

CHAPTER 2

DEVELOPMENTS IN INDIVIDUAL OECD COUNTRIES

UNITED STATES

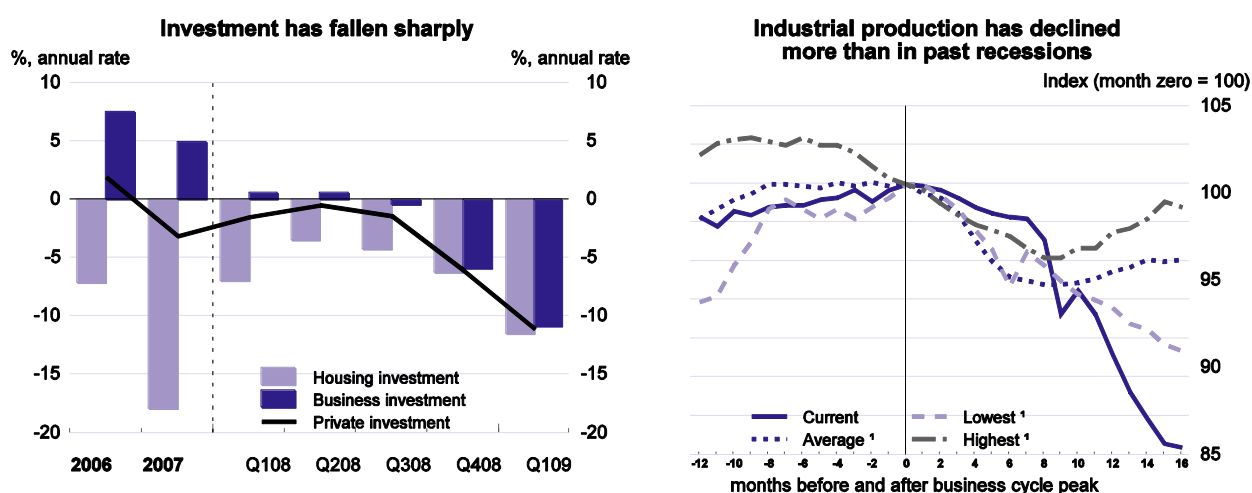
The US economy is going through a severe and protracted recession which is projected to bottom out later this year, as fiscal and monetary support takes hold and the housing cycle bottoms out. In 2010, even after a recovery gets under way, GDP growth is likely to remain weak because of the slowdown in capital accumulation, negative wealth effects and still adverse, albeit improving, financial conditions. In this environment, a considerable degree of economic slack, especially in the labour market, is likely to persist over the projection period, bringing inflation to very low rates.

The Federal Reserve should continue to support activity by expanding the scale of its quantitative easing operations, if needed. The authorities should also go ahead with the planned measures to remove impaired securities from banks' balance sheets. While the large fiscal stimulus is needed to support domestic demand in the next several quarters, once the recovery is firmly in place fiscal sustainability should be restored by reducing the budget deficit and tackling the challenge of rising entitlement spending.

The recession has been deep and broad

The US economy has contracted sharply since the intensification of the financial crisis last September. Residential investment, in particular, has remained very weak, falling to its lowest share of GDP in more than 50 years. Manufacturing output has also fallen sharply as consumer

United States



1. Average, lowest and highest values of past six recessions.

Source: Datastream and OECD.

spending, especially for durable goods, and global trade have slumped. The cumulative percentage decline in industrial production since December 2007 is significantly larger than in any other post-war recession. There have already been 6 million jobs lost, increasing the unemployment rate to a 26-year high. Incoming labour-market information suggests that employment is likely to decline further over the rest of 2009. In response to the opening of a substantial unemployment gap and a 25% drop in energy prices, the 12-month change in the consumer price index has become negative for the first time since 1955. Core inflation has remained positive but is also falling -- the recent blip being mostly accounted for by an increase in the excise tax on cigarettes. The current-account deficit had fallen to 3.7% of GDP by the end of 2008, and it is estimated to have fallen further thus far in 2009 as the trade balance has continued to improve.

