What is the economic outlook for OECD countries? An interim assessment

Paris, 3rd September 2009
11h00 Paris time

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1.   Economic news has been mostly favourable over the past few months:

- Falls in the cost of money market funding, a narrowing of corporate bond spreads, a rebound in equity markets and a moderation in the tightening of bank lending standards have contributed to a marked improvement in overall financial conditions. Nonetheless, bank lending continues to decline and concerns about the health of the banking system remain.

- The housing markets in the United Kingdom and the United States show some signs of stabilisation, both as regards prices and turnover.

- The inventory adjustment underway since the beginning of the year appears to have progressed to a point where inventory changes may no longer be a drag on growth and could add to it in the near term. Similarly, global trade appears to have reached a trough and is poised to accelerate as the economic recovery gathers strength and broadens in scope.

- In the large emerging-market economies, which were not directly concerned by the meltdown in financial markets, the recovery in economic activity that began earlier this year is gaining momentum. Notably in China, GDP is estimated to have risen by over 14 per cent (saar) in the second quarter and activity continues to pick up, supported by the substantial fiscal stimulus and rapid increases in bank lending. GDP growth in other Asian emerging-market economies has also strongly rebounded, partly in response to policy stimulus.

2.   Given the positive economic news and based on incoming high-frequency indicators, OECD short-term forecasting models point to an earlier recovery than envisaged a few months ago (see table opposite). As a consequence, the unprecedented rate of deterioration in labour market conditions witnessed over the past year should ease. Nonetheless, numerous headwinds imply that the pace of the recovery is likely to be modest for some time to come. Ample spare capacity, low levels of profitability, high and rising unemployment, anaemic growth in labour income and ongoing housing market corrections will moderate any uptick in private demand. At the same time, the need remains for households, businesses, financial institutions and governments to repair the damage to their balance sheets.

3.   Substantial spare capacity and the collapse in commodity prices until mid-year have led to negative or zero headline inflation in all major economies. Increased economic slack has also damped somewhat measures of underlying inflation and will continue to act as a brake on inflation. Nonetheless, since inflation expectations remain well anchored and given the recent rebound in commodity prices, the risk of sustained deflation appears to be small outside Japan.

4.   Substantial slack combined with the prospect for a weak recovery, implies that strong policy stimulus will continue to be needed in the near term. Regarding monetary policy, taking the first steps towards normalisation of policy interest rates from their current exceptionally low levels should in most cases and on current prospects wait until well into 2010 and in some cases even beyond. It is also important that central banks communicate their intentions explicitly, if conditionally, so as to affect interest rates at longer maturities more effectively. On fiscal policy, it is important that announced stimulus measures be implemented promptly. However, the possibility of a recovery taking hold a little sooner than envisaged only a few months ago diminishes the likelihood that further fiscal stimulus will be needed in those countries having scope for such action. Looking further ahead, OECD countries need to prepare for the removal of the exceptional degree of support afforded by current monetary and fiscal policy stances. In this regard, preparing credible exit strategies and fiscal consolidation plans now, even if actual implementation will only commence later, is desirable.

GDP growth in the G7 economies [1]

	Annualised quarter-on-quarter growth								Year-average growth in 2009	
									EO85 projection[2]	Implied projection[3]
	08Q1	**08Q2**	**08Q3**	**08Q4**	**09Q1**	**09Q2**	**09Q3**	**09Q4**		
United States	-0.7	1.5	-2.7	-5.4	-6.4	-1.0	1.6 (+/-1.9)	2.4 (+/-2.4)	-2.8	-2.8
Japan	3.9	-4.3	-3.9	-13.1	-11.7	3.7	1.1 (+/-2.9)	-0.9 (+/-2.8)	-6.8	-5.6
Euro Area	3.1	-1.5	-1.5	-7.1	-9.2	-0.5	0.3 (+/-1.3)	2 (+/-1.6)	-4.8	-3.9
Germany	6.5	-2.2	-1.3	-9.4	-13.4	1.3	4.2 (+/-2.2)	1.8 (+/-2.3)	-6.1	-4.8
France	1.8	-1.9	-0.9	-5.5	-5.3	1.4	1.6 (+/-1.3)	1.9 (+/-1.7)	-3.0	-2.1
Italy	2.0	-2.2	-3.1	-8.3	-10.3	-1.9	-1.1 (+/-1.7)	0.4 (+/-2)	-5.5	-5.2
UK	3.2	-0.2	-2.9	-7.0	-9.3	-2.6	-1 (+/-1.2)	0 (+/-1.2)	-4.3	-4.7
Canada	-0.7	0.3	0.4	-3.7	-6.1	-3.4	-2 (+/-1.6)	0.4 (+/-2.1)	-2.6	-3.0
G7	1.4	-0.5	-2.5	-7.3	-8.4	-0.1	1.2 (+/-1.8)	1.4 (+/-2.1)	-4.1	-3.7

1. GDP releases and high-frequency indicators published by 2nd September 2009. Seasonally and in some cases also working-day adjusted. Associated standard errors are in parentheses.
2. Finalised in June 2009.
3. The implied projection is calculated by mechanically extending the GDP outturn data up to the second quarter of 2009 with the indicator model projections for the third and fourth quarters. This means that differences between the column "EO85 projection" and "Implied projection" reflect both revisions in historical data and the Q3 and Q4 GDP projections.

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 to what extent the latest Economic Outlook projections for the larger economies are still on track.

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 variables, 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.

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* In the case of the euro area, some of the aggregate data cover only 12 euro area countries that are also OECD members, but these account for 99.4% of the euro area's total GDP.

** 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.

## Corporate bond spreads have come down

United States

Euro area
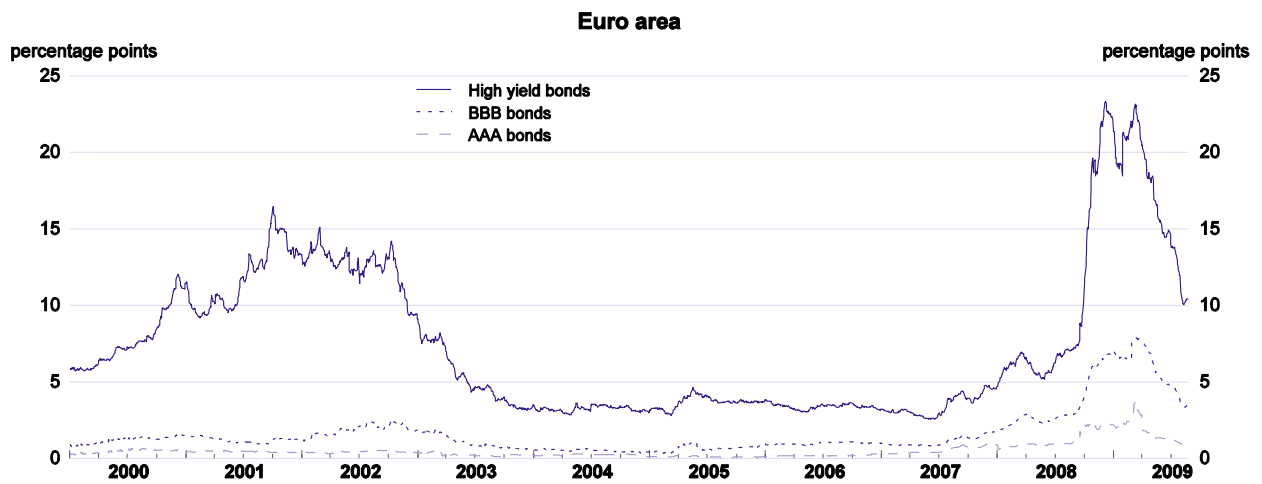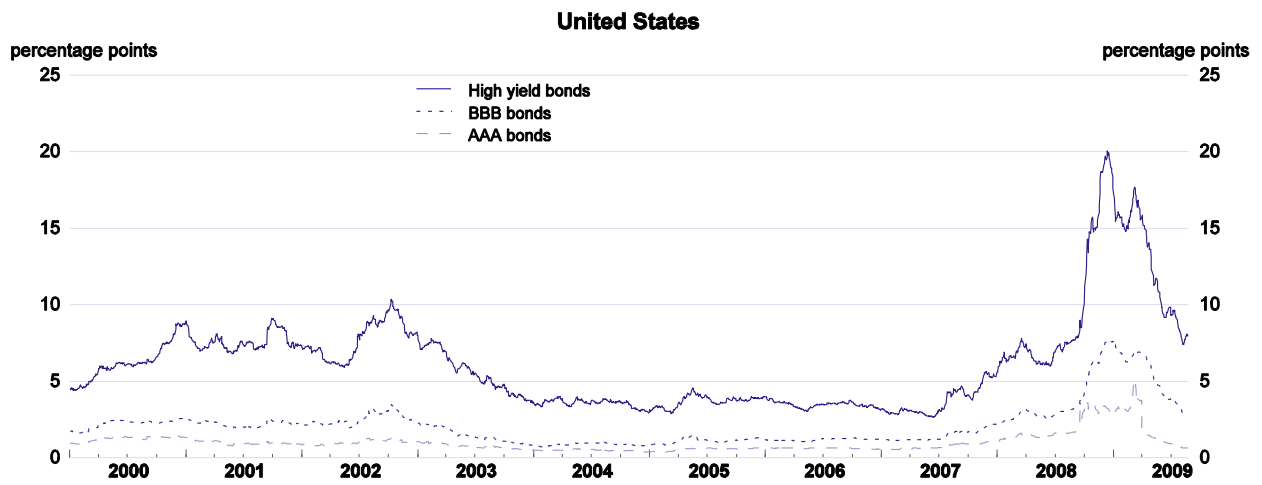
Note: Spreads between corporate bond and government bond yields. High-yield bonds are Merrill Lynch indices; corporate BBB rated bonds (Merrill Lynch) based on average yields for 5-7 years and for 7-10 years; corporate AAA rated bonds are Merrill Lynch for USA, IBOXX for euro area.

Source: Datastream.

