



What is the economic outlook for OECD countries?

An interim assessment

**Paris, 8 September 2011
11h00 Paris time**

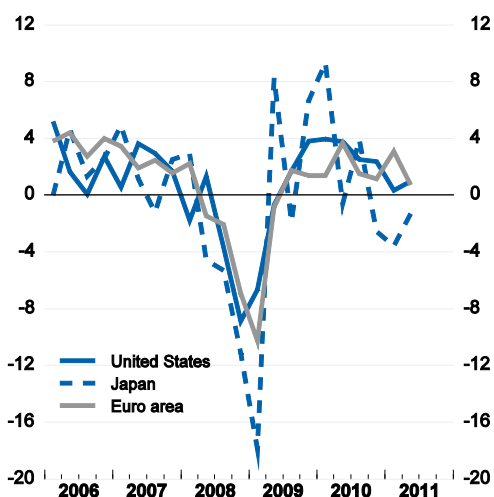
**Pier Carlo Padoan
OECD Chief Economist and Deputy Secretary-General**

Activity has come close to stagnation

- The recovery almost came to a halt in the second quarter in many OECD economies. And downward revisions to earlier published data point to weaker underlying activity economic than had previously been thought.
- Compared with the May *Economic Outlook* growth turned out weaker in the first half of the year both in the United States and the euro area.
- In Japan growth was less negative in the immediate aftermath of the March disaster than projected in the *Economic Outlook* (a second quarter update is scheduled for 9 September).
- Growth in China eased in the course of the first half of the year and manufacturing production has weakened.

Growth has decelerated in major OECD economies

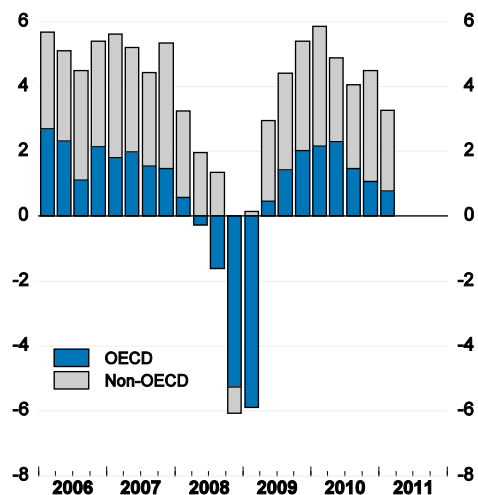
Quarterly growth of real GDP, annualised, in per cent



Source: OECD, Quarterly National Accounts database.

Non-OECD countries are also slowing

Contributions to quarterly world GDP growth, annualised, in per cent



Note: Calculated using moving nominal GDP weights, based on national GDP at purchasing power parities.
Source: OECD, Quarterly National Accounts database; and national sources.

Global trade has weakened, global imbalances persist

- World trade stagnated in the second quarter, only partly due to disruptions in supply chains after the March 2011 disaster in Japan. Export orders and costs of container shipment have declined.
- Current account imbalances remain large. The Chinese trade surplus has been widening recently with the effective exchange rate broadly stable. Oil exporting countries again post increases in their external surpluses on the back of high oil prices.

World trade is flat

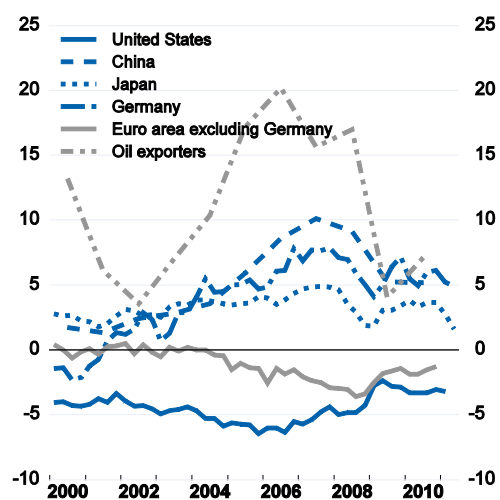
CPB indicator of world trade, 2000 = 100



Source: CPB.

Imbalances remain pronounced

Current account balances, in per cent of GDP



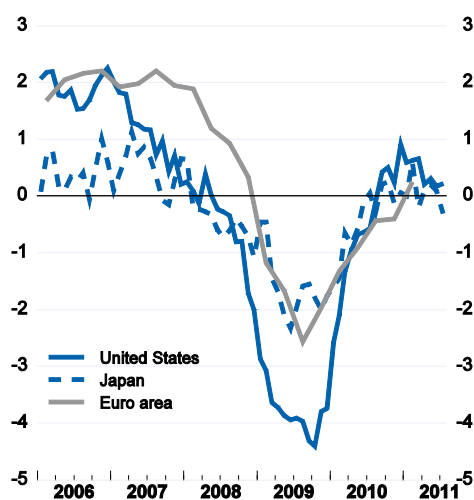
Note: China and oil exporters based on annual data.
Source: OECD, Quarterly National Accounts database; and OECD, System of National Accounts database.

