OECD
BETTER POLICIES FOR BETTER LIVES

Interim Economic Assessment

18 March 2015

Tailwinds driving a modest acceleration… but storm clouds on the horizon?

Growth prospects in the major economies look slightly better than at the time of the OECD November 2014 Economic Outlook, *but the near-term outlook is still one of moderate, rather than rapid, world GDP growth. Lower oil prices will boost global demand and have created conditions for many central banks to lower interest rates. Bold and open-ended action by the European Central Bank has boosted asset prices in the euro area and added to easier global financial conditions.*

The favourable tailwinds create an opportunity for the euro area and Japan to get back to somewhat stronger growth rates, and on balance the most recent indicators are encouraging. In the United States, a cyclical recovery continues, although one-offs like the severe winter weather in the Northeast may disrupt the quarterly profile of growth. Over the next two years India is set to grow faster than China, where growth is slowing towards the official target of around 7%. Oil and commodity exporters are facing weaker growth prospects as the result of lower prices.

OECD Interim Economic Projections[1]

	2014	2015		2016	
		March 2015 Interim Projections	difference from November Outlook	March 2015 Interim Projections	difference from November Outlook
United States	2.4	3.1	0.0	3.0	0.0
Euro area	0.9	1.4	0.3	2.0	0.3
Japan	0.0	1.0	0.2	1.4	0.4
Germany	1.6	1.7	0.6	2.2	0.4
France	0.4	1.1	0.3	1.7	0.2
Italy	-0.4	0.6	0.4	1.3	0.3
United Kingdom	2.6	2.6	-0.1	2.5	0.0
Canada	2.5	2.2	-0.4	2.1	-0.3
China	7.4	7.0	-0.1	6.9	0.0
India	7.3	7.7	1.3	8.0	1.4
Brazil	0.0	-0.5	-2.0	1.2	-0.8
Aggregate[2]	3.7	4.0	0.1	4.3	0.2

1. GDP at market value adjusted for working days. In the case of Germany, this differs from the "headline" measure, which does not include the working day adjustment. The unadjusted number for Germany would be higher by 0.2 percentage points in 2015 and by 0.1 percentage point in 2016.
2. Economies representing over 70% of global GDP measured at 2013 PPP exchange rates.

However, against this backdrop of somewhat better growth prospects, abnormally low inflation and interest rates create a growing risk of financial instability with risk-taking and leverage driven by liquidity

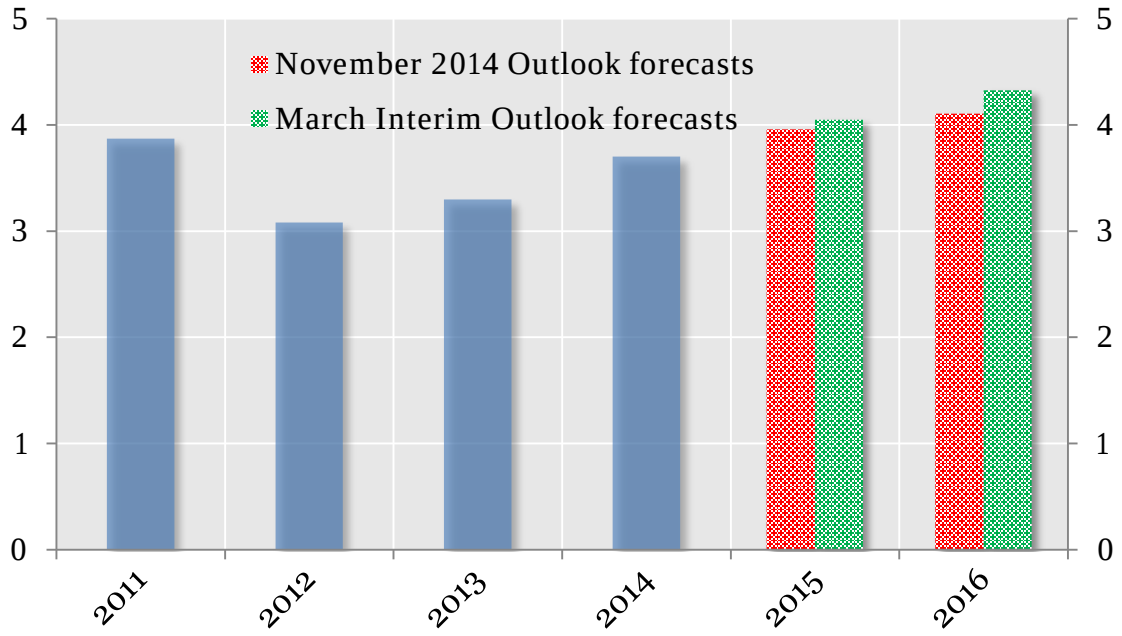
rather than fundamentals. Moreover, projected growth rates remain too low to fully repair and activate labour markets. While central bank policies remain the centrepiece of the recovery, the exclusive reliance on monetary policy to manage demand should be avoided to mitigate these risks. A more balanced approach to policy is required with fiscal and, especially, structural policies providing synergistic support to monetary policy.