Fewer banks are tightening credit
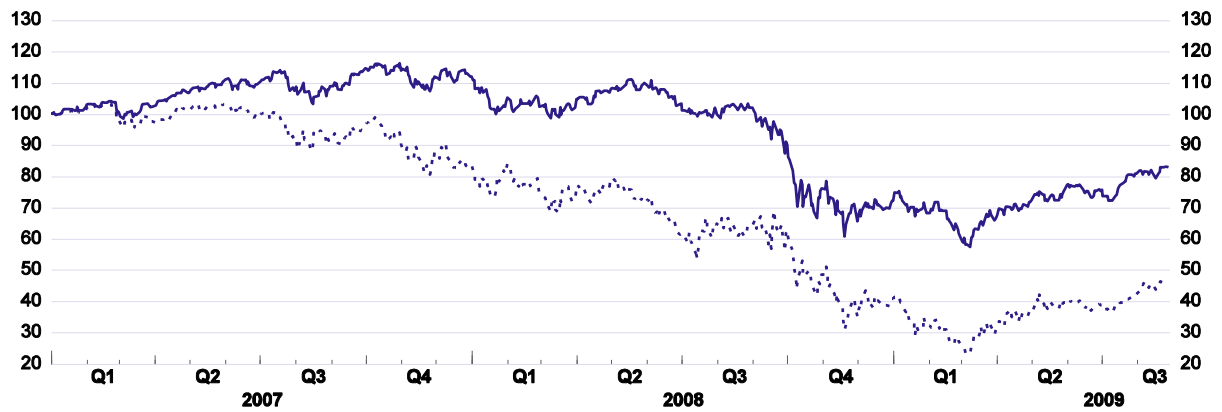
Net percentage of banks tightening credit

United States
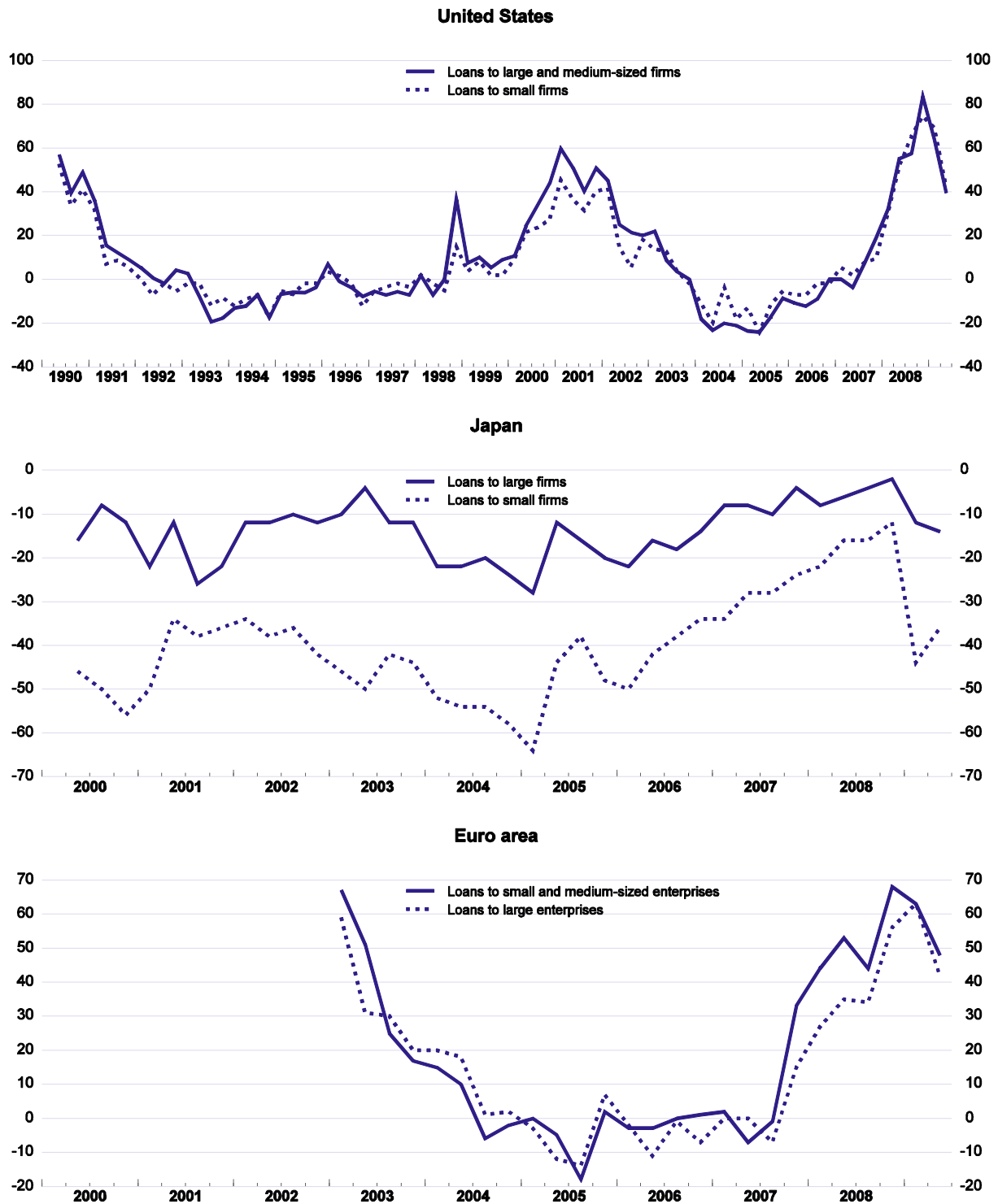
Japan

Euro area

Source: Federal Reserve; Bank of Japan; and ECB.

Share prices have rebounded

Indices, 1 January 2007 = 100

―――― Non-financial sector　　　‧‧‧‧‧ Financial sector

United States

Euro area
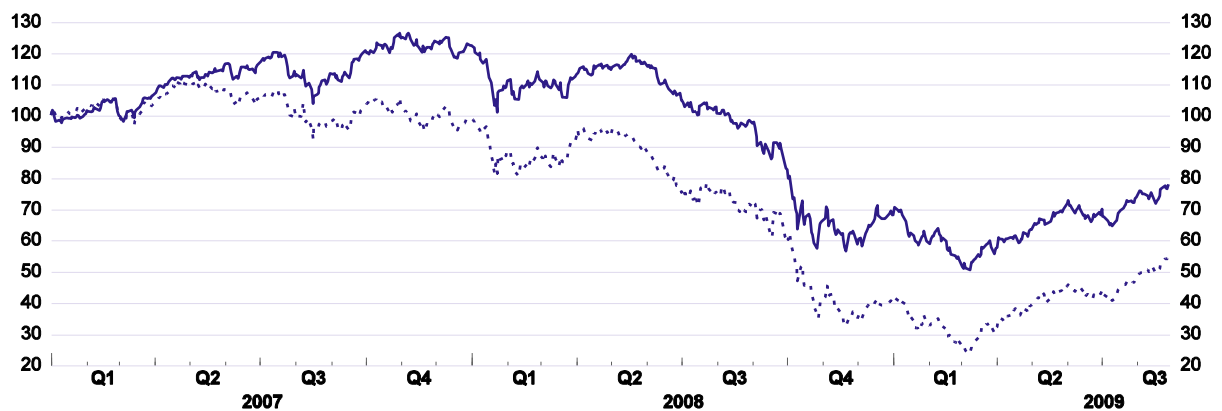
Japan

Source: Datastream.

Money market stress has eased
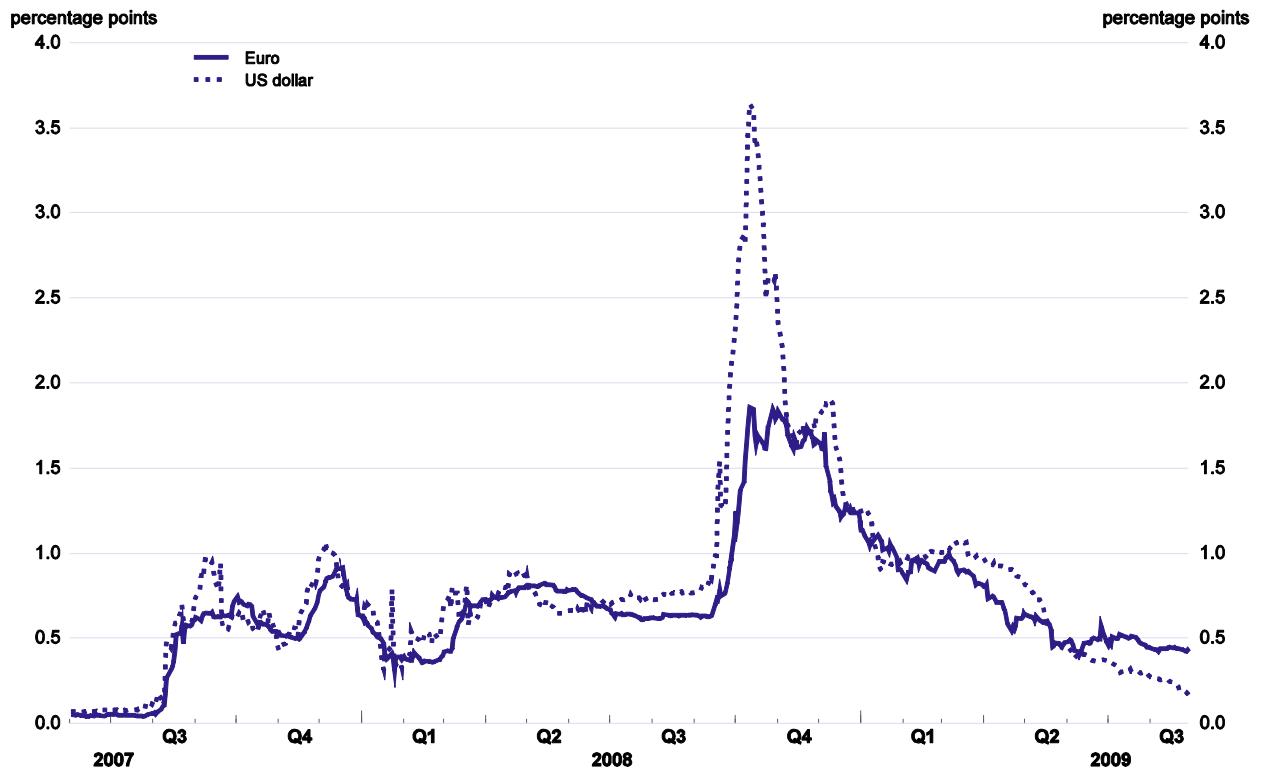
Note: Spread between three-month EURIBOR and EONIA three-month swap index for euro area; spread between three-month LIBOR and three-month overnight index swap for the United States.

Source: Datastream.