Improvements in labour markets are fading

- Hiring intentions have been softening over the summer. In Japan employment was adversely affected by the March 2011 disaster.
- High long-term unemployment and weak unemployment outflow rates in some economies point to a risk of high unemployment becoming entrenched. Reforms of structural labour market policies are required to prevent “cyclical” unemployment from becoming structural.

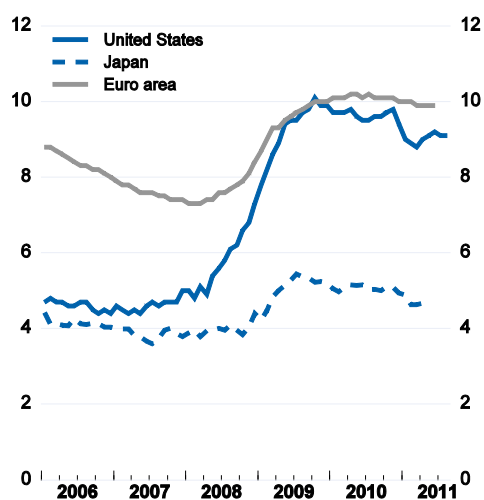
Employment growth has weakened

Over 12 months, in per cent



Unemployment remains very high

Rate, in per cent of labour force

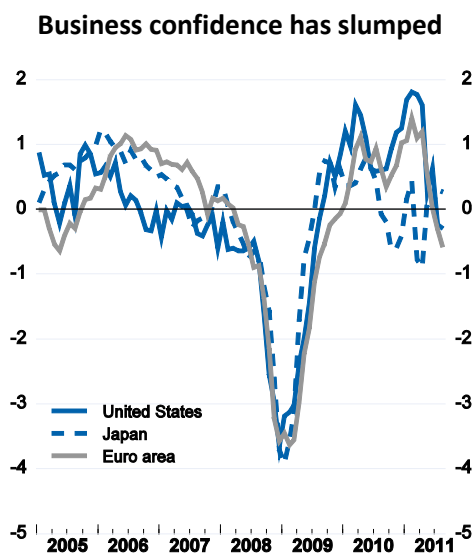


Note: Euro area based on quarterly series. For Japan since March 2011 excludes the Tohoku area
Source: OECD Main Economic Indicators, and Eurostat.

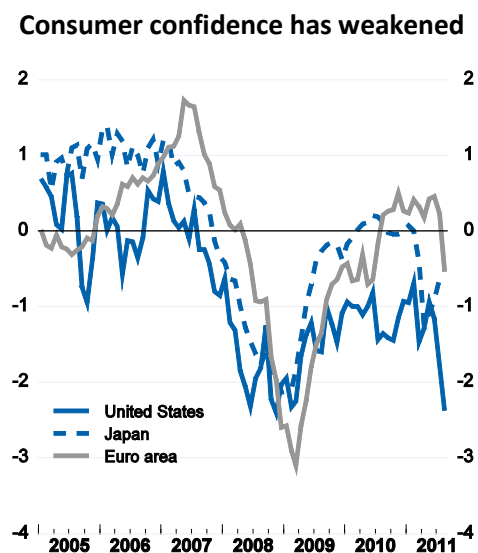
Source: OECD Main Economic Indicators, and Eurostat.

Confidence has weakened

- Consumer and business confidence fell in major OECD economies on the back of weak incoming data, gridlock over fiscal policy in United States, the euro area sovereign debt crisis and growing concern that there is less policy ammunition to offset further weakness.



Note: Normalised at period average and presented in units of standard deviation.
Source: Surveys of manufacturing enterprises. United States: ISM; Japan: Bank of Japan Statistics Bureau; Euro area: European Commission.

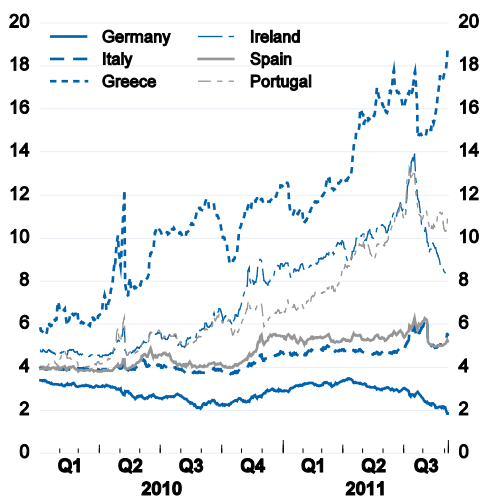


Note: Normalised at period average and presented in units of standard deviation.
Source: OECD Main Economic Indicators.