The global growth outlook has improved somewhat since late 2014

- Growth prospects in the major economies look slightly better than at the time of the OECD November 2014 *Economic Outlook,* with upward revisions to the main euro area economies, Japan and India. The growth outlook for the United States, China and the United Kingdom is largely unchanged from November, while significant downward revisions are made only for commodity-exporting countries (Brazil and Canada). Overall, the near-term outlook remains for moderate, rather than rapid, world GDP growth; real investment remains sluggish, and labour is not yet fully engaged.

GDP

Percentage change, seasonally adjusted annualised rate

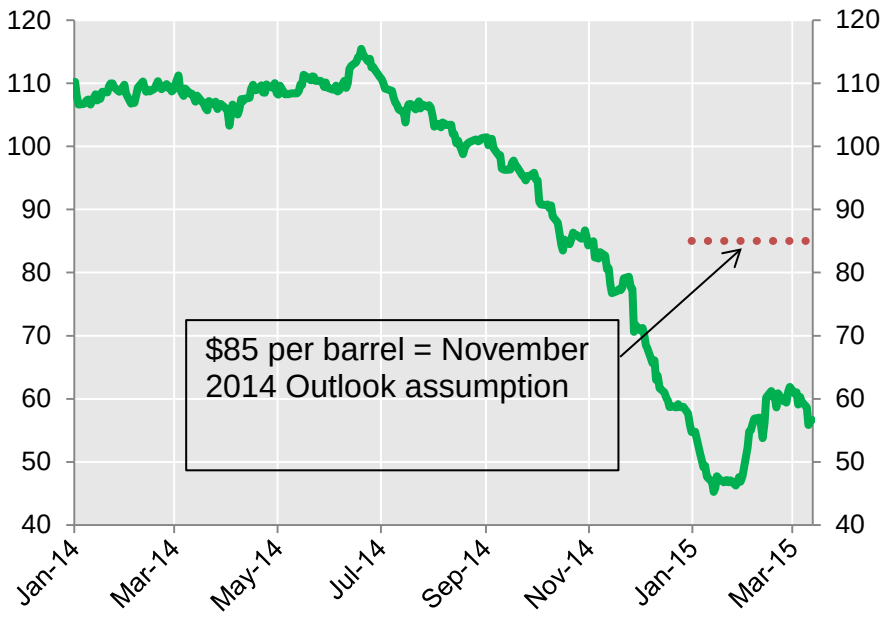


Source*:* OECD National Accounts database, November 2014 OECD Economic Outlook database; and OECD Interim projections.

- Tailwinds from lower oil prices and the effects of monetary policy easing are driving the overall improvement in the outlook. From June 2014 through January 2015 oil prices experienced one of their largest falls in recent decades and are about 35 percent lower than at the time of the OECD's November projections, after a partial rebound in February-early March was erased in recent days. The steep fall in crude oil prices reflects continued increases in production, especially in the United States, which outstripped the growth in final demand. OPEC's decision in late November not to cut production appears to have triggered a further downward move, creating consensus that excess supply would continue until high-cost production was squeezed out by the persistence of low prices.

