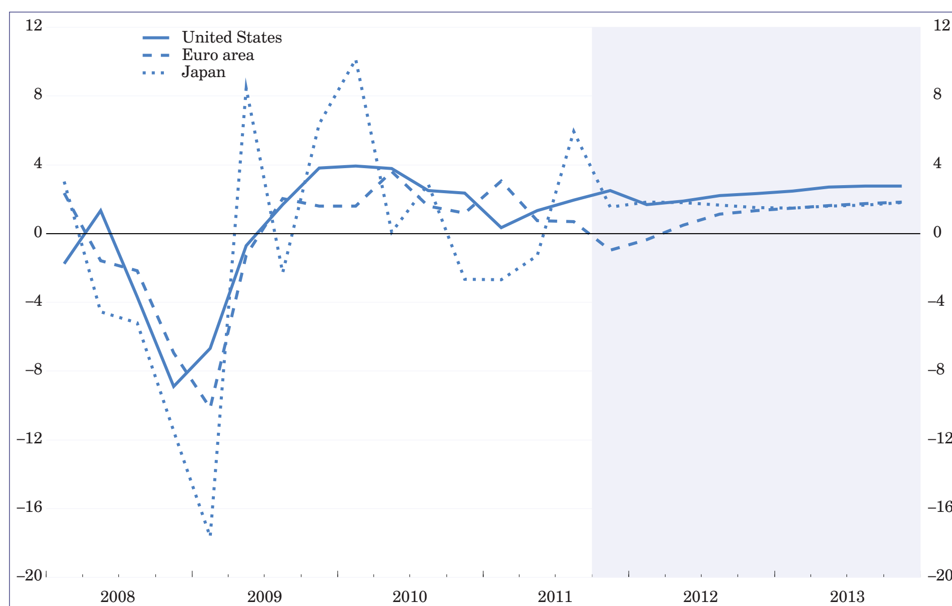


Note: The confidence indicator is the arithmetic average of the balances (in percentage points) for the questions on business conditions, as well as past and expected evolution of demand. Balances are the differences between the percentages of respondents giving positive and negative replies. Data are not seasonally adjusted. Europe includes Czech Republic, Germany, Spain, France, Italy, Luxembourg, Hungary, the Netherlands, Poland and the United Kingdom. Euro area includes Germany, Spain, France, Italy, Luxembourg, and the Netherlands.

2. THE BASELINE SCENARIO: MUDDLING THROUGH

The baseline scenario rests on two assumptions: that the sovereign debt and banking problems in the euro area can be contained and that excessive, pre-programmed fiscal tightening in the United States will be avoided. Against this backdrop, the key features of the baseline scenario for the major economies are as follows:

Figure 4. The recovery is projected to resume only slowly in the OECD area
Annualised quarter-on-quarter real GDP growth, in percent

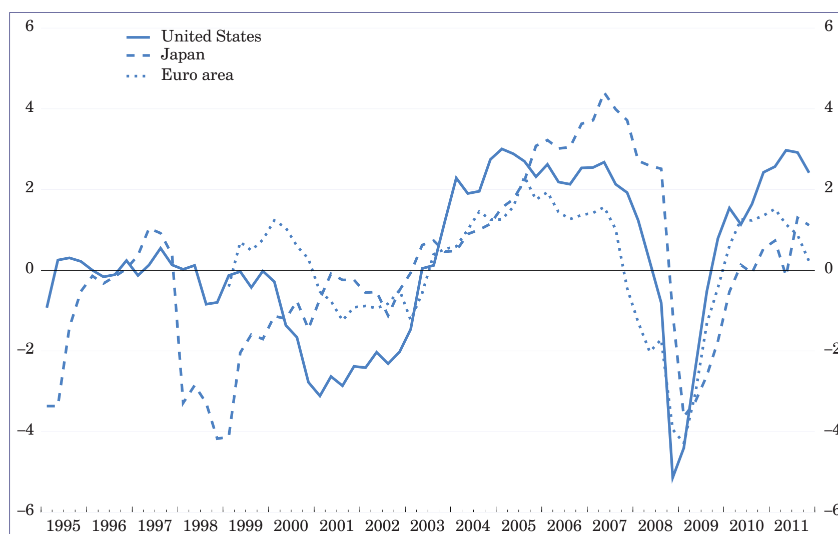


Source: *OECD Economic Outlook 90 database.*

❖ In the *United States*: weak confidence, persistently high unemployment and the renewed pressure on balance sheets from lower asset values are likely to damp consumers' expenditures. Heightened uncertainty should also moderate business investment in the short term, despite healthy corporate balance sheets. Continued fiscal consolidation will also hold back activity. With confidence recovering during 2012, accommodative monetary policy and strengthening external demand should buoy activity through 2013. But the unemployment rate is projected to remain high at around 8.5% by the end of 2013.

- The *euro area* has entered a mild recession, which will be followed by a merely hesitant pick-up in activity. Worsening of financial conditions and fiscal consolidation – both ongoing and announced in response to sovereign debt concerns – will act as a drag on the economy in both 2012 and 2013. Softening confidence, deteriorating labour markets conditions and renewed balance sheet problems should weigh on private consumption, while private investment is expected to be very weak in light of downbeat output expectations. In this muddling through scenario confidence should begin to recover from the second half of 2012 onwards, but slack will persist and the unemployment rate will remain high at just over 10% by the end of 2013.
- After an initial rebound in activity following the disruptions by the earthquake and the Fukushima disaster, the pace of recovery is moderating in Japan. Improved financial conditions and the planned fiscal package are likely to boost growth in 2012. As public reconstruction efforts fade, stronger business investment and a gradual improvement of labour market conditions should provide growth impetus, although the recovery will be checked by soft global growth and the appreciation of the exchange rate.