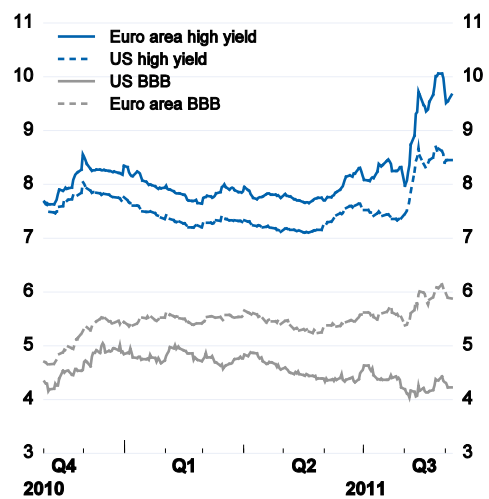
Risk perception changed

- Some elements of financial conditions have clearly deteriorated whereas others have improved, with the net balance somewhat different across countries.
- Heightened risk aversion in financial markets is reflected in wide sovereign risk spreads in the euro area, tumbling share prices and increasing yields on higher-risk corporate bonds, but not yet in tighter lending conditions.
- The fall in long-term government bond yields in some countries, reflecting a flight to safety and a belief that monetary policy will stay accommodative for a longer period, may provide an offset.

Euro area sovereign bond yields continue to diverge
In per cent



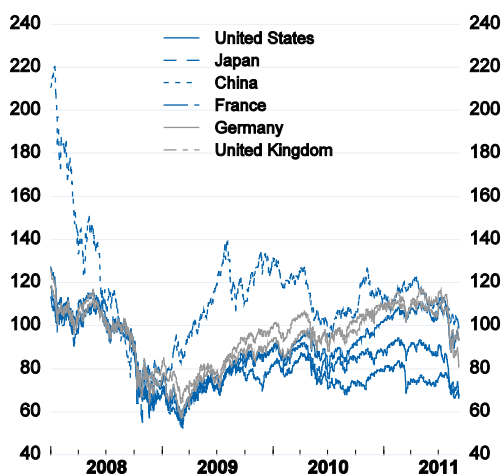
Corporate bond yields reflect rising risk
Percentage points



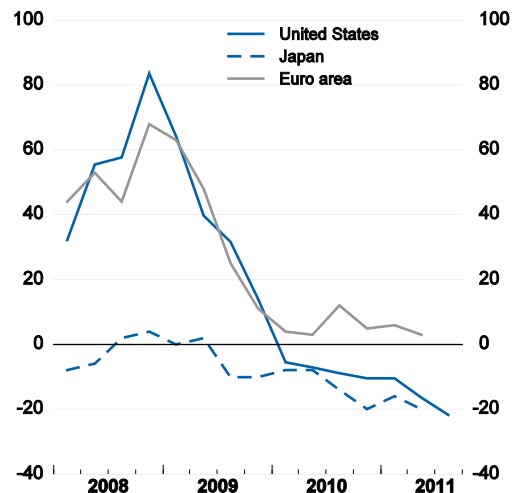
Source: Datastream.

Note: Spreads relative government bond yield – 10 year for high yield, and same maturities for average 5-7 and 7-10 years BBBs.
Source: OECD Main Economic Indicators.

Equity prices have tumbled
August 2008 = 100



Bank lending attitudes to business continue to loosen in the United States and Japan
Percentage points



Note: Net percentage of banks tightening credit to large and

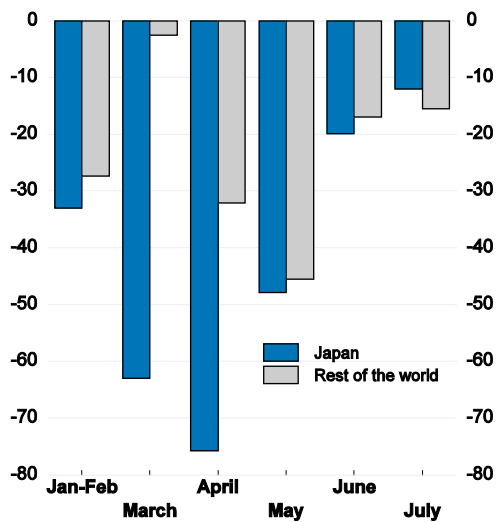
Note: Wilshire 5000; Nikkei 225; FTSE Eurotop 100;
FTSE 100; Shanghai Composite Index. *Source:* Datastream.

medium sized business. *Source:* Federal Reserve, Bank of
Japan and ECB.