United States: **Employment, income and inflation**

Percentage changes

	2006	2007	2008	2009	2010
Employment ¹	1.8	0.9	-0.6	-3.4	0.0
Unemployment rate ²	4.6	4.6	5.8	9.3	10.1
Employment cost index	2.9	3.1	2.8	1.5	0.8
Compensation per employee ³	3.9	4.1	3.2	2.8	1.7
Labour productivity	1.0	1.1	1.7	0.6	0.9
Unit labour cost	2.9	3.1	1.9	2.7	1.3
GDP deflator	3.2	2.7	2.2	1.7	0.7
Consumer price index	3.2	2.9	3.8	-0.6	1.0
Core PCE deflator ⁴	2.2	2.2	2.2	1.6	0.9
PCE deflator ⁵	2.8	2.6	3.3	0.2	0.8
Real household disposable income	3.5	2.8	1.3	2.5	1.8

1. Nonfarm employment, based on the Bureau of Labor Statistics (BLS) Establishment Survey.

2. As a percentage of labour force, based on the BLS Household Survey.

3. In the private sector.

4. Deflator for private consumption excluding food and energy.

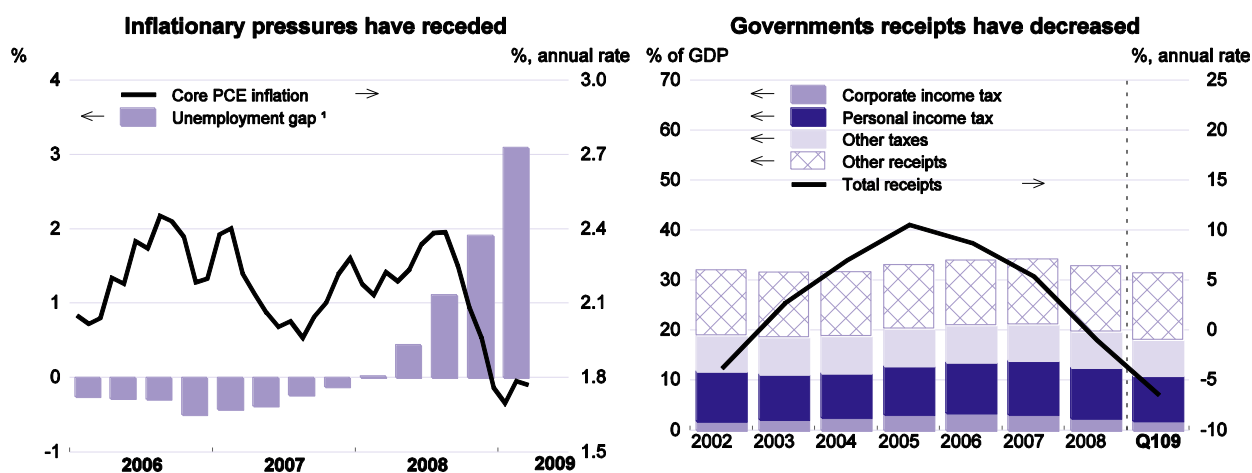
5. Private consumption deflator. PCE stands for personal consumption expenditures.

Source: OECD Economic Outlook 85 database.

Consumer spending and housing activity may be stabilising...

Consumer spending fell sharply in the second half of 2008, and then bounced back in the first quarter of 2009. In the second quarter, tax cuts boosted households' disposable income and consumer sentiment further improved. Nonetheless, a number of factors are likely to continue to weigh on consumer spending, among them the weak labour market, the declines in equity and housing wealth over the past two years, and continuing tight credit conditions. The ongoing deterioration in the housing market since 2006 may be approaching an end. Most importantly, as home sales have stabilised, the supply of unsold new homes has declined relative to demand – a precondition for any recovery in homebuilding. Prospects for a recovery in the commercial real estate sector are worse, with rising vacancy rates, falling prices and very tight financial conditions.

United States



1. Defined as the difference between actual unemployment rate and the OECD NAIU estimate.

Source: OECD.

... but business investment is likely to drop further

Despite the sharp contraction over the past two quarters, equipment investment is likely to drop further in the near term, despite improved business conditions; new orders for capital goods remain below the level of shipments and capital spending plans are restrained. The April survey of bank loan officers reported further weakening of demand for commercial and industrial loans. The same survey also indicated that the net fraction of banks that tightened their business lending policies remained high, although it has been declining. Firms have also reduced inventories, although inventory-sale ratios are still high.