Figure 5. Financial conditions are generally tightening
OECD Financial Conditions Index



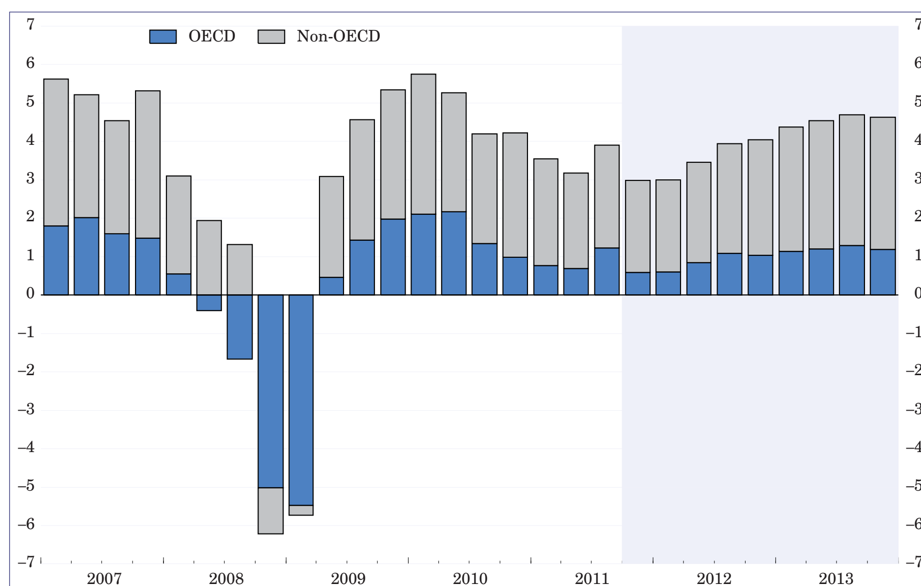
Note: A unit increase (decline) in the index implies an easing (tightening) in financial conditions sufficient to produce an average increase (reduction) in the level of GDP of 0.5 to 1% after four to six quarters. See details in Guichard et al. (2009). The estimation is done with available information up to 17 November 2011.

Source: Datastream; OECD Economic Outlook 90 database; and OECD calculations.

❖ The contribution of emerging markets to the global growth is set to remain substantial (Figure 6). Even so, the output growth in China is projected to be well below the potential in the near future. Domestic demand is buoyed by spending on social housing, but the net trade is likely to act as a drag on activity. As inflation and monetary conditions ease, growth is projected to pick up to rates close to 10% in 2013. India also experiences a soft patch, but growth should pick up to over 8% in 2013. In Brazil, domestic demand is projected to remain solid with more sluggish net exports providing some offset, with growth in the 3%–4% range. Sustained by constantly high oil prices, growth in Russia should be around 4% per annum.

Figure 6. World growth will be sustained by the non-OECD countries

Contribution to annualised quarterly world real GDP growth, percentage points



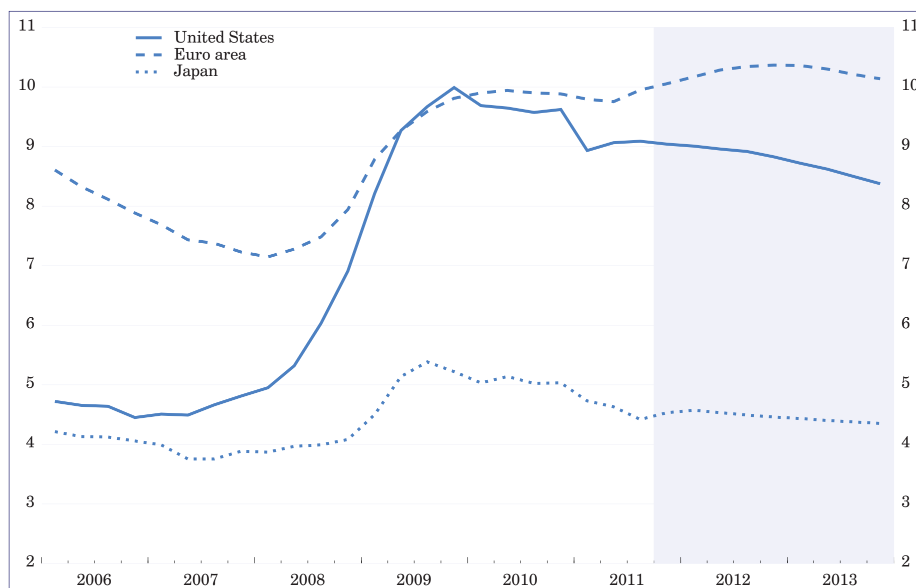
Note: Calculated using moving nominal GDP weights, based on national GDP at purchasing power parities.

Source: OECD Economic Outlook 90 database.

Headline inflation rates in most OECD and emerging market economies have started to decline, mostly due to the impact of hikes in waning commodity prices. Although core inflation has been drifting up in most countries, due to sharp increases in indirect taxes and administered prices in OECD countries along with capacity constraints in the BRICS countries, inflation expectations remain reasonably well anchored. These tendencies are set to continue, more so as slack in product and labour markets should bear down on wage and price inflation.

Following a brief period of improving outcomes, unemployment is rising once more in several economies, especially in Europe (Figure 7). In the baseline projection, the total OECD employment rises by between 0.5% and 0.75% in 2012 and 2013, with job growth in the United States offset in part by job losses in Europe and Japan.