Other factors shaping the near-term outlook

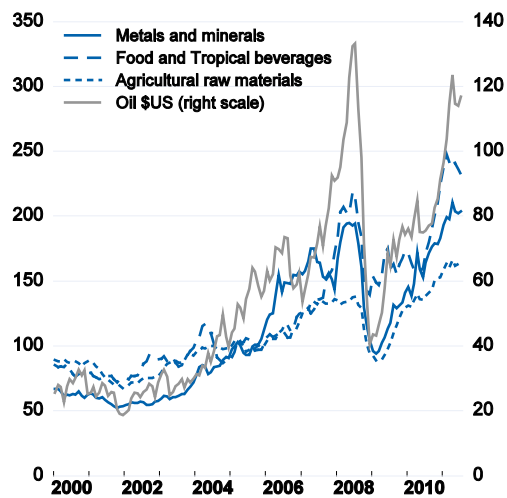
- The disruption in global supply chains in the aftermath of the March 2011 disaster in Japan has been larger than expected (not least for motor vehicles). The restoration of supply chains should boost growth in the remainder of this year.
- Commodity prices have risen to historical highs which could further affect household consumption in the second half of the year.
- Balance sheet restructuring among households and businesses has possibly progressed more rapidly than expected, which can be a harbinger for stronger private demand in the second half of this year.

Slowdown in car production coming to an end 12-month % change, number of units produced



Source: Toyota Motor corporation and Honda Motor Co. Ltd monthly report.

Commodity prices seem to have peaked Index 2005 = 100, US\$ per barrel (Brent)



Source: OECD Main Economic Indicators; and Datastream.

Growth likely to stay weak in second half of year

- OECD GDP indicator models project quarterly growth in G7 economies excluding Japan to remain less than 1% (annualised) on average in the second half of this year.
- The United States is set to grow in the range of ½-1%. Growth in Japan is expected to be buoyed by reconstruction, though its effect on growth is expected to fade in the final quarter. Germany and Italy are projected to post one quarter of negative growth.
- The impact of the sovereign debt woes in Europe and the United States and the associated turbulence in stock markets over the summer have not yet fully fed through into the indicators underpinning the projections.
- Uncertainty surrounding these projections is high (see page 10).
- The risk of more negative growth going forward has become higher in some major OECD economies, but a downturn of the magnitude of 2008/09 is not foreseen.