Brent crude price

US dollars per barrel



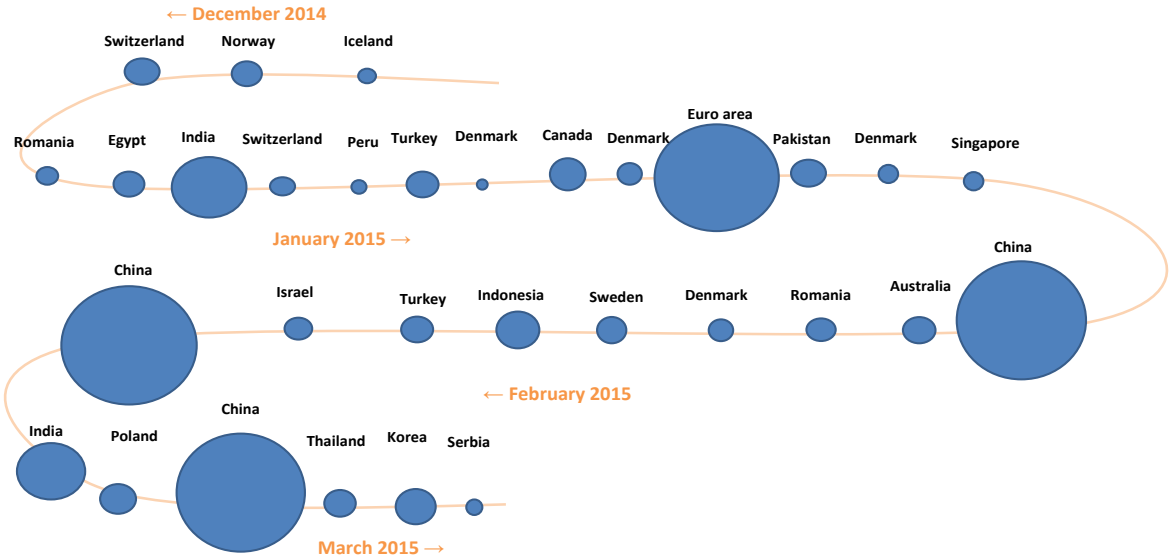
Source: Datastream.

- Lower oil prices both raise the real incomes of households and reduce costs for firms, and should therefore be beneficial for global growth, notwithstanding the loss of real income for oil producers. The fall in energy prices also puts downward pressure on consumer prices. Many central banks have responded to the shock by cutting interest rates or signalled a more accommodative policy stance.

- Probably the most significant of the decisions to ease taken in the past few months was that of the European Central Bank (ECB). The ECB announced on 22 January that it would take policy action to get inflation moving back up towards its target, including a large open-ended asset purchase programme to last until at least September 2016, building on earlier measures including purchases of asset-backed securities and negative overnight deposit rates. Unlike the many other central banks that have eased monetary policy since late 2014, the ECB signalled such a step well in advance, as inflation repeatedly undershot projections and inflation expectations drifted ever further below the ECB's target.

- The widespread easing of monetary policy over the past few months, affecting countries accounting for roughly half of global GDP, has resulted in improvements in global financial conditions. A number of the associated moves in exchange rates have been large, raising the question of overshooting in some cases.

Timeline of recent monetary policy easing decisions



Note: size of bubbles indicates relative GDP (at PPP). Russia, which raised policy rates sharply in December before cutting twice since, is not included as an easer over this period.
Source: OECD.

Tailwinds create an opportunity for the euro area to escape from stagnation

- Lower oil prices and the effects of quantitative easing by the ECB constitute important new positive growth factors that explain most of the upward revision to growth forecasts for the euro area. This provides a much-needed opportunity for the euro area to avoid a prolonged period of stagnant real incomes, weak labour markets, and excessively low inflation. Although the euro area is a less oil-intensive economy than the United States, the oil price shock is still beneficial for real household income, and consumer sentiment and retail sales have improved in recent months. Also, the shift to more aggressive easing by the ECB while the United States moves closer to raising policy rates has been associated with a substantial depreciation of the euro in real effective terms (by about 15% since June 2014), which will boost the euro area's net exports. The pass-through of higher import prices to the consumer price index will also offset some of the effect of the energy price decline and help to get inflation moving back up towards target.
- Increasing investment will be a key element of a cyclical recovery in the euro area as well as being necessary to raise productivity in the medium term. The Juncker Plan provides an important opportunity to catalyse private investment using public support within the current fiscal constraints. By acting together, EU countries can have a greater demand impact and take forward investment projects with high returns. This includes investment in cross-border infrastructure in network industries such as electricity, gas and air and rail transport. The Plan needs the support and contributions of national governments to achieve effective implementation. However, the effectiveness of the Plan requires reforms to market regulations and cross-border regulatory frameworks to ensure the viability of the investments. This could help to tackle the wide price dispersion within the Single Market in areas such as electricity. Further convergence in regulation across many areas would give a major boost to trade and FDI.
- While euro area growth is expected to strengthen in 2015-16, domestic demand has been persistently weak since the crisis and strong policy support to demand remains warranted. With the ECB undertaking exceptional policy stimulus and given the considerable progress already made in fiscal consolidation since the crisis, fiscal policy can be more supportive of demand. For the coming years, fiscal policy in the euro area as a whole is expected to be broadly neutral compared with the sharp tightening of earlier years.
- The euro area's fiscal rules are essential to the stability of the monetary union, but their complexity has created uncertainty in recent years, not least because of the repeated resort to *ad hoc* extensions of deadlines for corrective budgetary action. Such extensions have been used 12 times since 2009. The uncertainty created by this *ad hoc* approach reduces the demand impact of expansionary changes in policy. An open discussion is needed of how to make the rules more effective and more credible.