Figure 7. Unemployment is expected to remain high for an extended period
Unemployment rate, percentage of labour force

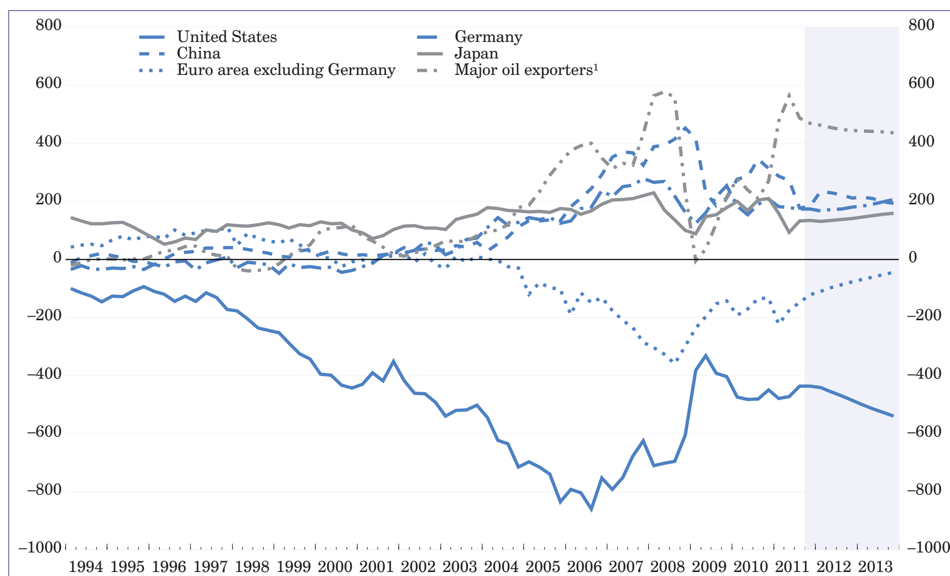


Source: *OECD Economic Outlook 90 database.*

The narrowing of global imbalances since the advent of the crisis in 2008 has now slowed, and little further rebalancing is expected over the projection period (Figure 8). Global imbalances are set to persist, at least in part, due to large increase in the external surpluses of the oil-exporting economies on the back of continually high oil prices. In fact, some of the recent rebalancing among major economies is related to oil price developments as well, with most of the decline in the Chinese trade surplus explained by a rise in energy imports. In contrast, over the projection period, developments in current accounts largely reflect differences in the respective cyclical positions, with the US external deficit widening by 0.5% of GDP, the euro area surplus widening by around 1% of GDP and the Chinese surplus narrowing to around 2.25% of GDP in 2013.

The main risks around these projections are tilted to the downside. Aside from possible events arising from the evolution of the euro area debt crisis and fiscal policy in the United States, these risks stem from inter alia: (i) uncertainty about

Figure 8. Global imbalances will continue to be pronounced
Current account balances, in US$ billions



Note: 1. Includes Azerbaijan, Kazakhstan, Turkmenistan, Brunei, Timor-Leste, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, United Arab Emirates, Yemen, Ecuador, Trinidad and Tobago, Venezuela, Algeria, Angola, Chad, Rep. of Congo, Equatorial Guinea, Gabon, Nigeria and Sudan.

Source: OECD Economic Outlook 90 Database; and OECD calculations.

power shortages as a result of continuing nuclear plant suspensions and closures in Japan; (ii) tightening monetary conditions and its impact on property and financial asset values in China; (iii) continued strong demand for crude oil in emerging economies and its impact on oil prices; and (iv) slower potential output growth associated with heightened risk aversion in financial markets.

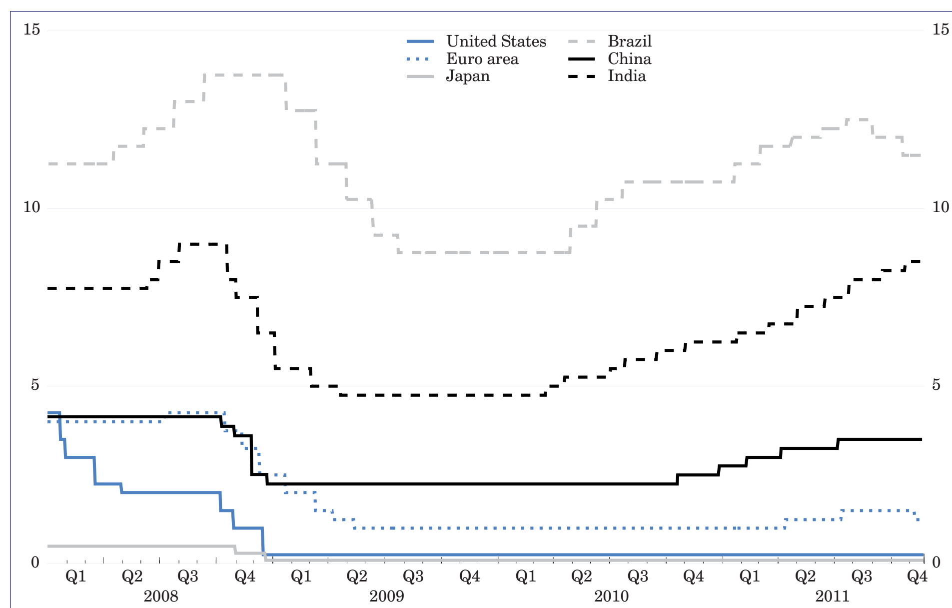
Continued accommodative monetary policy is warranted against this backdrop. In addition, central banks should provide ample liquidity to calm tensions in financial markets. In some OECD economies, where monetary tightening has already started, policy interest rates should be reduced. Near zero-rate policies are not costless as they can prompt excessive risk taking and capital misallocation. Nevertheless, such considerations are outweighed by the need to provide monetary accommodation in the current context.