United States: Financial indicators

	2006	2007	2008	2009	2010
Household saving ratio ¹	0.7	0.6	1.8	5.4	6.5
General government financial balance ²	-2.2	-2.9	-5.9	-10.2	-11.2
Current account balance ²	-6.0	-5.3	-4.7	-2.3	-2.4
Short-term interest rate ³	5.2	5.3	3.2	1.0	0.5
Long-term interest rate ⁴	4.8	4.6	3.7	3.4	4.1

1. As a percentage of disposable income.

2. As a percentage of GDP.

3. 3-month euro-dollar.

4. 10-year government bonds.

Source: OECD Economic Outlook 85 database.

Financial conditions remain fragile

Conditions in a number of financial markets, including the interbank markets and the commercial paper market, have recently improved. Furthermore, mortgage rates have fallen since late last year as the Federal Reserve purchased agency debt and agency mortgage-backed securities. However, the supply of mortgage credit is still relatively tight and mortgage activity remains heavily dependent on government support. More generally,

financial markets and financial institutions remain under considerable stress, and cumulative declines in asset prices, tight credit conditions and high levels of risk aversion continue to weigh on the economy. Restoration of trust in financial intermediaries and markets is vital for a sustained and strong economic recovery to occur.

United States: Demand and output

	2005	2006	2007	2008	2009	2010
	Current prices \$ billion	Percentage changes, volume (2000 prices)				
Private consumption	8 694.1	3.0	2.8	0.2	-1.0	0.5
Government consumption	1 957.5	1.6	1.9	2.8	2.0	2.6
Gross fixed investment	2 440.6	2.0	-2.0	-3.5	-16.0	-0.6
Public	397.8	2.1	3.0	3.3	-1.7	2.6
Residential	769.7	-7.1	-17.9	-20.8	-20.7	0.4
Non-residential	1 273.1	7.5	4.9	1.6	-19.2	-2.1
Final domestic demand	13 092.2	2.6	1.8	0.0	-3.1	0.7
Stockbuilding ¹	43.3	0.0	-0.4	-0.3	-0.4	0.1
Total domestic demand	13 135.5	2.6	1.4	-0.3	-3.5	0.8
Exports of goods and services	1 311.5	9.1	8.4	6.2	-13.8	1.6
Imports of goods and services	2 025.1	6.0	2.2	-3.5	-15.7	1.2
Net exports ¹	- 713.6	0.0	0.6	1.3	1.0	0.0
GDP at market prices	12 421.9	2.8	2.0	1.1	-2.8	0.9

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook Sources and Methods* (<http://www.oecd.org/eco/sources-and-methods>).

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

Source: OECD Economic Outlook 85 database.

Fiscal policy will provide a considerable boost

The new Administration has quickly enacted a fiscal stimulus package, which is estimated to add more than 2% of GDP to the federal government deficit in each of 2009 and 2010 and should help to jumpstart the economy over the next few quarters. The boost from these measures will gradually wane over the course of 2010, and, beyond that, measures to restore fiscal sustainability need to be implemented when economic recovery is firmly in place.

Monetary policy is focused on avoiding deflation

The monetary policy stance has quickly been loosened. The Federal Reserve reduced its policy rate to near zero late last year and implemented credit easing measures to support key credit markets, such as those for commercial paper and mortgages. These policies should remain in place until the recovery has firmed. Moreover, the scale of quantitative easing operations could be increased to further support growth. The announcement of an explicit inflation target would more firmly anchor inflation expectations.

The recession is projected to end later this year...

The US economy is projected to contract further in the second quarter and then to stabilise during the second half of the year, as the retrenchment of housing construction bottoms out and the decline in inventory investment slows. A gradual recovery should take hold in 2010, as consumer spending picks up with the job market stabilising. However, GDP

growth is likely to remain moderate, as potential growth has been reduced by the slowdown in capital accumulation and households continue to increase their savings to rebuild wealth.

United States: **External indicators**

	2006	2007	2008	2009	2010
	\$ billion				
Goods and services exports	1 480.8	1 662.4	1 859.4	1 508	1 543
Goods and services imports	2 238.1	2 370.2	2 528.6	1 852	1 894
Foreign balance	- 757.3	- 707.9	- 669.2	- 343	- 351
Invisibles, net	- 30.8	- 23.4	- 4.1	25	8
Current account balance	- 788.1	- 731.2	- 673.3	- 318	- 343
	Percentage changes				
Goods and services export volumes	9.1	8.4	6.2	- 13.8	1.6
Goods and services import volumes	6.0	2.2	- 3.5	- 15.7	1.2
Export performance ¹	- 0.1	1.0	2.6	3.1	- 0.9
Terms of trade	- 0.8	- 0.1	- 4.7	8.4	- 0.4

1. Ratio between export volume and export market of total goods and services.

Source: OECD Economic Outlook 85 database.