CDS spreads for banks remain elevated
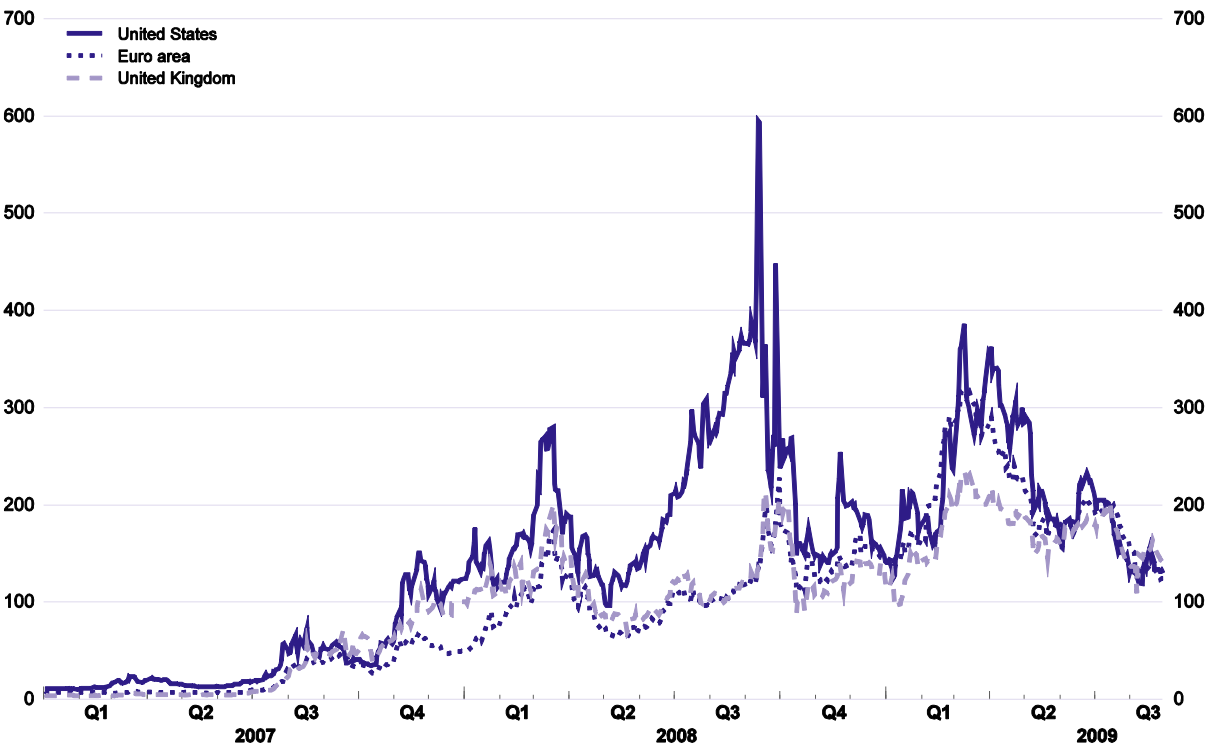
Source: Datastream.

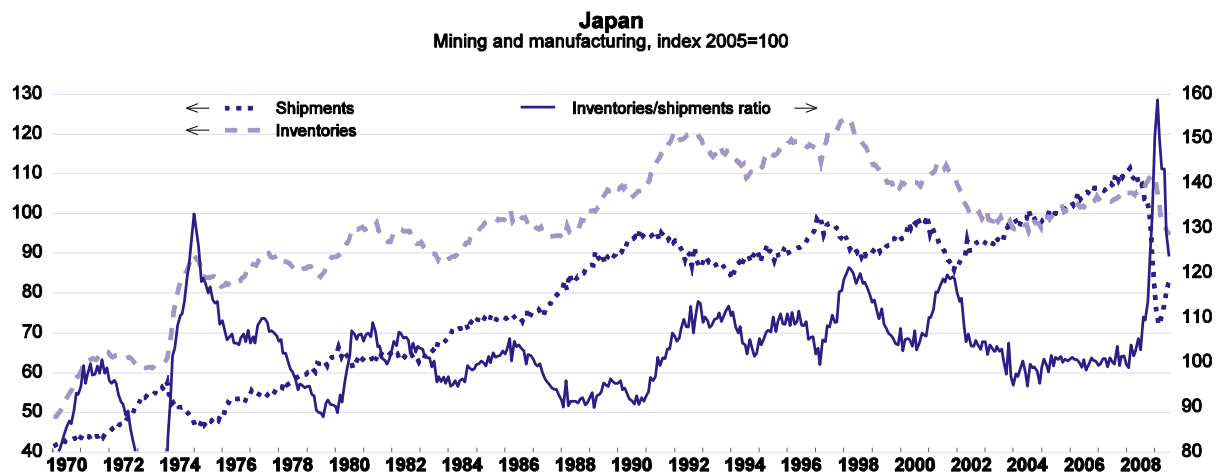# Financial conditions have improved

United States
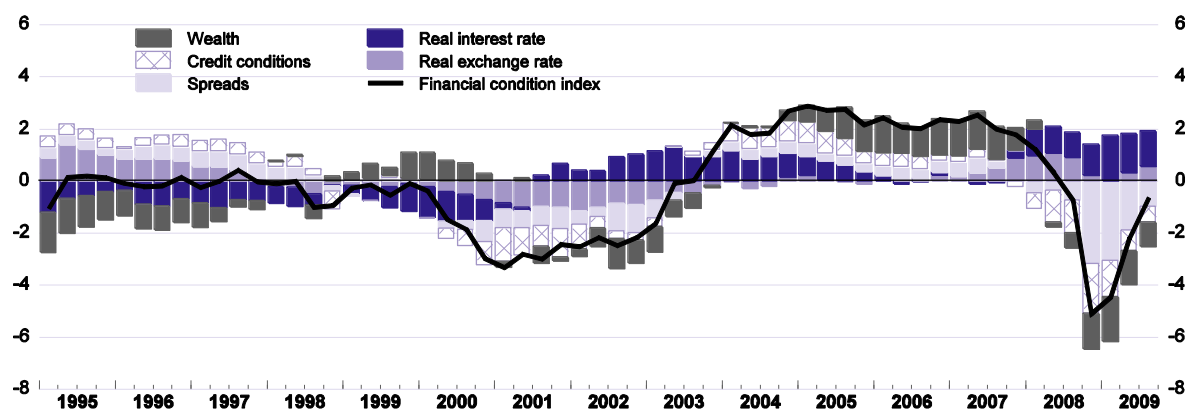
Japan
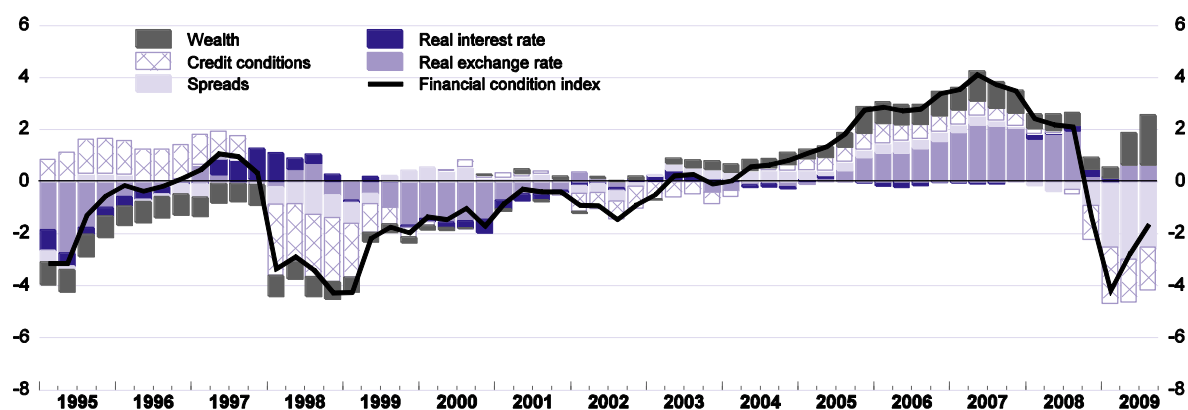
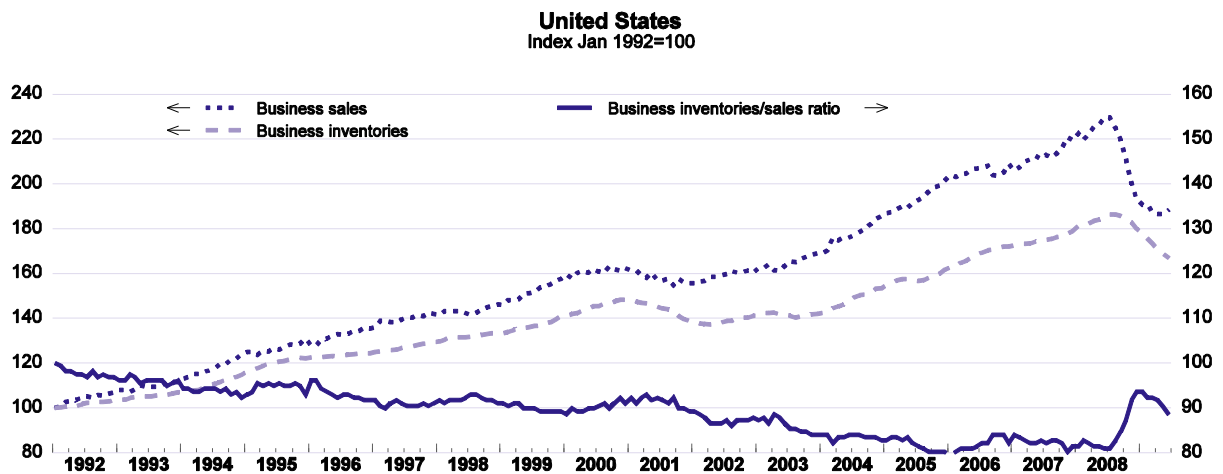## Euro area
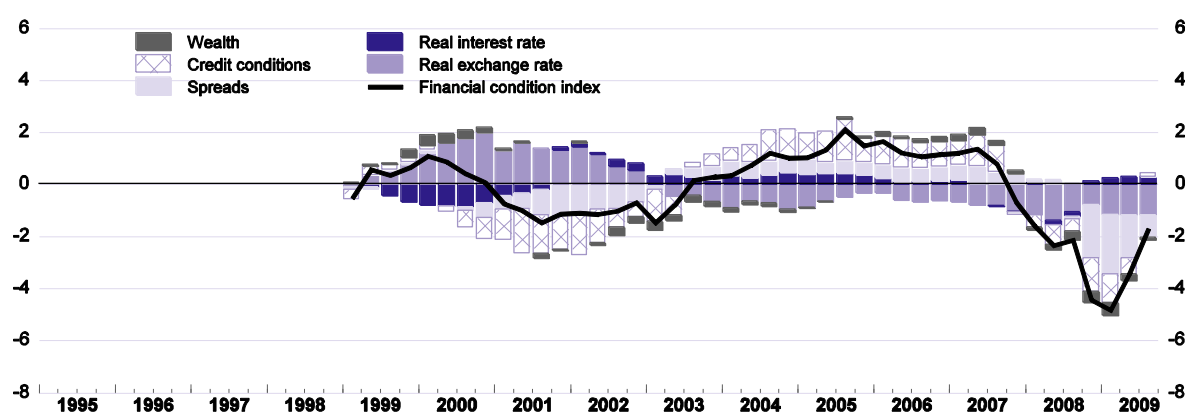
Note: A unit decline in the index implies a tightening in financial conditions sufficient to produce an average reduction in the level of GDP by 1% after 4-6 quarters. Components of the index for 2009q3 are based on the last available information.