Notably in the euro area, the weak prospects for the economy and fading inflation argue for further prompt reductions in interest rates, supported by non-conventional monetary policies to extend the balance sheets of central banks

(Figures 9 and 10). Furthermore, monetary authorities in most countries and areas should prepare contingency plans to be implemented swiftly if downside risks materialise. In large emerging market economies outside the OECD, inflationary pressures are mitigating but in several cases inflation still exceeds targets, limiting the room for policy easing. In China, monetary authorities are well advised to allow an effective appreciation of the exchange rate so as to improve the scope for domestic policy to stem a possible downward spiral between property prices and bank capitalisation if some of the downward risks materialise.

In most cases the fiscal policy assumptions employed in the projections are based on existing government programmes, though normative assumptions have been made where there is a particular uncertainty about budget policies in 2012 and 2013. Specifically, in the United States it has been assumed that that the fiscal tightening will amount to 0.5% and 1% of GDP in 2012 and 2013, respectively. This compares with a fiscal tightening embodied in current legislation of about 2% and 3% in 2012 and 2013, respectively, which would be excessive in the current macroeconomic situation. In Japan, the fiscal policy is officially programmed to be eased by 0.5% over the projection period, incorporating reconstruction expenditure

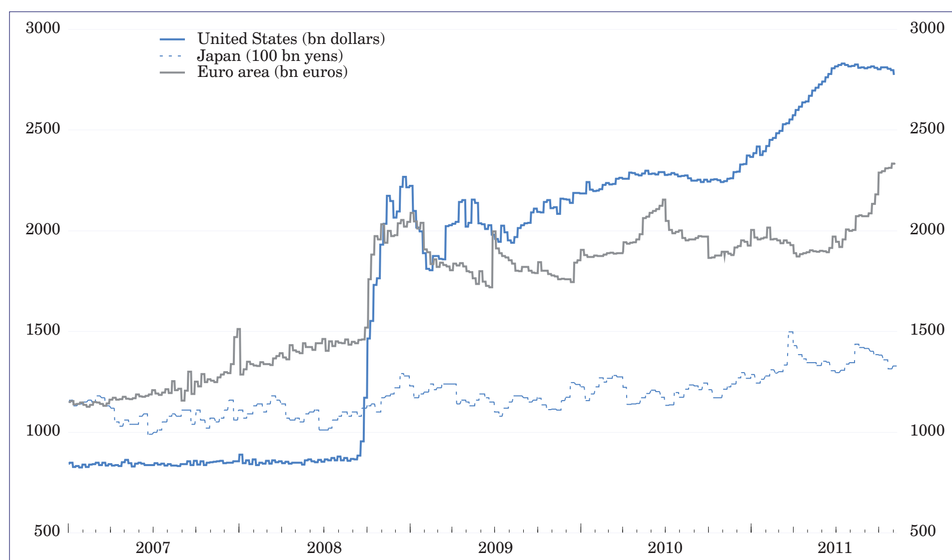
Figure 9. Policy interest rates are again becoming more accommodative in some countries
Policy interest rates, in percent



Source: Datastream; Central Bank of Brazil; Reserve Bank of India; and CEIC.

amounting to some 2% of GDP. In the euro area, the fiscal projections are also based on announced policies, with an aggregate consolidation of 1.5% and 1% of GDP assumed in 2012 and 2013, respectively. In the United Kingdom, the projection embodies consolidation of 1.25% of GDP in both years in line with the government's medium-term consolidation strategy. Healthy public finances generally permit an expansionary stance of fiscal policies in emerging market economies, not least because high growth rates tend to ease debt dynamics, except in Brazil and India, where consolidation is underway and should remain a priority.

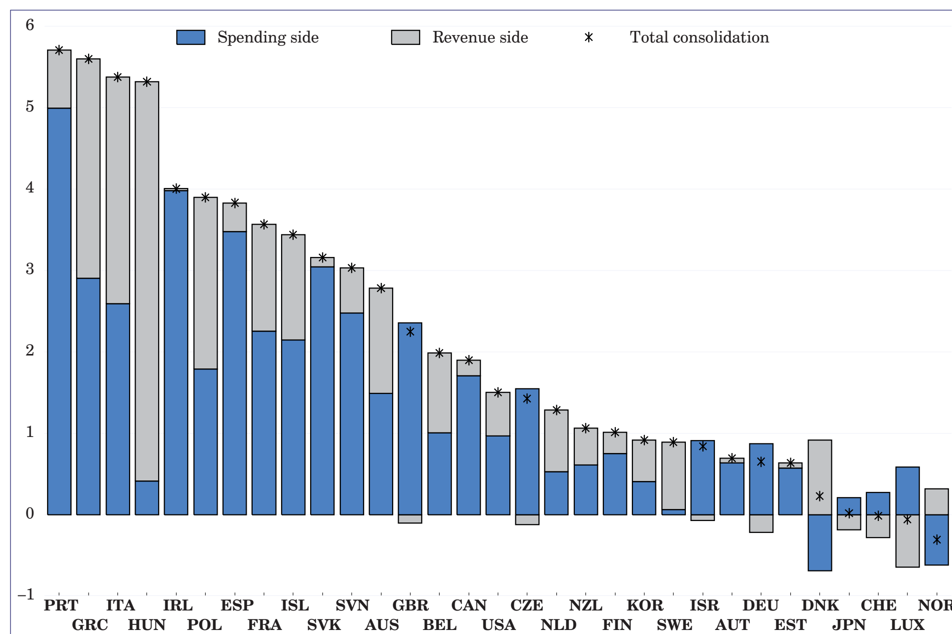
Figure 10. Unorthodox monetary measures have been strengthened
Central bank liabilities, local currency



Source: Federal Reserve; Bank of Japan; European Central Bank.