GDP growth in the G7 economies

Annualised quarter-on-quarter growth, in per cent¹

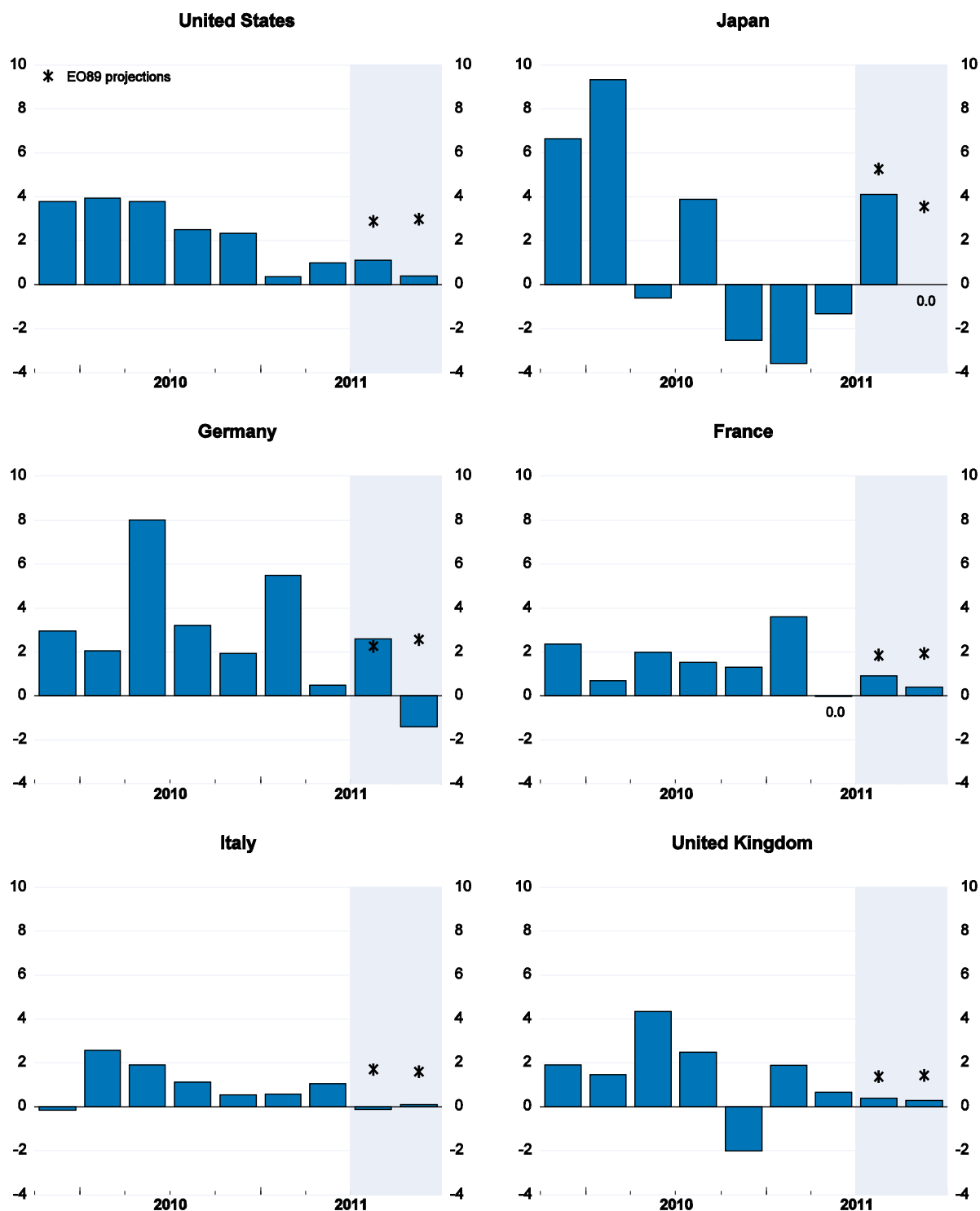
	10Q3	10Q4	11Q1	11Q2	11Q3	11Q4
United States	2.5	2.3	0.4	1.0	1.1 (+/-1.7)	0.4 (+/-1.5)
Japan	3.9	-2.5	-3.6	-1.3	4.1 (+/-2.5)	0.0 (+/-2.7)
Euro 3 ²	2.2	1.4	3.7	0.5	1.4 (+/-1.7)	-0.4 (+/-1.7)
Germany	3.2	1.9	5.5	0.5	2.6 (+/-2.2)	-1.4 (+/-2.1)
France	1.5	1.3	3.6	0.0	0.9 (+/-1.1)	0.4 (+/-1.2)
Italy	1.1	0.6	0.6	1.0	-0.1 (+/-1.4)	0.1 (+/-1.6)
UK	2.5	-2.0	1.9	0.7	0.4 (+/-1.2)	0.3 (+/-1.3)
Canada	2.5	3.1	3.6	-0.4	1.0 (+/-1.6)	1.9 (+/-2.0)
G7	2.6	1.0	0.8	0.4	1.6 (+/-1.7)	0.2 (+/-1.8)
G7 excluding Japan	2.4	1.7	1.6	0.7	1.1 (+/-1.5)	0.2 (+/-1.6)

1. GDP releases and high-frequency indicators published by 7 September 2011. Seasonally and in some cases also working-day adjusted. Annualised real GDP growth rates; associated standards error ranges are in parentheses. The confidence bands around the growth projections shown in the table are based on the historical period up to 2007. Uncertainty since the onset of the financial crisis has been higher (see page 10 of this handout).

2. Weighted average of the three largest countries in the euro area (Germany, France and Italy).

Note: See Appendix for underpinnings and status of the interim forecast.

Recent weakness is expected to continue for the next two quarters in most major OECD economies
 Annualised quarter-on-quarter real GDP growth, in per cent



Note: EO89 projections refers to OECD Economic Outlook No. 89 projections (published in May 2011).