***... if financial conditions
do not relapse***

Recovery will depend on financial conditions remaining stable for the remainder of 2009 and gradually improving thereafter, underlining the importance of the authorities' efforts to restore confidence in the financial system. Recent stress tests indicate that some major banks will need more capital, and it is assumed that they will be recapitalised, including by an injection of public funds if needed. Nevertheless banks' balance sheets remain encumbered with impaired assets. Overall, the fragility of the financial system still represents a downside risk to the outlook. On the other hand, the recovery could be faster than projected if the boost from the fiscal stimulus is larger than anticipated -- according to OECD estimates, the US fiscal multipliers are about 0.6 in the current circumstances -- or if firms turn out to be less reluctant to hire workers next year.

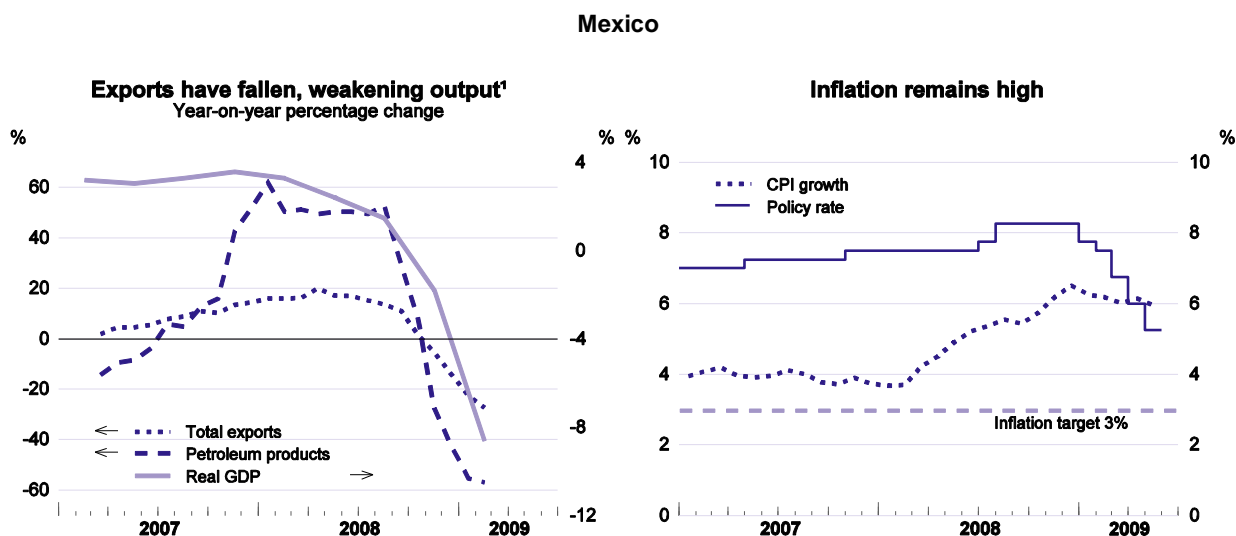
MEXICO

Mexico entered recession in late 2008, and growth had turned highly negative by the first quarter of 2009, as both exports and domestic demand contracted in the wake of the crisis. The outbreak of influenza and continued troubles for auto manufacturers are likely to have contributed further to the downturn. Growth is set to pick up during the second half of 2009 and accelerate further through 2010, reaching quarterly growth rates of above 4% in annualised terms. Inflation has remained relatively high, despite the sharp drop in demand, largely due to sticky administered prices. This persistence in inflation has limited the scope for monetary easing.

The fiscal response to the crisis has been welcome, although it could have been better targeted. While the room for further stimulus is limited, Mexico should not rush into fiscal consolidation and aggravate the recession needlessly. To avoid adverse market reactions to breaking the balanced budget rule, a clear medium-term fiscal strategy should be formulated and communicated. To help boost activity, the central bank should use the room it has for cutting policy rates further, while keeping an eye on the exchange rate and possible exchange-rate pass-through into consumer prices.