For most countries, present consolidation plans envisage some mix of spending restraint and revenue-raising measures (Figure 11). The choice of consolidation instruments needs to take into consideration their impact on a range of policy objectives beyond budget consolidation, including short-term aggregate demand, economy-wide efficiency and equity, as well as their political acceptance. Each consolidation instrument has its advantages and disadvantages, but the possible trade-offs may be less stark when considering a broad package of different measures that contribute to both raising potential output and consolidating budgets. In practice, this means that budget-friendly structural reform and growth-friendly fiscal consolidation largely overlap.

Figure 11. Consolidation plans combine spending cuts with tax increases
Change in the underlying primary balance 2011–13, in per cent of potential GDP



Note: Total consolidation is the projected difference in the underlying primary balance; revenue side is the projected increase in the underlying receipts excluding interest earned on financial assets; and spending side is the projected decline in the underlying primary spending excluding interest payments on debt.

Source: OECD Economic Outlook 90 database; and OECD calculations.

Reforming disability, sickness and unemployment benefit schemes, along with old-age pension systems and *de facto* early retirement schemes, could contribute to immediately improving fiscal balances while boosting employment and thereby raising tax revenues in the longer term. Public spending efficiency is another key policy area where reforms could allow for reduced expenditure, while maintaining or even increasing outputs. In particular, improving the efficiency of education systems is the key policy objective in almost all OECD countries and improving health care sector efficiency could deliver even larger fiscal gains. Public subsidies, when not addressing market failures, distort resource allocation and hurt productivity.

On the revenue side, while difficult to quantify, tax expenditures have probably increased over time, notably in order to address market failures or income distribution concerns. In several countries, broadening tax bases by reducing tax

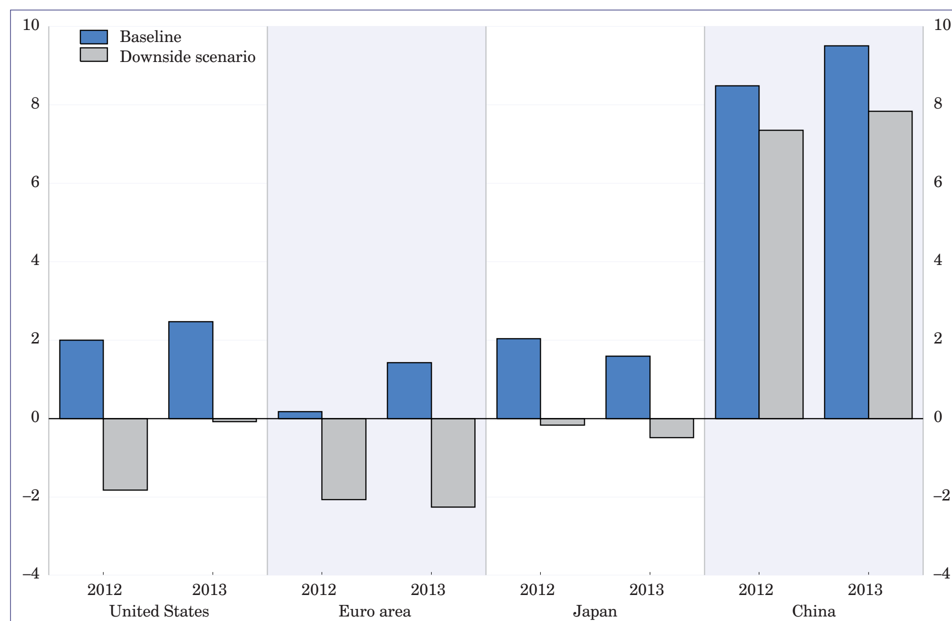
expenditures would enhance the efficiency of the tax system by enabling a reduction in tax rates and by cutting economic distortions and administrative compliance. Improving the effectiveness of tax administrations in tax collection and the fight against tax evasion is an important way to both enhance tax efficiency and reduce fiscal deficits, and the amounts of tax revenues involved can be significant. Even if the revenue is neutral, tax reforms can also make some indirect contribution to fiscal consolidation through their medium-term effects on income, productivity and tax receipts. For instance, cuts in labour tax wedges to offset increases in indirect taxes could have positive effects on employment and indirectly contribute to fiscal consolidation, as higher employment implies more tax revenues and less spending over the medium run. Finally, policies to tax public “bads”, such as pollution, could enhance welfare (though not GDP as conventionally measured) while assisting fiscal consolidation.

Financial market policy has a key role to play in restoring confidence by insisting on more solid capital bases of banks. For instance, in the euro area, the immediate concern is that accounting rules allow sovereign debt held in banking books to be valued at acquisition cost and not at market prices when they intend to hold these securities to maturity. This has opened a gap between market and accounting measures of these assets. There are also concerns that some banks outside the euro area have large exposures to vulnerable euro area countries and banks, especially through credit default swaps. To strengthen confidence in banking systems, the EU governments have announced plans to strengthen the core capital ratios of the major European banks. To avoid generalised undue bank deleveraging, regulators should insist that banks increase their capital levels rather than shrinking the assets. Where needed, this may have to involve public capital injections, preferably in the form of ordinary shares so as to give tax payers, not only in potential losses, but also potential upsides. Coordination at the EU level should be employed to avoid stigma effects and associated disruptive cross-border capital flight.