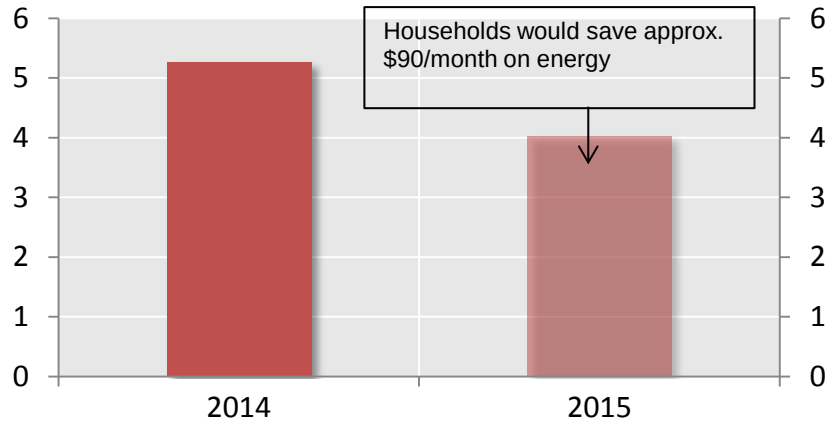
Cyclical recovery in the United States continues, despite severe weather in early 2015

- Employment and consumer spending in the United States continue to expand at a steady pace, confirming that the private sector demand recovery is well advanced. Lower oil prices will lead to significant gains in household spending power. Business investment is improving but the recovery in capital spending on machines and equipment is lagging other areas. Growth in the first quarter is likely to have been held back by severe weather in the Northeast in January-February, but this should be unwound in the coming months.

- The sharp appreciation of the dollar that has occurred in recent months will hurt US net exports, but this is not expected to pull GDP growth below potential, permitting a continued gradual shrinking of the output gap. And the counterpart to worsening net exports for the United States is that the US economy is increasing its contribution to demand in other countries, which is helpful in the current context of global demand.

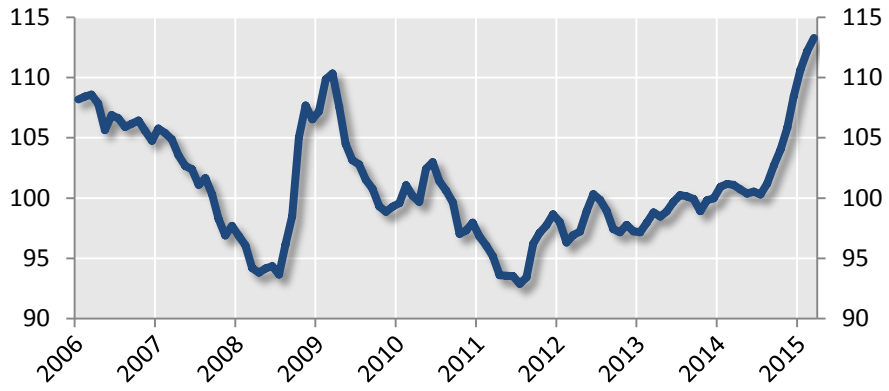
- Lower oil prices and the appreciation of the dollar make it appropriate for the Federal Reserve to wait longer to raise policy interest rates, providing some on-going support to private demand through the wealth effect. Fiscal policy should remain broadly neutral; it is important to avoid renewed fiscal brinkmanship and to legislate a credible medium-term plan for the government finances.

United States -- estimated effect of lower oil prices on share of energy in household spending
Per cent



Source: Bureau of Economic Analysis; and OECD calculations.