Source: OECD Economic Outlook 85 database; Datastream; and OECD calculations.
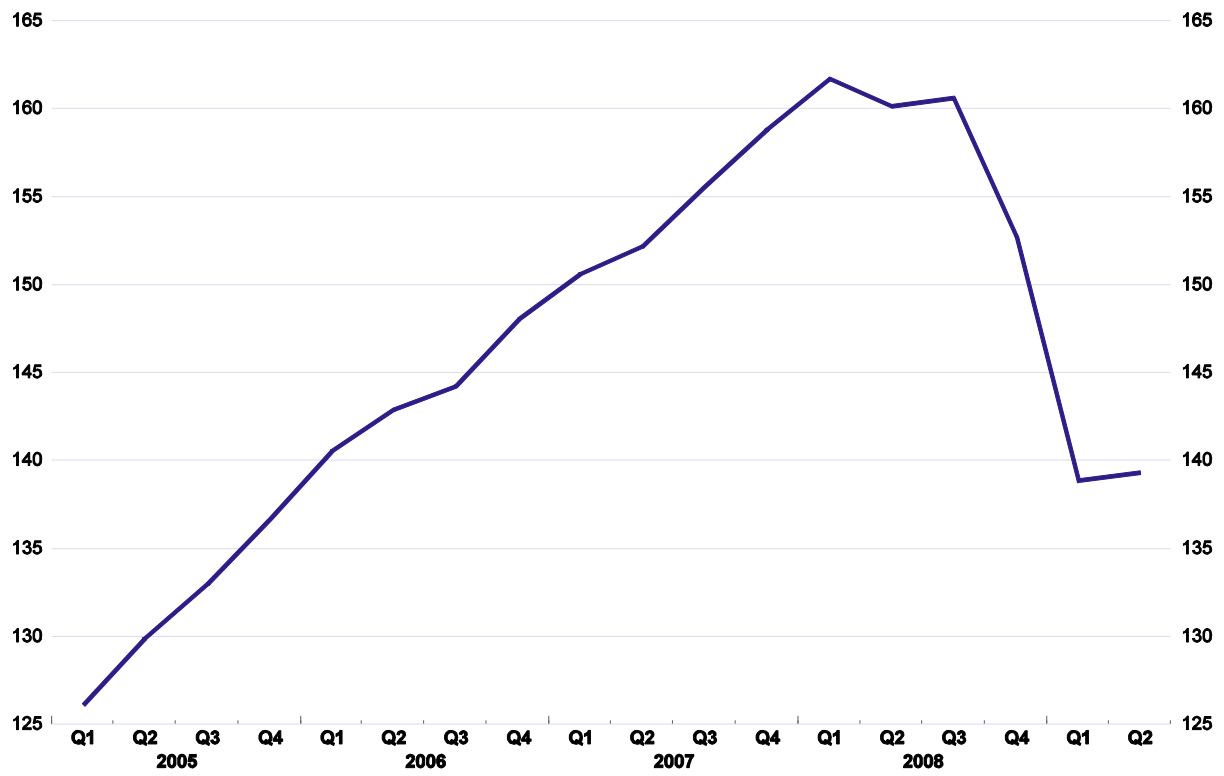
Inventories have corrected

United States
Index Jan 1992=100

Legend: ← Business sales (dotted), ← Business inventories (dashed), Business inventories/sales ratio → (solid)

Japan
Mining and manufacturing, index 2005=100

Legend: ← Shipments (dotted), ← Inventories (dashed), Inventories/shipments ratio → (solid)

Euro area
Net balance, relative to normal

Legend: Stock of finished goods (solid), Order book position (dotted)

Source: Datastream; and OECD calculations.

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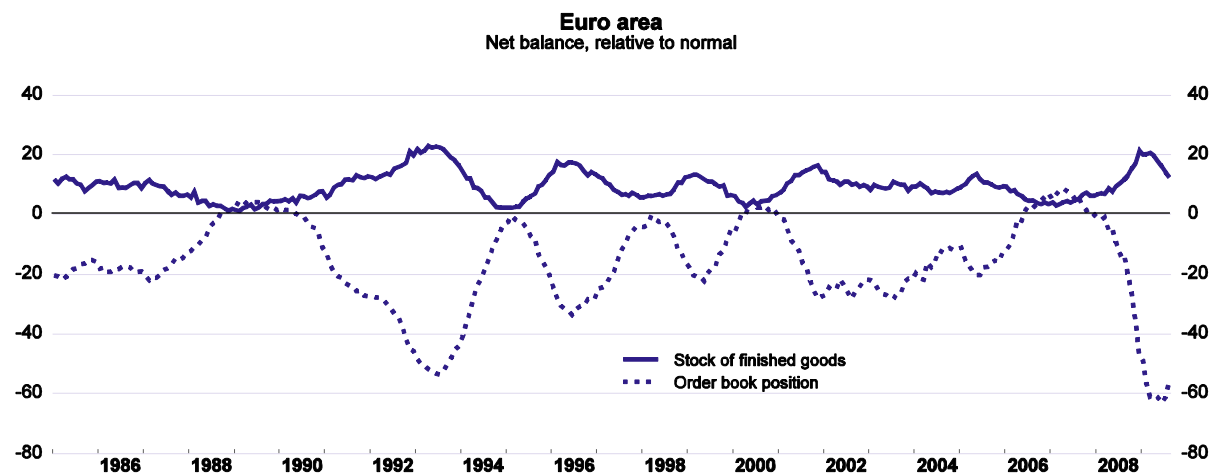
World trade volume has stabilised

Index, 2000 = 100

Source: OECD Secretariat.
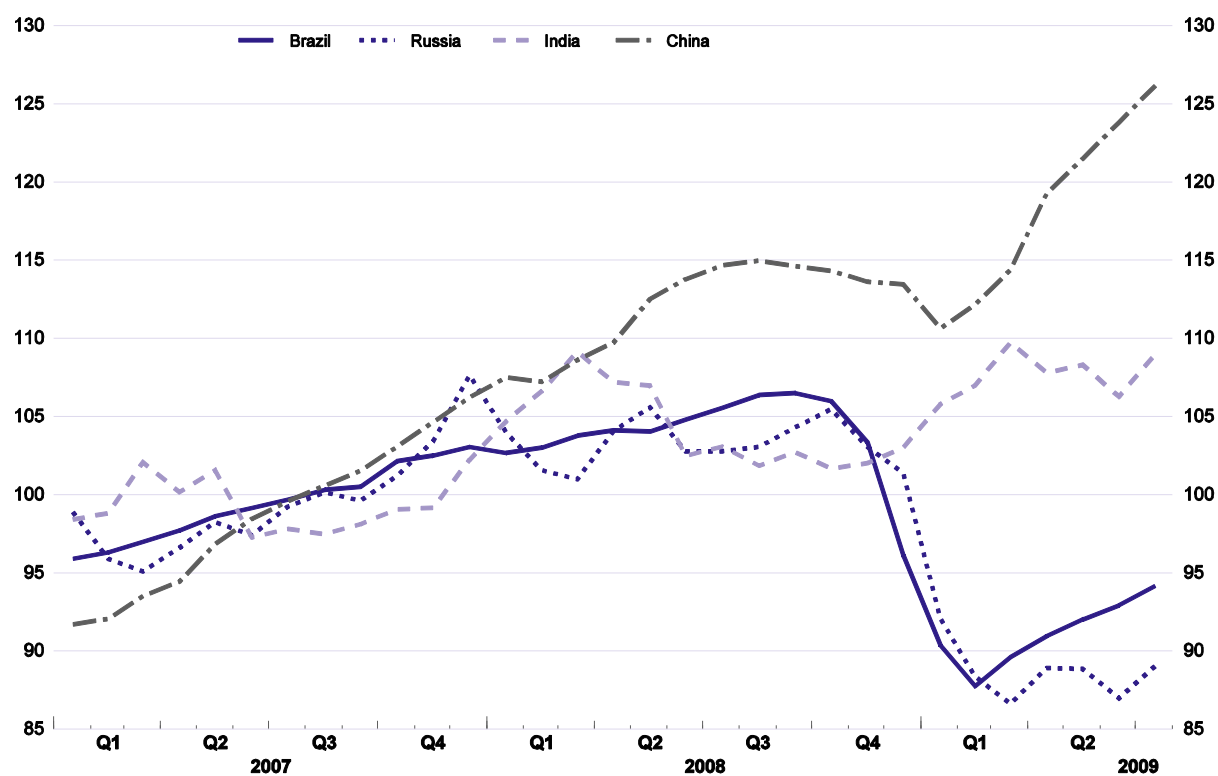
Export orders have firmed
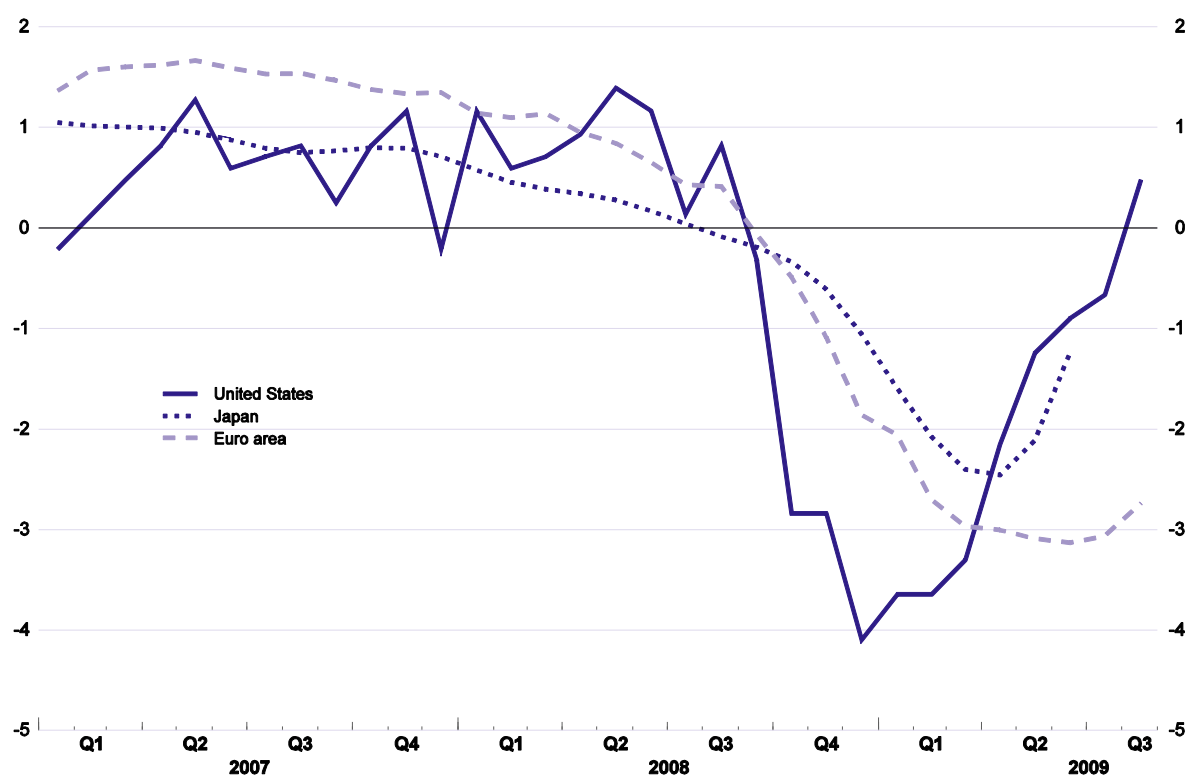
Note: Balance of respondents reporting an increase and a decrease in export orders, normalised on historical averages.