3. ALTERNATIVE SCENARIOS

The *OECD Economic Outlook* elaborates a number of downside risks associated with the sovereign debt crisis in the euro area and the fiscal stalemate in the United States which, if they came to a head would result in a deep recession in the United States, the euro area and – to a lesser extent – Japan, while emerging market economies such as China would also be adversely affected (Figure 12). In addition to the downside scenario, the *Outlook* also presents an upside scenario in which it is assumed that credible and decisive policy action is taken in the euro area while fiscal consolidation in the United States remains at a measured pace as in the baseline scenario (Figure 13).

Figure 12. Downside scenario
GDP growth, percent per annum



Source: OECD calculations.

3.1. The downside scenario

Intensified concerns about sovereign debt sustainability in larger euro area countries with high or rapidly rising debt, as well as the contagion to countries with relatively solid public finances, have the potential to escalate to massive economic disruption. This is the case of not only Italy, where long-term government bond yields have risen rapidly, but also of Spain and Belgium. The interaction between public finance and banking woes could result in self-reinforcing feed-back loops: banking problems requiring costly public interventions, which in turn would raise long-term interest rates with additional adverse effects on economic growth, banks, etc. If unchecked, such a development could lead to fears of sovereign and banking defaults. A deep euro area crisis would have significant adverse effects outside the euro area. Aside from the exposure of banks in the United States and Japan to Europe, equity markets in the two countries would be hit as their exports to Europe would fall, as would earnings of their subsidiaries in Europe. Falling risk appetite more generally would hit emerging market economies through large-scale capital outflows.

The *Economic Outlook* provides some illustrative estimates of the possible outcomes (incorporated in the Figure above), pointing to sharp falls in the growth rate of output in the OECD economies relative to the already relatively weak baseline projection of the order of 2–3% in 2012 and 2013, a decline in the level of world trade relative to the baseline of up to 9–10% by the end of 2013, and likely deflation in many OECD economies by 2013. This is based on an assumed deterioration in credit condition, corporate bond spreads and equity prices of the same order of magnitude as in the 2008–09 crisis. Moreover, long-term bond yields in this scenario are assumed to rise by 350 basis points in Italy, Spain and Belgium.

Though this is not quantified in the *Economic Outlook*, this downside scenario could be strongly accelerated and amplified if it was accompanied by one or several countries leaving the euro and re-establishing their own currencies – or even just expectations thereof. For instance, this could be prompted by the need to restore external competitiveness after large erosion since entry into the currency union. If everything came to a head, the political fall-out would be dramatic and pressure for the euro area exit could be intense. The establishment and likely exchange rate changes of the new national currencies could imply large losses for debt and asset holders, including banks that could become insolvent. Such turbulence in Europe, with the massive wealth destruction, bankruptcies and a collapse in confidence in the European integration and the cooperation it entails, would most likely result in a deep depression in both the exiting and remaining euro area countries as well as in the world economy.

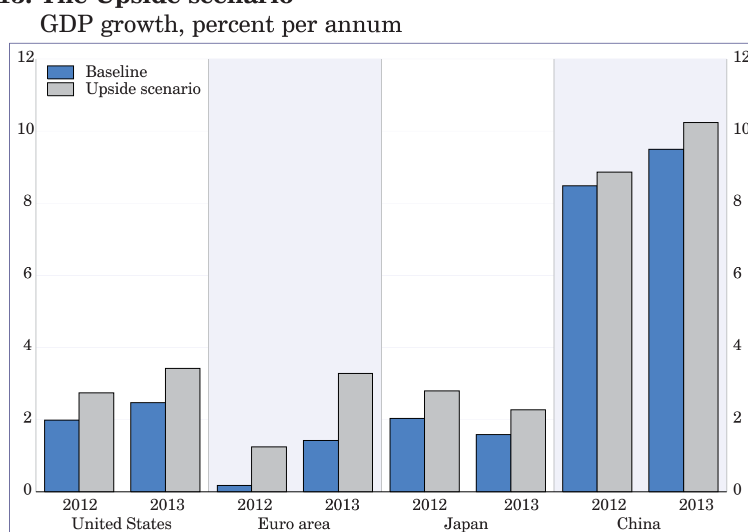
As discussed above, a second downside risk around the baseline projection stems from uncertainty about the likely path of fiscal policy in the United States. Existing legislation implies that in the absence of offsetting action there could be a fiscal tightening of, respectively, up to 2% and 3% of GDP in 2012 and 2013, when the extension of the 2001–03 tax cuts are set to expire and automatic expenditure cuts worth around 0.75% of GDP would kick in. This is a much stronger consolidation than assumed in the baseline projection. Model simulations of this additional fiscal tightening on the United States suggest that the US economy would move close to recession in 2012 and experience only weak growth in 2013, with the unemployment rate rising by over half a percentage point. There would be negative, but relatively mild, spillover effects elsewhere. If the additional fiscal consolidation in the United States were to also lead to a depreciation of the US dollar, then the effects on US activity would be muted and the effects on activity in other economies somewhat larger.

In the event that additional fiscal consolidation in the United States occurred in combination with the euro area downside scenario materialising, OECD GDP would be lower by around 6% after two years. Unemployment would rise sharply, by more than 2.5% in the United States and by over 2% in Europe. Deflation would likely be widespread.

3.2. The upside scenario

A successful blocking of contagion, the establishment of strengthened medium-term fiscal and structural policies in the euro area could offer significant near-term benefits for the economic outlook. In particular, there would likely be a marked reduction in the long-term government bond spreads in many euro area countries, as well as a more general improvement in financial conditions and restoration of confidence. An illustrative scenario (incorporated in Figure 13), assumes a reduction in euro area government bond yield spreads and the rapid reversal of the decline in financial conditions since August. The results suggest that OECD output growth would be 1.25–1.5 percentage points higher in 2013 than in the baseline projection, and considerably higher than would be the case if the downside scenario (both in the euro area and the United States) materialised.

