The Road to Economic Recovery: Clearing Skies, Bumps Ahead

By Nicholas Bray, European Correspondent

The outlook for the world economy is gradually brightening. But it is going to be an uneven recovery, with some countries emerging from recession faster than others and many still needing to address major structural weaknesses. A report from the OECD.

“Growth is coming back,” says **Pier Carlo Padoan**, deputy secretary general and chief economist of the Organisation for Economic Cooperation and Development (OECD) in an interview with INSEAD Knowledge at the OECD’s Ministerial Forum in Paris in May. “But it is coming back at different speeds.”

The U.S., in particular, is enjoying an industrial renaissance fuelled by shale gas, cheap natural gas produced through a controversial technology known as fracking. Japan is benefiting from major macroeconomic stimulus measures. Developing countries have mostly recovered from the crisis, according to the World Bank, effectively leaving only Europe mired in recession.

Echoing the OECD, the World Bank's June 2013 Global Economic Prospects hailed a global economy "transitioning into what is likely to be a smoother and less volatile period." Global gross domestic product (GDP), it predicted, would grow by 2.2 percent this year and 3 percent in 2014.

Increased productivity

U.S. exporters are becoming more competitive. Unit labour costs fell by 0.9 percent in the U.S. in the first quarter of 2013, according to OECD figures, boosted by increased productivity. And unemployment is falling. In just over three years, **Alan B. Krueger**, the chairman of President Barack Obama's Council of Economic Advisers, told INSEAD Knowledge, the U.S. economy has added more than 6.8 million private sector jobs.

In Canada, meanwhile, Royal Bank of Canada economists have raised their growth forecasts for 2013 to 1.9 percent, from 1.8 percent forecast in March, citing improving trade prospects and the strength of corporate balance sheets. In Britain, growth forecasts are edging up, with small businesses, in particular, showing greater confidence. And in Germany, hopes for an upswing were bolstered in June by an unexpected decline in unemployment, contradicting market expectations of an increase.

The China conundrum

For the moment, nonetheless, there still are doubts about how strong and how fast the global recovery will be.

Uncertainties are fuelled by doubts about the pace of economic growth in China. In the first quarter of 2013, Chinese GDP grew by 7.7 percent, still high compared with other major economies, but below market forecasts of 8 percent.

The Chinese government, Padoan notes, has embarked on a major structural reform agenda to shift the composition of domestic demand more towards private consumption and away from investment. This shift, though welcome in terms of economic policy management, will require careful orchestration.

In the meantime, weakening Chinese trade figures are adding to analysts' concerns about prospects for growth internationally. In May, Chinese exports grew by only 1 percent, against market expectations of 7.3 percent, while imports fell by 0.3 percent, compared with expected growth of 6 percent. In June, the HSBC China Purchasing Managers' Index, based on data from purchasing executives in more than 420 manufacturing companies, fell for the second month in a row, signalling a further slowdown.

Paralleling such data, there are signals in the U.S. that the OECD's May predictions of 1.9 percent growth in U.S. GDP this year, rising to 2.8 percent in 2014, may turn out to be too rosy. The U.S Commerce Department's Bureau of Economic Analysis recently cut its first quarter estimate for the U.S. growth to 1.8 percent from 2.4 percent, reflecting lower-than-expected private consumption. Adding to the uncertainties, the MNI Chicago Report's June business barometer surprised analysts by dropping more than seven points from May, hinting that U.S. business is being hit harder than expected by fiscal constraints and stagnant export markets. And the Federal Reserve has signalled that it may soon start pulling back on its easy money policy, heralding a possible rise in interest rates.

European Woes?

Europe, meanwhile, is still largely stuck in the doldrums, with growth being held back by low confidence and continued banking-sector and fiscal restructuring.

In the automobile sector, according to **Jean-Dominique Senard**, CEO of French tyre manufacturer Michelin, "only Europe is really in crisis." An ongoing drum roll of gloomy economic news continues.

In Italy, the employers' federation, Confindustria, recently forecast a decline in GDP this year of 1.9 percent, steeper than the 1.1 percent fall it predicted last December. France, meanwhile, has revealed that it is back in recession with a 0.2 percent drop in its first quarter GDP on top of a similar 0.2 percent contraction in the last quarter of 2012. Ireland recently reported a 0.6 percent decline in its first quarter GDP, after a 0.2 percent fall in the final three months of 2012, weighed down by lower consumer spending and exports amid unemployment of close to 14 percent. And Portugal has been plunged into political turmoil by public rejection of searing austerity measures imposed as part of a package to pull it out of a debt crisis.

Worryingly, too, average unit labour costs in the 17-nation euro area rose by 0.6 percent in the first quarter, pushed up by higher wages in a trend that threatens to further reduce Europe’s competitiveness. Overall, according to OECD predictions, GDP in the euro area is likely to shrink by a further 0.6 percent this year, before recovering to modest growth of 1.1 percent in 2014.

The conditions for revival

No prizes for guessing why these countries are doing so poorly. In general, remarks Padoan, the performances of individual countries reflect how well or badly each has handled funding shortfalls in their banking sectors and how far each has developed or failed to develop a long-term strategy for recovery. Many European countries are lagging in both respects. Until they address these twin challenges, Padoan says he sees little hope for a revival in business and consumer confidence.

“The private sector will begin to believe in a sustainable growth environment once it is convinced that the policy makers have the situation more or less under control,” he says. “Some countries have a clear long-term strategy. Others are still struggling to get it on board.”

So where should investors – and governments – focus their attention in the quest for stronger growth?

In an effort to draw lessons from the crisis, the OECD has launched a far-reaching review of ‘New Approaches to Economic Challenges’. One key conclusion, comments Padoan, is that governments cannot solely look for growth without taking account of the impacts of policies in other areas.

“If you have a policy which enhances growth, for instance by injecting more competition in product markets, then you have more growth but (also) consequences for inequality, for the distribution of wealth, for pressure on resources. You have to take on board all these dimensions.”

Pushing the frontier

In Europe, he urges further integration through measures to boost the European single market, for example in services. More widely, he calls on governments to press ahead with necessary structural adjustments, an area in which he singles out Germany for particular praise. “One of the reasons why Germany, despite the crisis, is doing so well is that they implemented reforms before the crisis,” he points out.

Above all, however, Padoan and others say, innovation and investments in knowledge-based capital hold the key to future growth.

“Emerging economies grow because they catch up with the frontier, and this is why they grow more,” says Padoan. “But countries on the frontier have to push the frontier, and we know how that happens: innovation, knowledge-based capital and structural measures to make markets work better.”

The U.S. is a prime example. In interviews with INSEAD Knowledge, both Krueger and **Robert D. Hormats**, U.S. under secretary for economic growth, energy and the environment, stress the importance of shale gas as a demonstration of successful collaboration between government and the private sector.

From 60 percent dependence on imported oil five years ago, the U.S. is now down to 40 percent, thanks to a combination of increased supplies of home-produced oil and gas and effective energy savings, says Hormats. Shale gas, he predicts, “will continue to be an important part of American economic recovery.”

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