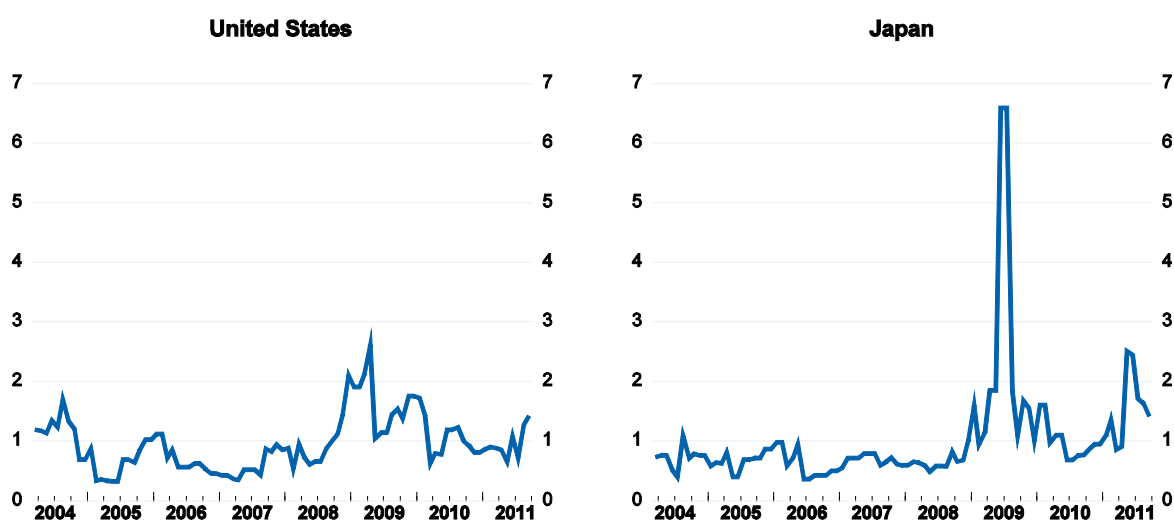
Source: OECD, Quarterly National Accounts database; OECD Economic Outlook 89 database; and OECD Indicator Model forecasts.

Uncertainty around projections unusually large

- Since the onset of the financial crisis, errors in the forecasts presented at the Interim press conferences have been larger than implied by the estimated average error range pre-crisis. In times of high uncertainty, as presently is the case, the average revision from successive updates of the indicator model projections tend to be larger.
- Uncertainty is currently particularly high for Japan (which reflects the difficulty in assessing the impact of the March 2011 disaster) and the United States.

Uncertainty around the forecasts is higher in some economies

Normalised index



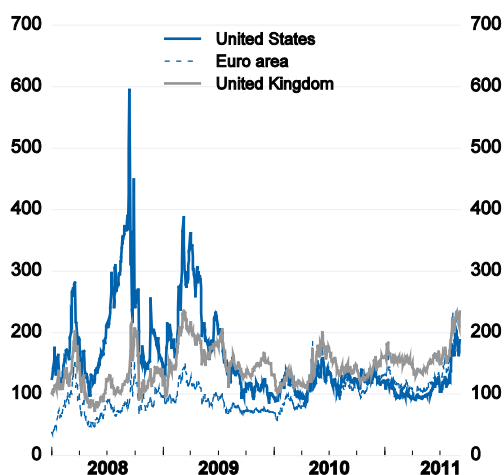
Note: The measure of uncertainty is based on the dispersion of projections from a range of models used by the OECD to predict short-term movements in GDP and it has been normalised so that 1.0 is equal to the historical average over the period 2004-2011. See Appendix for further details.

Multiple sources of risk

- Levels of residential construction, business investment and durables consumption are low. Hence, destocking or disinvestment are unlikely sources of further weakness.
- The unwinding of temporary factors that damped growth in Germany (shutdown of nuclear plants) and France (effects from car scrapping phase-out) in the second quarter may prompt a sharper than projected rebound in activity in the third quarter.
- Federal budget outcomes have been better than expected so far this year in United States. More generally, stronger fiscal consolidation may have been exerting more drag on activity than anticipated, and it is unclear what repercussions this might have for demand in the near term.
- The recent decline in oil and other commodity prices has been less than expected on the basis of historical relationships with global demand, adding uncertainty as to how these prices might behave in the near term.
- A sharp widening in the sovereign yield spreads of Italy and Spain in August prompted the European Central Bank to intervene heavily in government bond markets. The sovereign debt crisis in the euro area could intensify again.
- Renewed concerns over balance sheet of banks, reflected in CDSs and money market spreads, point to possible further tightening of financial conditions. If money markets freeze up, growth may be adversely affected.

Higher risk in the banking sector

Bank credit default swap rates, basis points



Note: Banking sector 5-year credit default swaps.
Source: Datastream.

And in money markets

Money market spreads, basis points

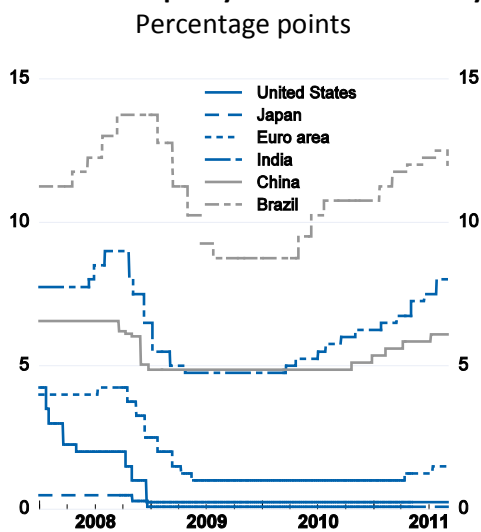


Note: Spread between 3-month EURIBOR and EONIA swap index for euro area.
Source: Datastream.