Figure 13. The Upside scenario
GDP growth, percent per annum



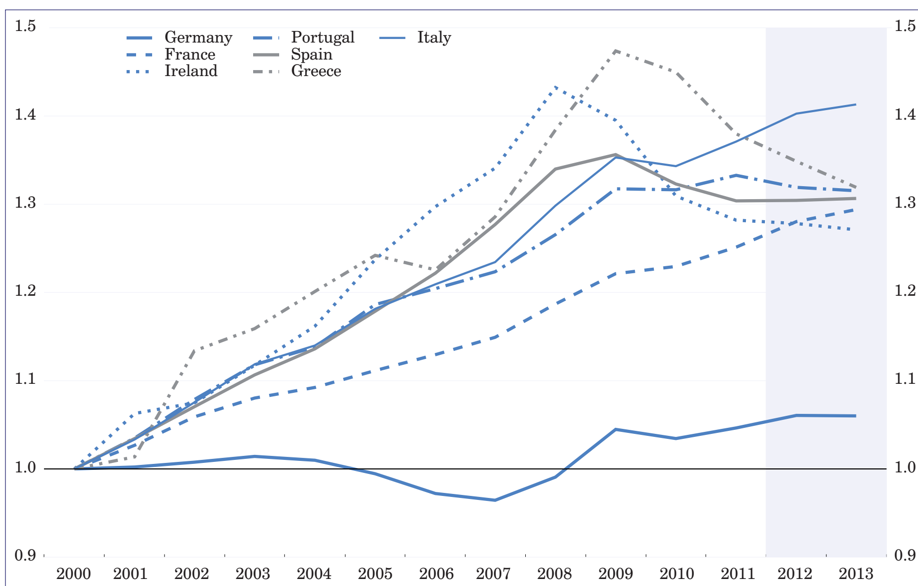
Note: Prerequisites for achieving the upside scenario:
The euro area:
The 26 October package must be implemented, including:
1. Stabilisation by means of leveraging reserves in the European Financial Stability Fund (EFSF).
2. A voluntary exchange of Greek sovereign bonds by private investors, with a nominal 50% discount.
3. Shoring up the banking sector through recapitalisation.
4. Be ready to provide guarantees for term liquidity to the banking sector if needed.
5. Overhaul of euro-area governance, combined with substantive structural reforms.

These measures need to be followed up at the next ECOFIN Council on 9 December.
The United States:
Efforts need to be redoubled to reach an agreement on a credible fiscal programme.
Source: *OECD calculations.*

What should be done to achieve this outcome? The firewall represented by the resources available for the EFSF and ESM have been signifcantly strengthened and ECB has intervened strongly to provide liquidity to the banking system in the euro area through the LTRO. At the same time as mobilising adequate resources, it is important to strengthen fiscal governance in the euro area to counter the potential moral hazard from intervening to block contagion. Possible, not mutually exclusive, options are: stronger enforcement of existing rules all the way to establishing a "fiscal compact; the creation of blue/red bonds; or establishing a framework for orderly sovereign debt default to discipline fiscal behaviour through the market".

Is this sufficient for achieving the upside scenario? Probably not. It is important to bear in mind that the present crisis has its origins in the build-up of economic imbalances among the euro area countries (Figure 14). Among the weaker economies' symptoms there are: weak competitiveness, loss of market shares and external deficits, low growth exacerbating fiscal imbalances through adverse debt dynamics and over-reliance on domestic demand to drive growth. Amongst the stronger economies, growth has been excessively reliant on exports, and domestic saving has exceeded domestic investment with surplus saving flowing to finance consumption, government spending and low-productive real estate development in the weaker economies.

Figure 14. Rebalancing in the euro area also requires unit labour cost adjustments
Unit labour costs, 2000 = 1



Source: *OECD Economic Outlook 90 Database.*

Against this backdrop, there is a need to not only establish sound fiscal policies, but also to ensure that private saving and investment decisions are based on sound incentives; ensure that cumulated competitiveness problems converge quickly; and ensure that growth is not held back by policy barriers. Structural reforms, including those associated with a stronger single market, are crucial for achieving rebalancing and for speeding up adjustment at the EU level. In addition, stronger growth spurred by structural reforms would help improve the debt dynamics, which is particularly urgent in the countries faced with serious credibility problems. In the financial sector, a truly unified banking system, where all regulatory and supervisory responsibilities are transferred to the euro area level, is essential to eliminate the return of adverse feedback loops.

4. THE OECD STRATEGIC RESPONSE

The OECD Strategic Response outlined in the *Economic Outlook* identifies country-specific policy actions that need to be implemented if the downside scenario discussed above materialises: the financial sector must be stabilised and the social safety net protected; further monetary policy easing should be undertaken; and fiscal support should be provided where it is practical and feasible. At the same time, stronger fiscal frameworks should be adopted to reassure markets that the public finances can be brought under control.