Source: OECD, Main Economic Indicator database.
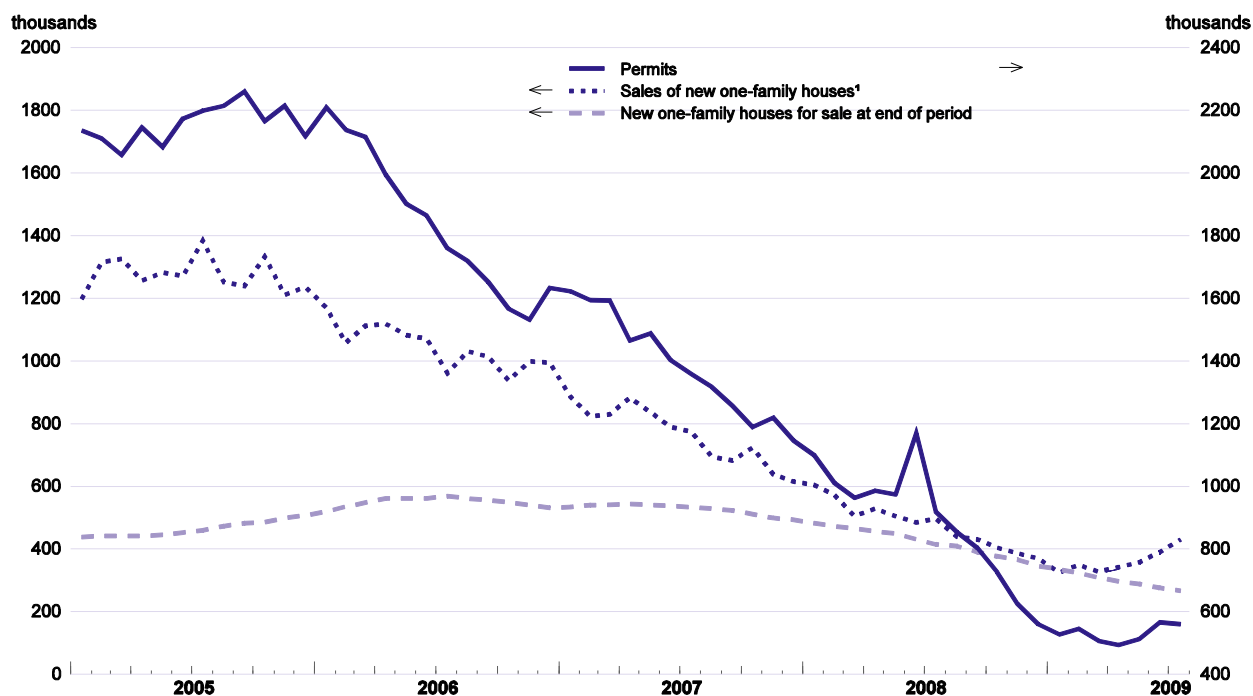
The recovery is underway in most BRIC countries

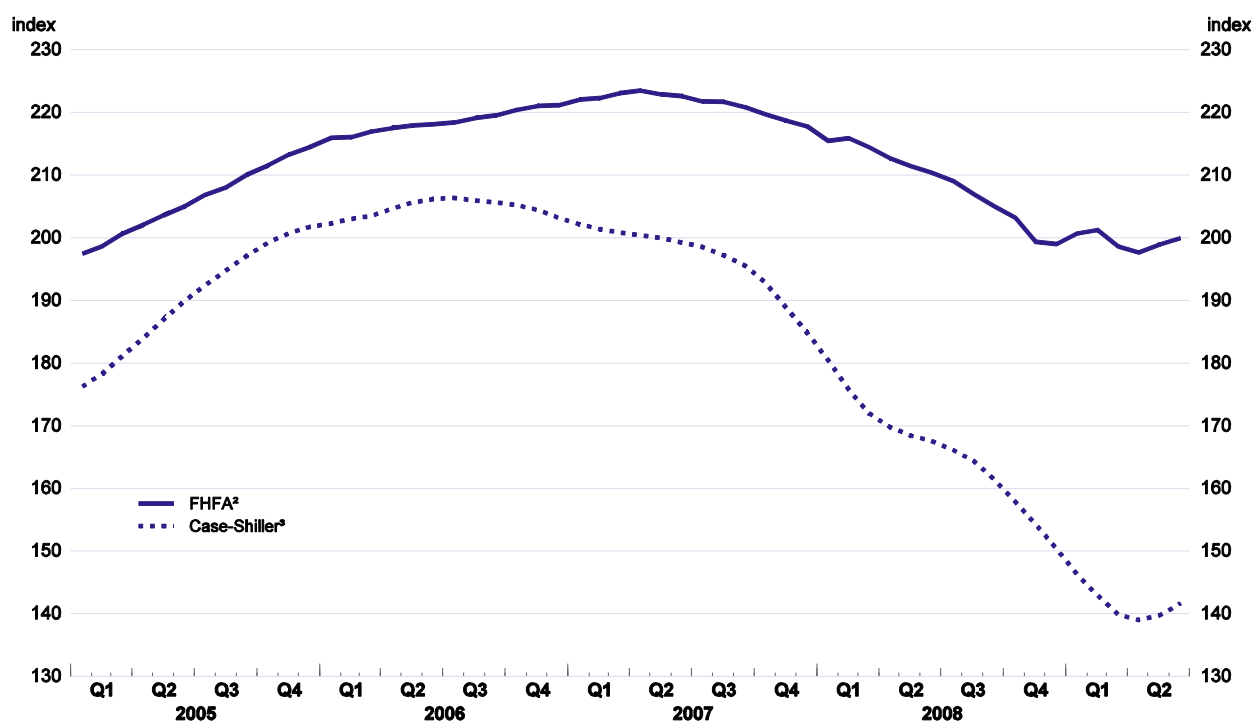Industrial production, index, 2007 = 100, three-month averages

Note: Not seasonally adjusted except for China and Brazil.

Source: OECD, Main Economic Indicators database; and Datastream.

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## US housing construction may be nearing a bottom

thousands   thousands

Legend:
- Permits
- ← Sales of new one-family houses[1]
- ← New one-family houses for sale at end of period
- →

(x-axis: 2005, 2006, 2007, 2008, 2009)

US housing prices appear to have stabilised

index   index

Legend:
- FHFA[2]
- Case-Shiller[3]

(x-axis: Q1 Q2 Q3 Q4 2005, Q1 Q2 Q3 Q4 2006, Q1 Q2 Q3 Q4 2007, Q1 Q2 2008)

1.   Data are annualised.

2.   Federal Housing Finance Agency's seasonally adjusted purchase-only house price index.

3.   Composite index of the top 20 metropolitan statistical areas in the country.

Source: Datastream.