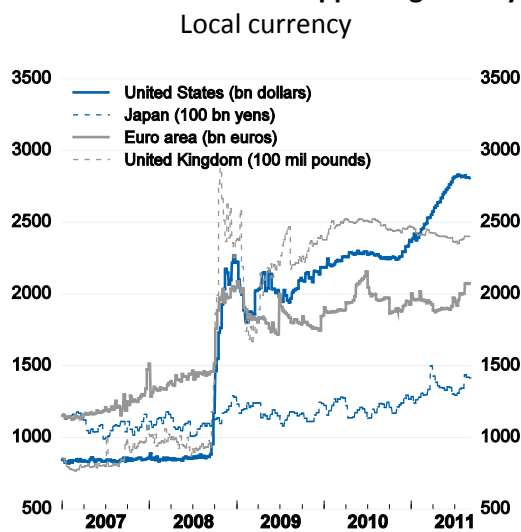
Requirements for monetary policy

- Policy rates in most OECD economies should be kept on hold. If in the coming months signs emerge of the weakness enduring or the economy risks relapsing in recession, rates should be lowered where there is scope.
- Where there is not such scope, other measures could include further central bank interventions in securities markets (even if at diminishing returns) and strong commitments to keep interest rates low over an extended period.
- Emerging market economies should withdraw monetary tightening if inflation is moving towards target. They should allow appreciation of effective exchange rates in cases where inflation is still high and the trade balance is widening.

Central bank policy rates reflect activity

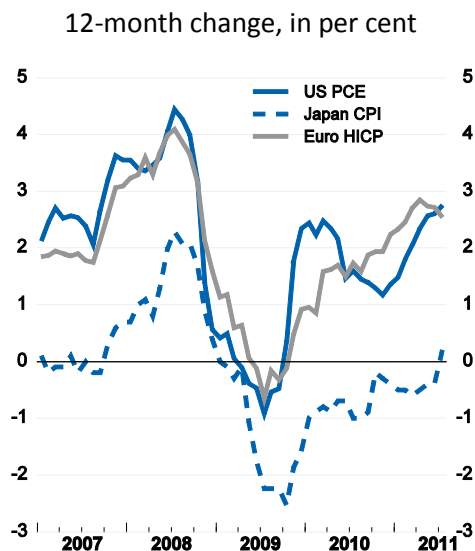


Central bank liabilities supporting activity



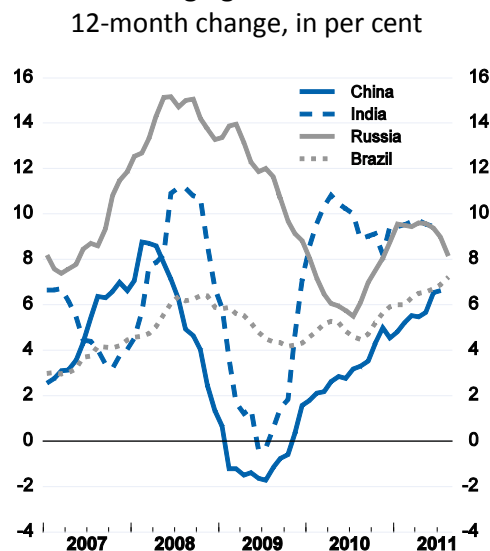
Note: Last observation is 6 September 2011. Source: Federal Reserve; Bank of Japan; European Central Bank; and BoE.

Rebound in headline inflation in major OECD economies



Source: OECD Main Economic Indicators.

Headline inflation possibly peaking in emerging economies



Note: Consumer price indices, except in India, where the

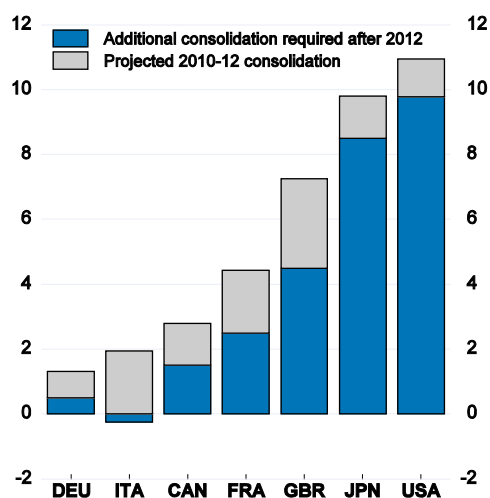
wholesale price index is used. *Source:* OECD, Quarterly National Accounts database; and national sources.