Beyond this, the Strategic Response identifies a wide range of structural measures which, though desirable in their own right, will become even more urgent. While priorities vary from country to country, such policies include the removal of barriers in product and labour markets that inhibit economic activity and employment. Appropriate labour market policies are needed to deal with the consequences of unemployment which is turning from cyclical to structural, thereby sapping potential growth, hitting confidence and undermining public finances. More specifically, the following country-specific reforms would become urgent:

- *Product market reforms*. Product market reforms targeted at increasing competition in general or network industries (e.g. France, Mexico and Turkey), professional services (Germany, France, Italy), and retail services (France) would spur growth and encourage innovation. Increased privatisation would also be appropriate (Italy and Poland). Further integration of national services markets in the European Union could provide a boost to demand and confidence. Outside the OECD area, product market reforms are called for in China and South Africa.
- *Trade, foreign investment and financial reforms*. Increased international openness would be appropriate in Japan and Korea, as well as in the Russian

Federation and India. Higher inward foreign direct investment could boost investment levels and increased trade openness in countries with buoyant activity should raise real incomes and support exports from countries with weaker activity. Rapid implementation of already decided financial reforms would become more urgent in the United States. Also, enhancing the possibility of refinancing mortgage loans at a low rate could be a particularly effective device.

- *Labour market reforms*. Labour market reforms can raise long-term sustainable employment levels and provide fiscal room for manoeuvre while also easing adjustment; therefore they become more urgent in a crisis. Such reforms are warranted in around half of all OECD countries (including Italy, United Kingdom, Canada, Belgium, Estonia, Ireland, Portugal, Slovenia, Spain, Sweden and Turkey) and outside the OECD area, in Indonesia and South Africa.
- *Public sector reforms*. Increasing the drive for public sector efficiency, including in the United Kingdom (notably in the NHS) and New Zealand, could help to generate increased space for fiscal manoeuvre in the near term. Pension, early-retirement and disability/sickness reforms would be called for in several countries (including Belgium, Denmark, Finland, Norway, the Slovak Republic and Slovenia) to reduce the future public costs of population ageing and increase confidence in the future strength of public finances. Revenue-neutral tax reform aimed at reducing taxes on labour and corporate incomes and increasing indirect taxes and other (*e.g.* green) taxes could stimulate growth in Japan, Germany, France and Canada. Outside the OECD area, tax reform would be particularly urgent in Brazil.

5. CONCLUDING REMARKS

The world economy is at a critical juncture and it could take different paths going forward. The projections presented in the *Economic Outlook* portray a scenario that rests on the assumptions that monetary policy remains very supportive (and, in some places, becomes more so), that sovereign debt and banking sector problems in the euro area are contained and that excessive fiscal tightening will be avoided. From the second half of 2012, confidence is assumed to recover gradually as it becomes clearer that worst-case outcomes have been avoided.

Alternative scenarios are possible, and may be even more likely than the baseline. A downside scenario would be characterised by materialisation of negative risks and the absence of adequate policy action to deal with them. An upside scenario could arise if policy action were successful in boosting confidence and no significant negative events occurred. In the downside scenario, the implications of a major negative event in the euro area will depend on the channels at work and their

virulence. The results could range from relatively benign to highly devastating outcomes. A large negative event would, however, most likely send the OECD area as a whole into recession, with marked declines in activity in the United States and Japan, and prolong and deepen the recession in the euro area. Unemployment would rise even further. The emerging market economies would not be immune, with global trade volumes falling strongly, and the value of their international asset holdings being hit by weaker financial asset prices.

What would be required for an upside scenario to materialise? A credible commitment by euro area governments that contagion would be blocked, backed by clearly adequate resources. To eliminate contagion risks, banks will have to be well capitalised. Decisive policies and the appropriate institutional responses will have to be put in place to ensure smooth financing at reasonable interest rates for sovereigns. The increases in the capacity of the EFSF and the anticipation of the lauch of the ESM together with, more decisive action by the ECB to support the banking systems in the euro area have significantly increased the effectiveness of the firewall. Such forceful policy action, complemented by appropriate governance reform to offset moral hazard, could result in a significant boost to growth in the euro area and the global economy.

An upside scenario also requires substantial and credible commitment at the country level, in both advanced and emerging market economies, to pursue a sustainable structural adjustment to raise long-term growth rates and promote global rebalancing. In Europe, such policies are also needed to make progress in resolving the underlying structural imbalances that lie at the heart of the euro area crisis. Deep structural reforms will be instrumental in strengthening the adjustment mechanisms in labour and product markets that, together with a robust repair of the financial system, are essential for the good functioning of the monetary union. By raising confidence, lowering uncertainty and removing impediments to economic activity, rapid implementation of such reforms could raise consumption, investment and employment.

If combined, stronger macroeconomic and structural policies might raise OECD output growth by as early as 2013. The largest benefits would be felt in the euro area, though these could take some time to emerge. Stronger activity and trade, and the consequent rise in asset values in the OECD economies, should boost activity in the emerging market economies as well.

In view of the persisting great uncertainty policy makers confront, they must be prepared to face the worst. The OECD Strategic Response identifies country-specific policy actions that need to be implemented if the downside scenario materialises: the financial sector must be stabilised and the social safety net protected; further monetary policy easing should be undertaken; and fiscal support should be provided where it is practical. At the same time, stronger fiscal frameworks should be adopted to reassure markets that the public finances can be

brought under control. Beyond this, a wide range of structural measures, which are desirable in their own right, will become urgent. While priorities vary from country to country, such policies include the removal of barriers in product and labour markets that inhibit economic activity and employment. Appropriate labour market policies are needed to deal with the consequences of unemployment which is turning from cyclical to structural, thereby sapping potential growth, hitting confidence and undermining public finances.

The difference between the upside and the downside scenarios reflects the impact of credible, confidence building policy action. Such action, as we have seen, requires measures to be implemented at the euro area level as well as at the country level throughout the OECD, especially in the structural policy domain. In the case of a downside scenario, policy action would clearly be needed to avoid the worst outcomes. But then the question arises of why policy efforts are not taken to deliver the upside scenario even if the worst case does not materialise. Why, in other words, should we settle for less?