Mexico is in recession, but inflation remains persistent

Growth turned negative towards the end of 2008, led by a sharp fall in both exports and domestic demand. As the recession deepened in the United States, Mexico's main export market, industrial production fell sharply, making growth highly negative in the first quarter of 2009. Private consumption has been weakened by the decline in real wages and rapidly rising unemployment rates. To sustain domestic demand, the authorities



1. Export data are expressed in USD.

Source: OECD Economic Outlook 85 database; INEGI.

have introduced a relatively modest stimulus package, including large, poorly targeted gasoline and electricity subsidies. Despite the collapse in demand, inflation has remained high. This is largely because Mexico kept administered prices for energy products artificially low through 2008, leaving the scope for a reversal in prices lower than in other countries. Coupled with concerns about capital outflows, the persistent inflation has caused the central bank to keep rate cuts limited, compared to actions taken in most other OECD countries. As inflation eases, there should be room for further rate cuts. Still, there is a risk that pass-through to consumer prices from the recent exchange rate depreciation could cause yet more persistence in inflation.

Mexico: Demand, output and prices

	2005	2006	2007	2008	2009	2010
	Current prices MXN billion	Percentage changes, volume (2003 prices)				
Private consumption	6 139.0	5.7	3.9	1.6	-6.8	1.0
Government consumption	991.9	1.7	2.1	0.6	4.6	3.3
Gross fixed capital formation	1 867.1	9.8	7.2	5.0	-11.9	5.8
Final domestic demand	8 998.0	6.1	4.4	2.2	-6.8	2.2
Stockbuilding ¹	385.4	-0.3	-0.5	0.2	-1.5	0.5
Total domestic demand	9 383.4	5.7	3.8	2.3	-8.1	2.8
Exports of goods and services	2 505.6	11.0	5.6	1.5	-18.4	2.1
Imports of goods and services	2 639.6	12.7	7.0	4.5	-17.5	2.1
Net exports ¹	- 134.0	-0.7	-0.6	-1.0	0.4	-0.1
GDP at market prices	9 249.5	5.1	3.3	1.4	-8.0	2.8
GDP deflator	–	6.7	4.5	6.6	3.6	3.4
<i>Memorandum items</i>						
Consumer price index	–	3.6	4.0	5.1	5.4	3.1
Private consumption deflator	–	3.4	4.8	6.9	7.7	3.2
Unemployment rate ²	–	3.2	3.4	3.5	5.7	6.9
Current account balance ³	–	-0.4	-0.8	-0.4	-0.4	-0.5

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

2. Based on National Employment Survey.

3. As a percentage of GDP.

Source: OECD Economic Outlook 85 database.

The outbreak of influenza worsens short-term prospects

The outbreak of influenza A H1N1 had an immediate dampening effect on activity, as many businesses were forced to temporarily close and the important tourism industry took a hit. Tourism receipts are likely to be affected for some time, weighing on economic activity through 2009. A targeted fiscal package for affected businesses was introduced to provide some relief. Subsequently, the government announced cuts of a similar size in operational and wage expenditures, to ensure an unchanged deficit target.

Growth is projected to pick up somewhat in 2010.

Following the sharp drop in the first half of the year, which has been exacerbated by the influenza outbreak, the worst should now be over. The weak US economy, particularly the manufacturing sector, and the declining oil extraction will keep export growth negative until the end of the year. Domestic demand will decline through 2009 as private consumption growth

is held down by rising unemployment rates. Growth is set to pick up from late 2009, reaching quarterly growth rates above 4% in annualised terms during 2010. Revenues from an oil price hedge are helping authorities finance a fiscal stimulus this year, partly sustaining domestic demand. However, no such price hedge was arranged for 2010, leaving the government budget vulnerable to low world oil prices. Under the existing fiscal rule, a fall in government oil revenues in 2010 would require cuts in government consumption and lead to a pro-cyclical negative fiscal impulse.

Risks have become more balanced.

The main downside risk to the Mexican economy is that the downturn in the US economy and world demand may prove to be longer or deeper than projected. This would worsen the troubles of the car industry, limit worker remittances sent to Mexico, and delay the recovery of both exports and international commodity prices. Still, should US demand and industrial production, as well as international oil prices, pick up faster than projected, Mexican industrial production and exports would be given a much needed boost, and government revenues would improve more than projected, reducing the need for pro-cyclical spending cuts.