Requirements for fiscal and structural policy

- The space for fiscal policy to react depends on the state of public finances, the ease at which government debt can be funded, the underlying strength of the economy and the presence of credible medium-term frameworks so as to not undermine confidence.
- If there are prospects for a long-lasting slowdown in activity, countries that have, or put in place, credible fiscal frameworks are in a better position to react and should do so. Countries with limited fiscal space have restricted scope for fiscal easing and some have to tighten amid cyclical weakness.
- Growth-friendly structural reforms should be adopted as these favourably affect public revenues, primary expenditures and debt dynamics, while reducing government borrowing costs via confidence effects. A proper mix of consolidation instruments, including an increase in the pensionable age (raising life-time earnings), can limit adverse effects on, or even stimulate, demand in the short run.
- A first step to address the euro-area debt crisis is to implement the euro-area framework decided on 21 July this year. But to stop contagion and restore confidence, the governance of the euro area must be improved and the capitalisation of banks strengthened in view of their exposure to fiscally distressed euro-area countries.

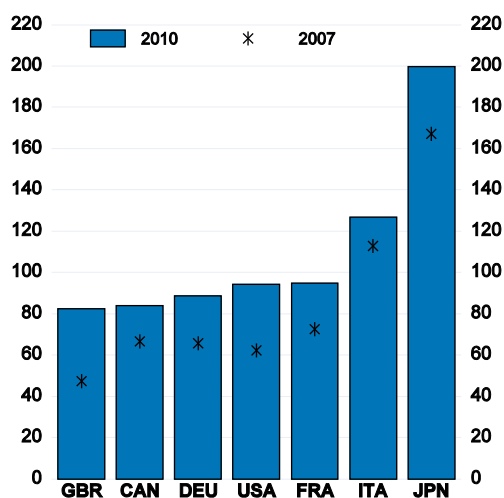
Fiscal consolidation required is large in many countries

Improvement in underlying primary balances, percentage points of GDP



Note: Consolidation through 2011 and 2012 as projected in Economic Outlook 89; consolidation after 2012 assumed to be an additional ½ percentage points of GDP each year until the debt-to-GDP ratio stabilises. Source: OECD Economic Outlook 89 database, OECD calculations.

Gross government debt climbed through the recession In per cent of GDP



Note: Data for 2010 for Japan are OECD Economic Outlook 89 projections (published in May 2011). Source: OECD, System of National Accounts database; and OECD Economic Outlook 88 database.

Appendix

Underpinnings and status of the interim forecast

Since March 2003, the OECD has presented a brief overview of the near-term prospects in the major OECD economies between each issue of the *Economic Outlook*. This interim assessment should not be seen as a full update of the biannual *Economic Outlook* projections, since it rests on a more limited information set, has a shorter horizon and covers a much smaller number of economic variables and countries. However, it helps evaluate the extent to which the latest *Economic Outlook* projections are still on track for the larger economies.

In this context, the main tool is a suite of indicator-based models that serve to forecast real GDP for each of the G7 economies.* These models cover the two quarters following the last one for which official data have been published. They use a small, country-specific selection of monthly indicators, hard (*e.g.* industrial production, retail sales) and/or soft (*e.g.* business confidence). These models have been shown to outperform a range of other models relying solely on published quarterly data, as regards both forecast-error size and directional accuracy. The weight of the different models varies across countries and over time, according to observed forecasting performance. The models used for the US and the UK economies have been modified to better capture the influence of developments in the housing sector, with the inclusion of various forward-looking housing indicators.

Details of the calculation of the uncertainty index

The indicator of uncertainty relies on a suite of models including three bridge models as well as several VAR models* and represents the dispersion of the forecasts produced by this set of models. The intuition behind this indicator is that when monthly indicators are moving in different directions or fluctuate a lot, giving contradictory signals, they will result in more diverse forecasts than under more normal conditions and the dispersion of these forecasts can be used as an indicator of uncertainty around the model projections. Each series has been rescaled by dividing by its historical mean over the period 2004-2011 so that a value of 1 indicates that it is equal to the historical average. When this uncertainty is high, the revisions from successive updates of the indicator model projections tend to be significantly larger than when uncertainty is low.

* See Pain, N. and F. Sédillot, "Indicator models of real GDP growth in the major OECD economies", *OECD Economic Studies*, No. 40, 2005 and Mourougane, A., "Forecasting monthly GDP for Canada", *OECD Economics Department Working Paper*, No. 515, 2006.