Consumer confidence indicators remain at a weak level
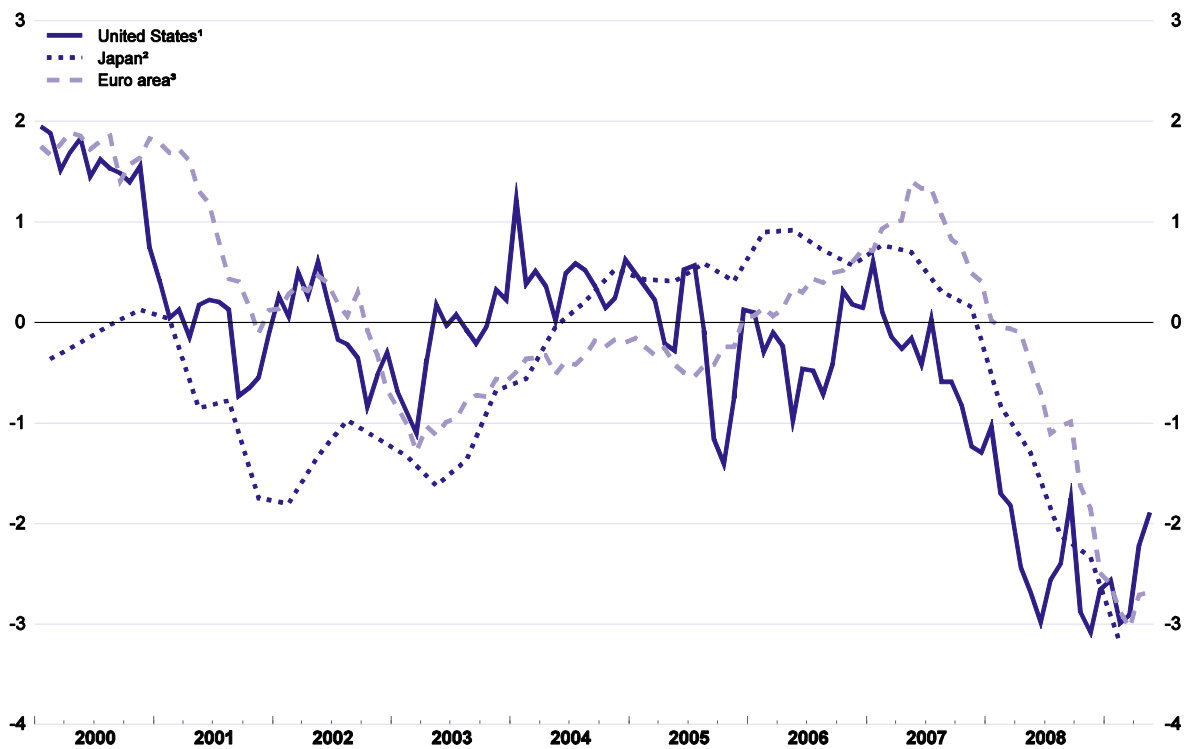
Note: Consumer confidence indicators have been normalised at the average for the period starting in 1985 and are presented in units of standard deviation. Monthly data, seasonally adjusted except Japan (quarterly, s.a.).
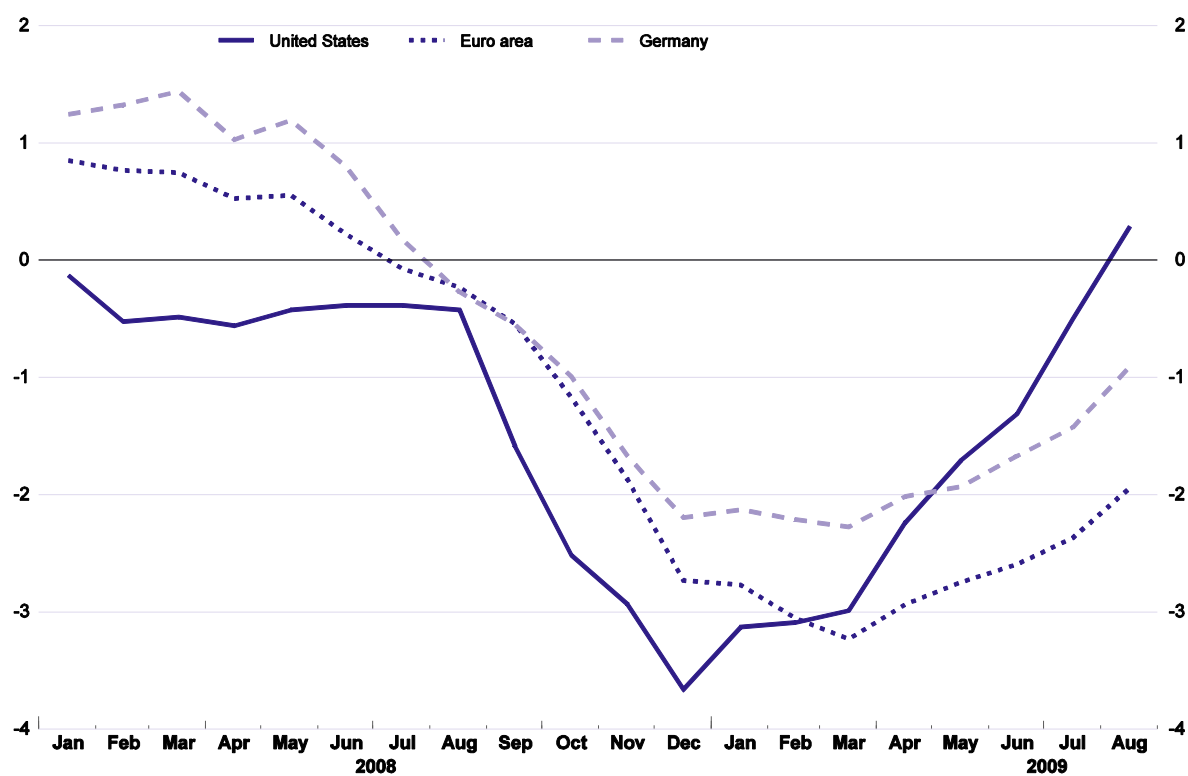
1.   Consumer Confidence Survey - Expected Economic Situation (University of Michigan).

2.   Consumer Confidence Index.

3.   Consumer Opinion Surveys - Expected Economic Situation.

Source: OECD, Main Economic Indicators database.

Business confidence has recovered further

Monthly data

Note: Series have been normalised at the average for the period starting in 1985 and are presented in units of standard deviation.

Source: Datastream; and OECD, Main Economic Indicator database.

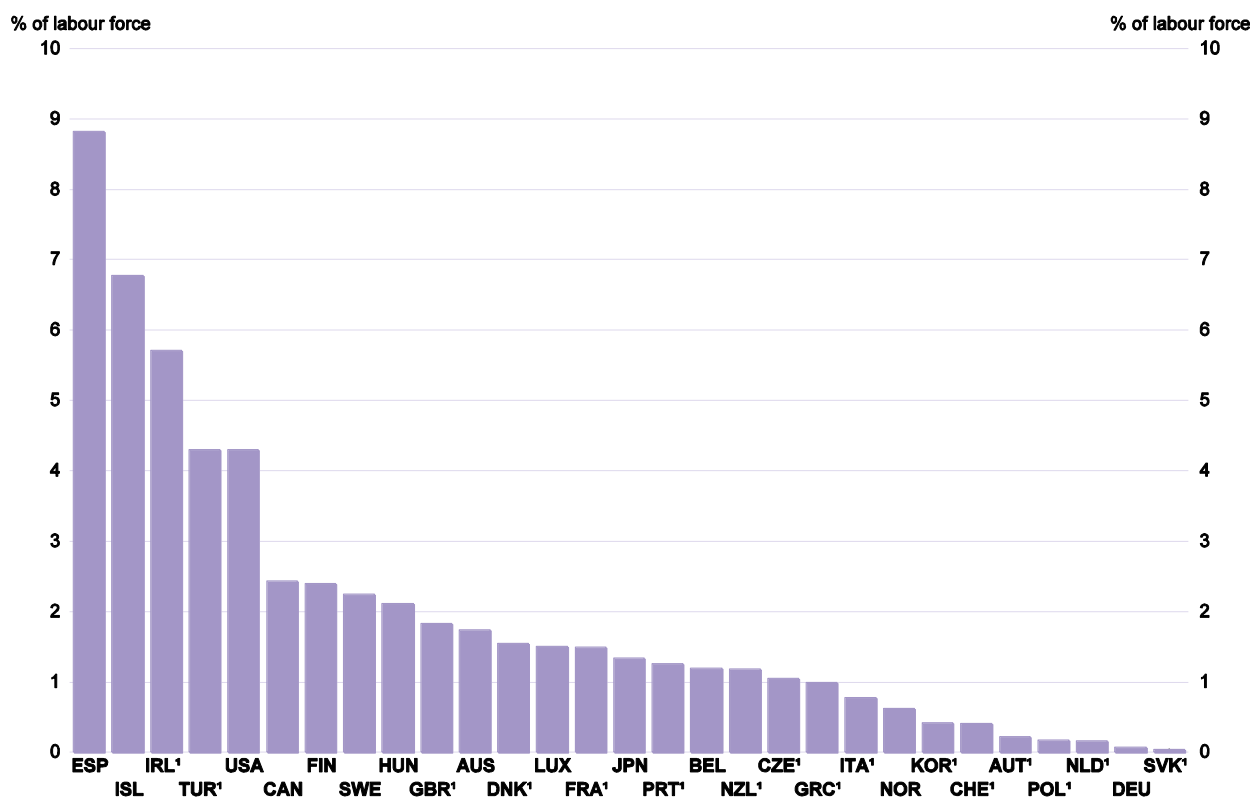**Estimates for third quarter activity have been revised up**

Successive indicator-based growth estimates - third quarter 2009, annualised growth rates
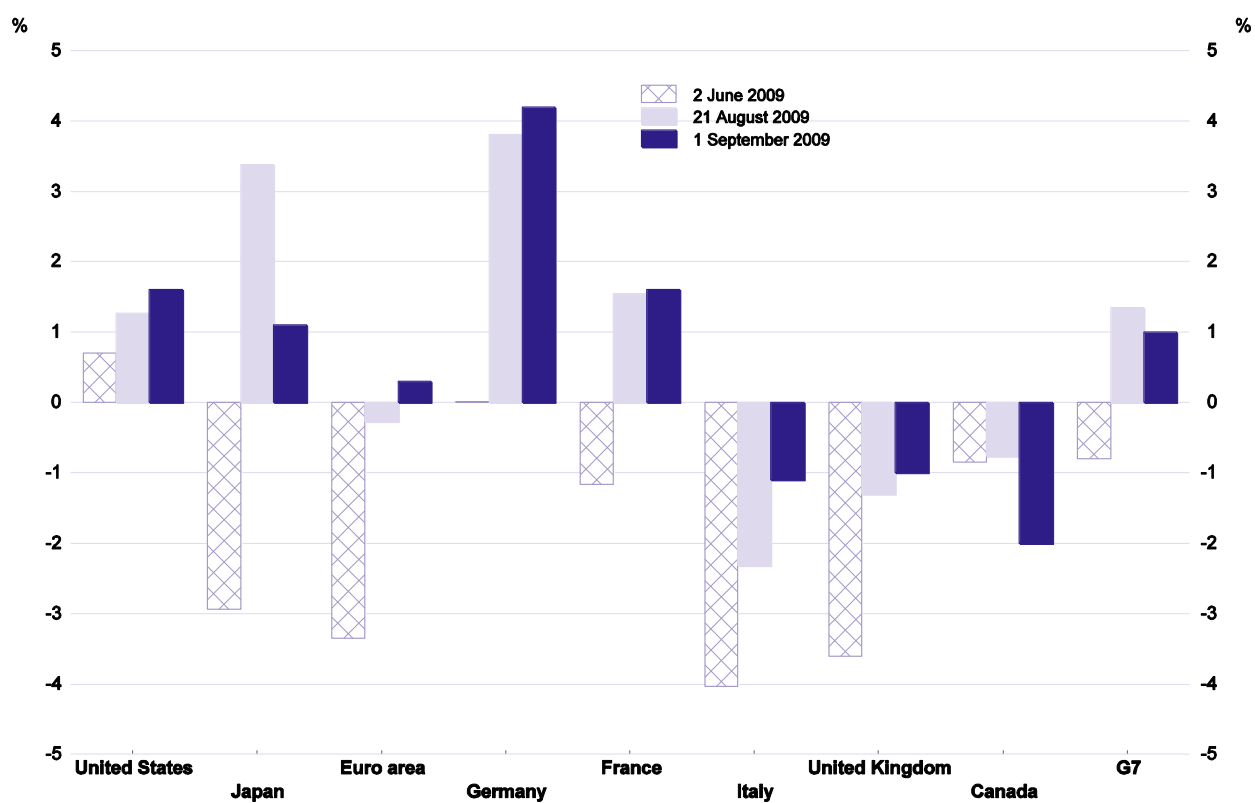
Source: Datastream; and OECD calculations.

Unemployment rates have risen strongly in some countries but not in others

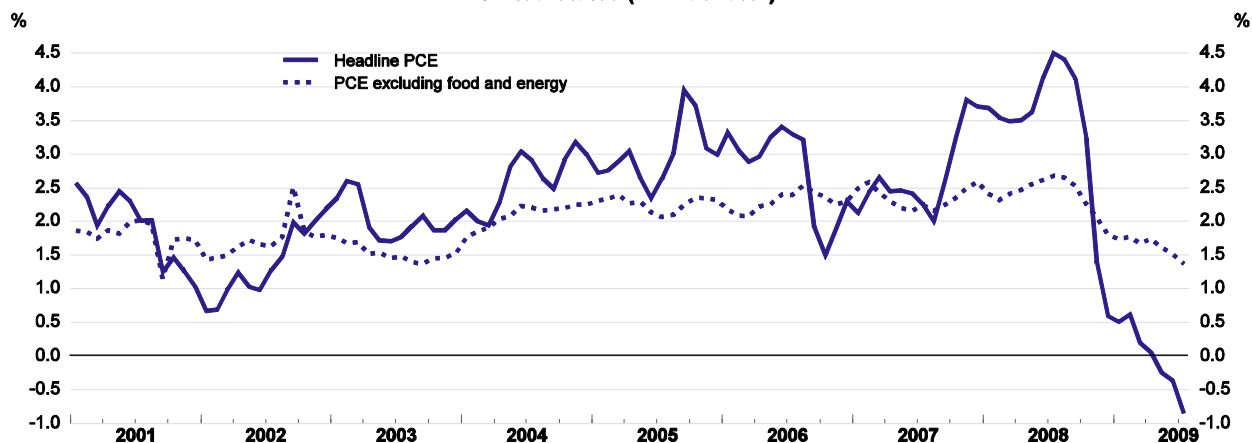Evolution between the beginning of 2008 and the second quarter of 2009

1.   Last available date is the first quarter of 2009.
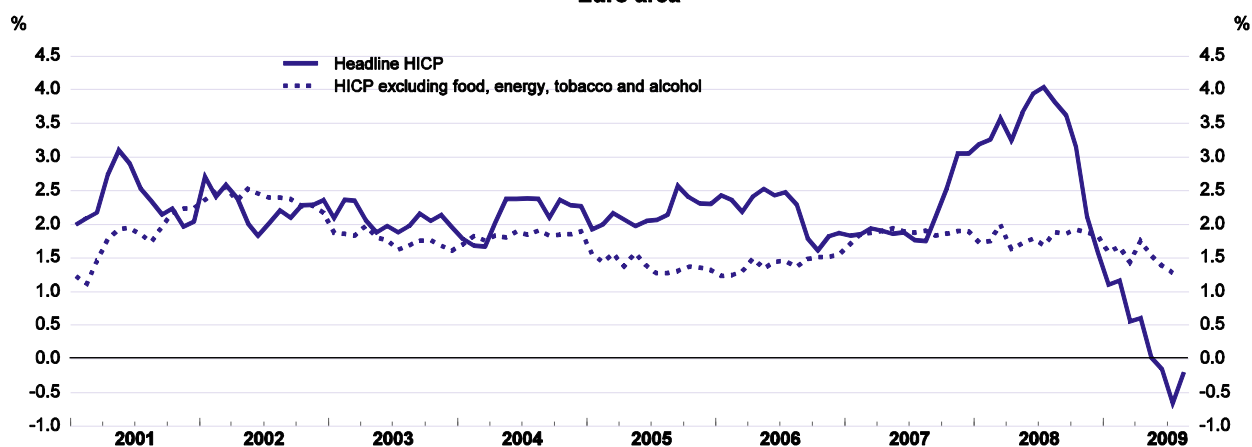
Source: OECD, Main Economic Indicators database.

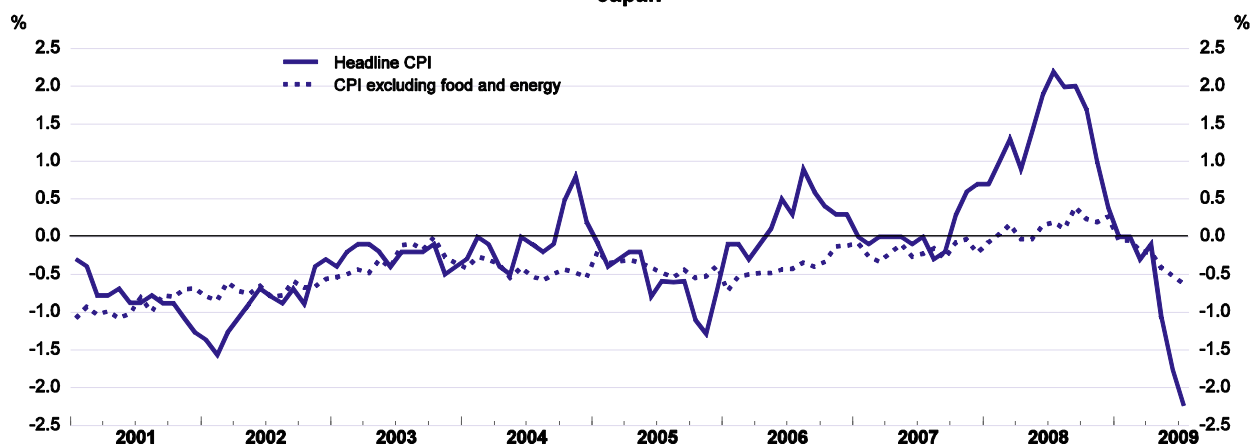# Inflation is still falling but mostly reflecting oil prices

12-month percentage change

United States (PCE deflator)

Headline PCE
PCE excluding food and energy

Euro area

Headline HICP
HICP excluding food, energy, tobacco and alcohol
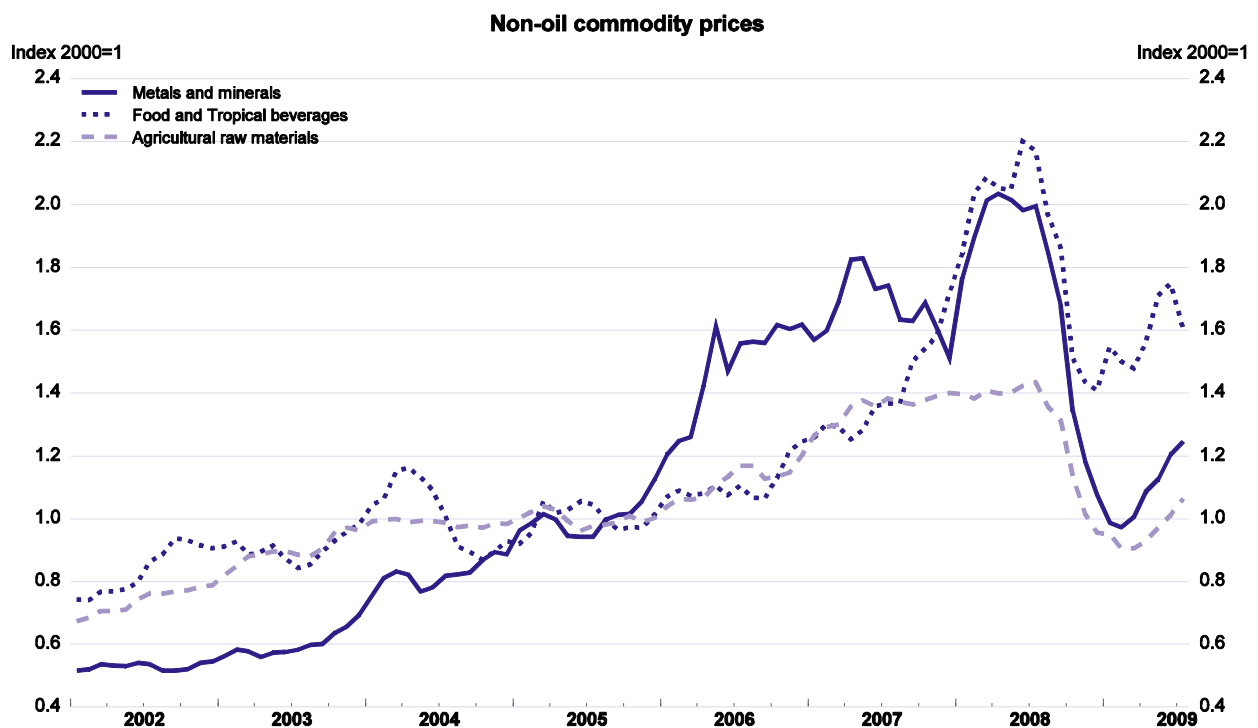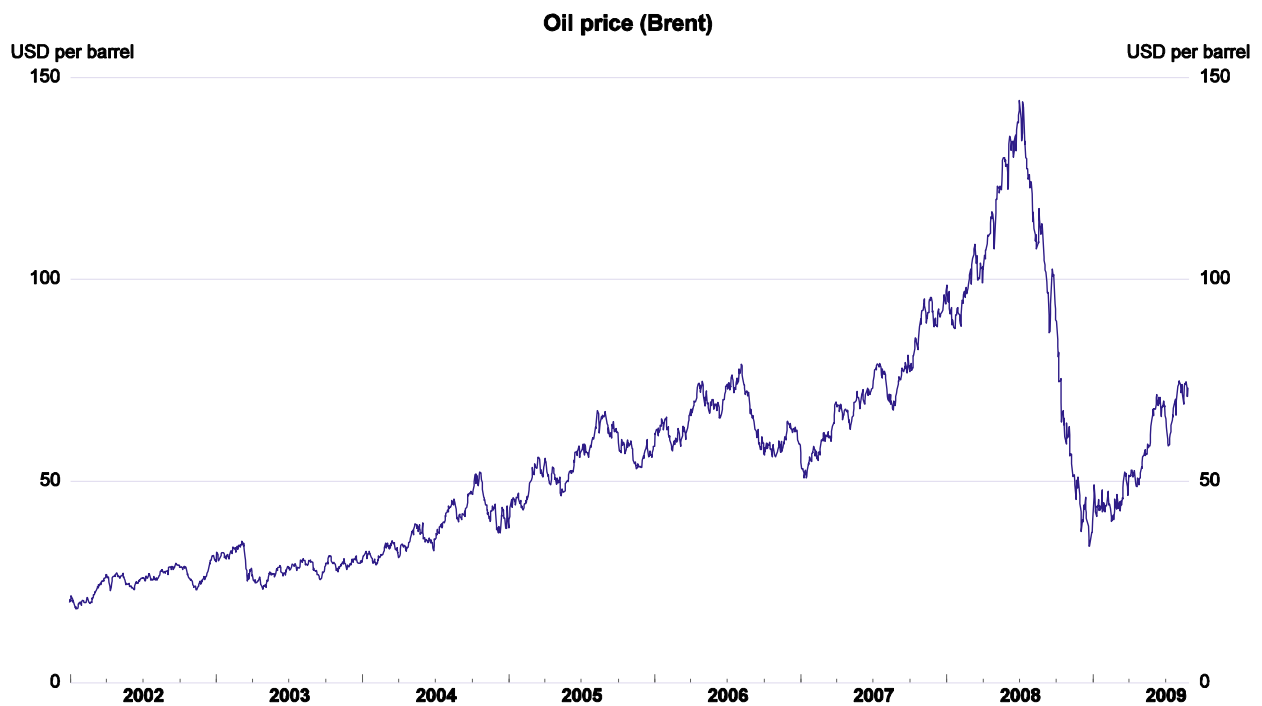
Japan

Headline CPI
CPI excluding food and energy

Note: PCE refers to personal consumption expenditures, HICP to harmonised index of consumer prices and CPI to consumer price index.

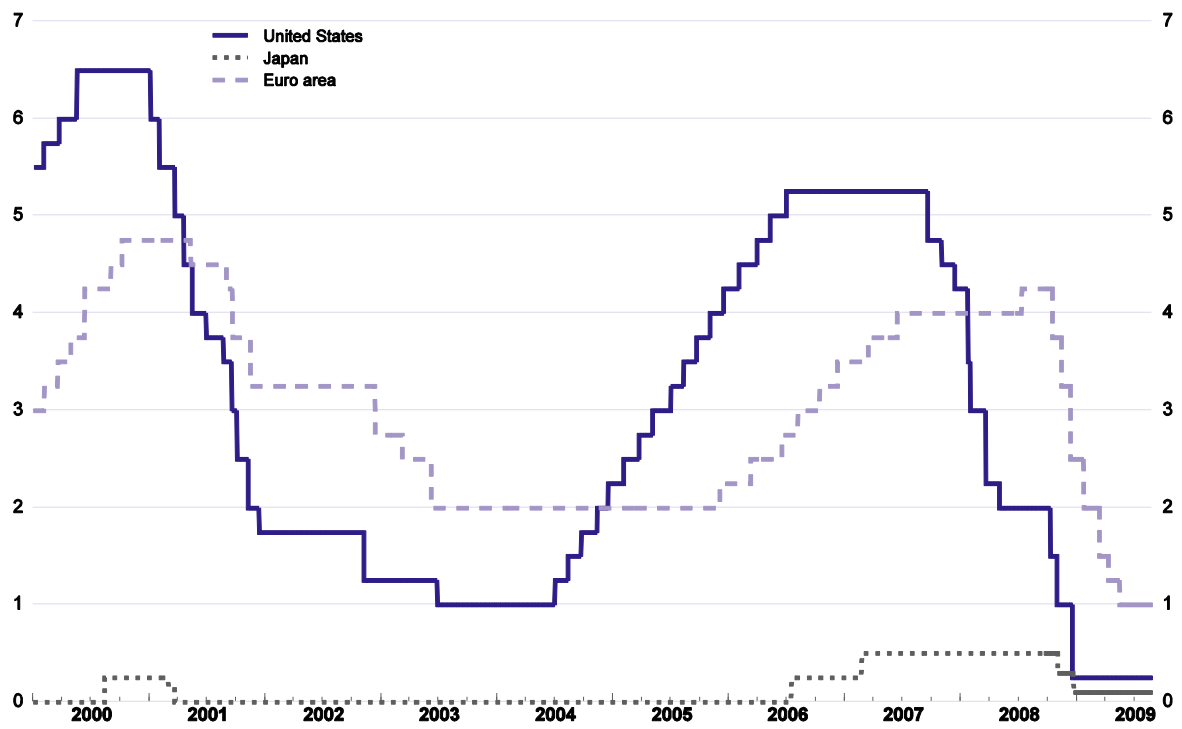*Source*: OECD, Main Economic Indicators database.

Oil and most other commodity prices have risen

Oil price (Brent)

USD per barrel

Non-oil commodity prices

Index 2000=1

- Metals and minerals
- Food and Tropical beverages
- Agricultural raw materials

Source: OECD, Main Economic Indicators database.
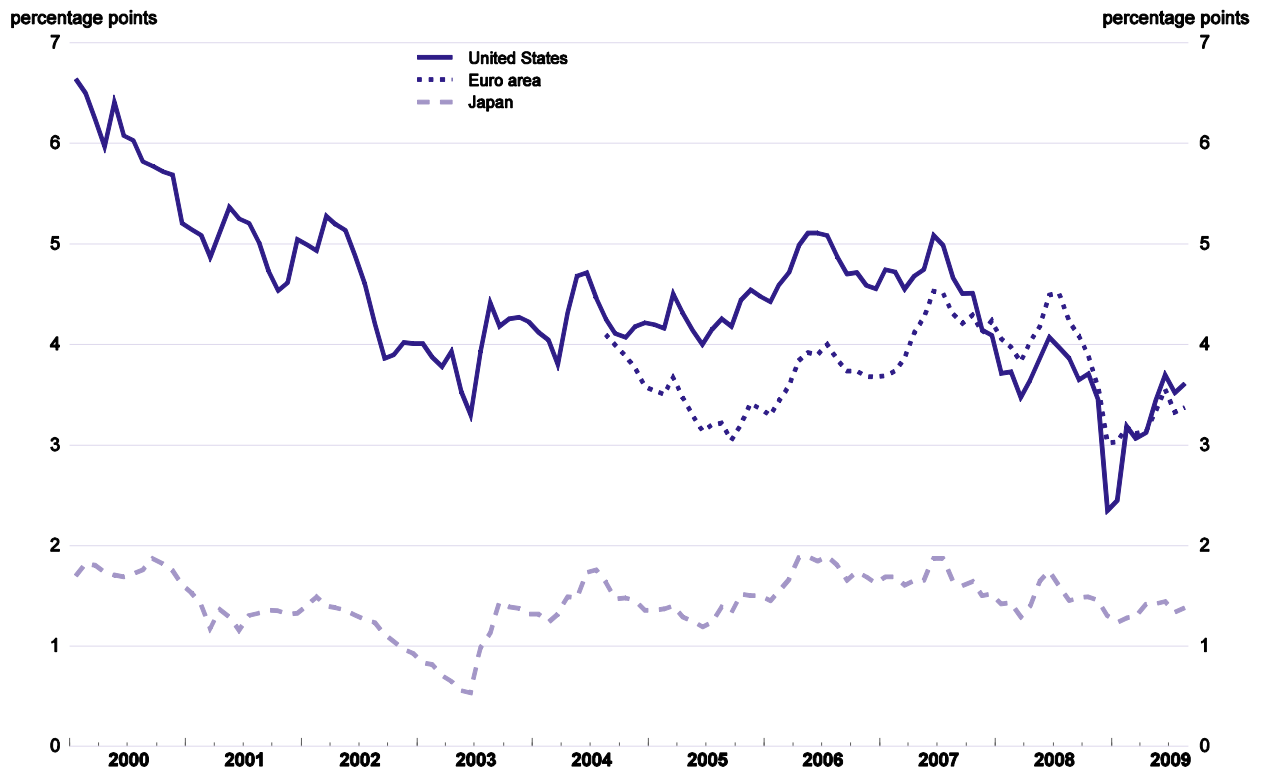
Policy rates have remained at a low level

Source: US Federal Reserve, Bank of Japan, European Central Bank.

Central bank balance sheets have expanded strongly in the United States and the euro area

Legend:
- United States (bn $)
- Japan (100 bn ¥)
- Euro area (bn euros)
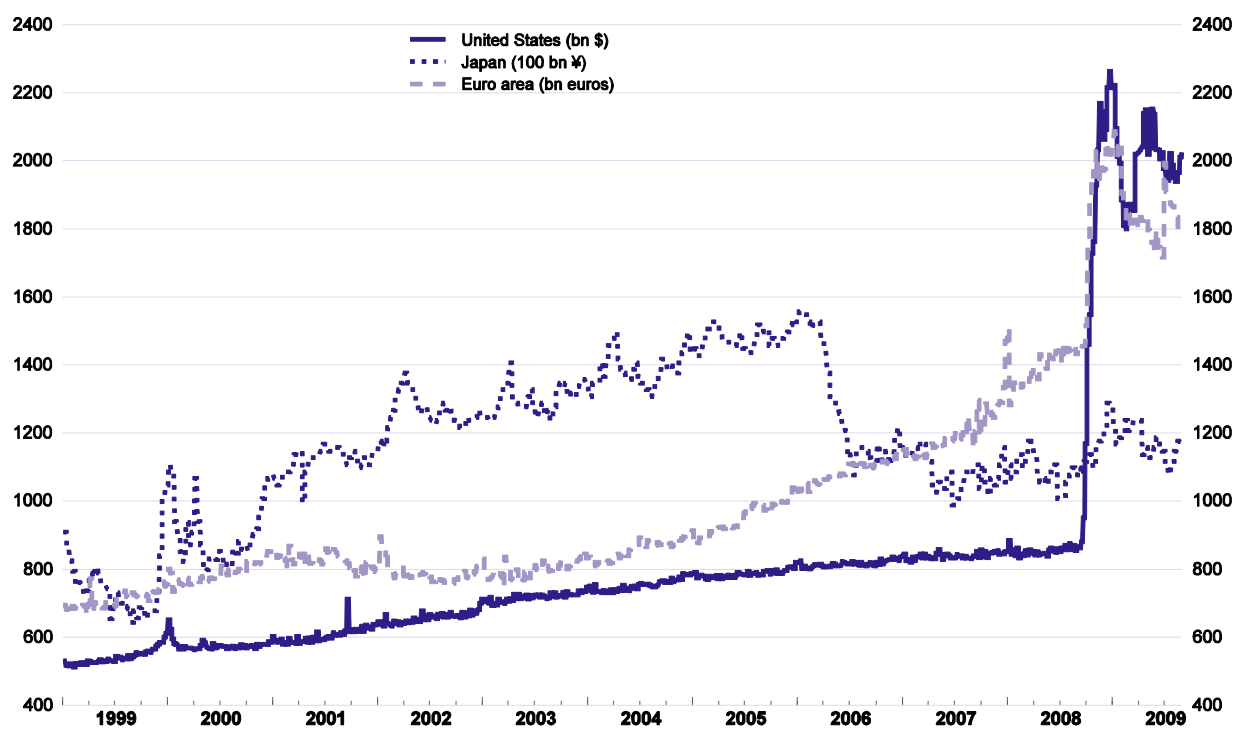
Source: Datastream.

Government bond rates have normalised

percentage points

Source: Datastream.