United States -- nominal effective exchange rate
Trade-weighted broad currency index, 2010 = 100,



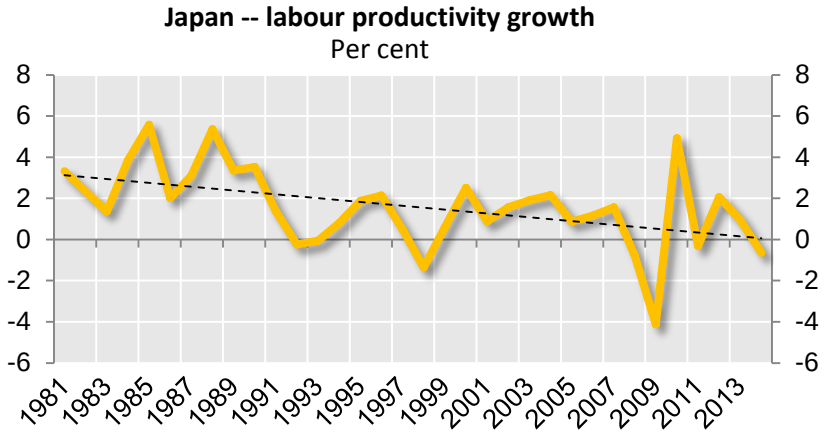
Source: US Federal Reserve.

Growth in Japan is getting back on track, but the challenges ahead remain formidable

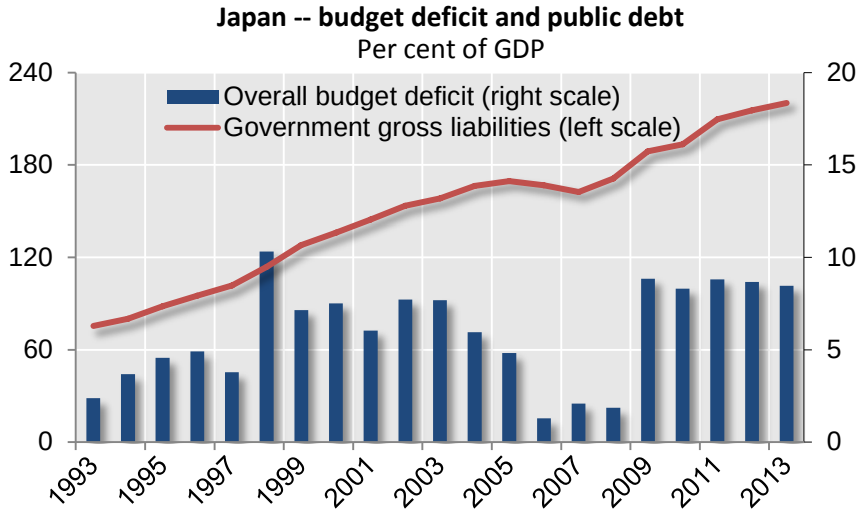
- Growth in Japan is expected to pick up in 2015-16 after a sharp contraction following the April consumption tax hike. Consumer spending on durables goods is increasing, although private consumption remains at a low level. Recent developments show early signs of a pick-up in business investment, although companies remain reluctant to spend high cash holdings. Demand will be lifted by the fall in oil prices, the fiscal stimulus package for 2015 and the announced continuation of monetary easing measures. While lower oil prices are likely to push headline inflation lower, yen depreciation and recovering nominal demand will lead to firmer core inflation, although it will take some time to reach the Bank of Japan's inflation target of 2%. A key requirement for reaching a new equilibrium with satisfactory demand growth and inflation close to the official target is a significant rise in average nominal wages, making the current annual wage bargaining round critical.

- The lack of growth in 2014 marks a setback in the strategy to restore Japan's growth and end deflation. While additional fiscal and monetary stimulus help to create the right conditions, structural changes to boost competition, trade and labour force participation are essential to raising the growth of potential output. Progress on the "third arrow" of structural reform has already been made, but greater ambition is required.

- Faster long-run output growth facilitated by implementation of the third arrow will be one critical element in a long-term strategy to shrink the daunting public debt burden. In the short run, the most critical contribution to meeting that major challenge may be to boost nominal GDP growth via a return to sustained low positive inflation. Beyond that horizon, an extended period of fiscal consolidation will be necessary to achieve a primary surplus and get the public-debt-to-GDP ratio moving down decisively to safe levels.



Source: OECD National Accounts database.



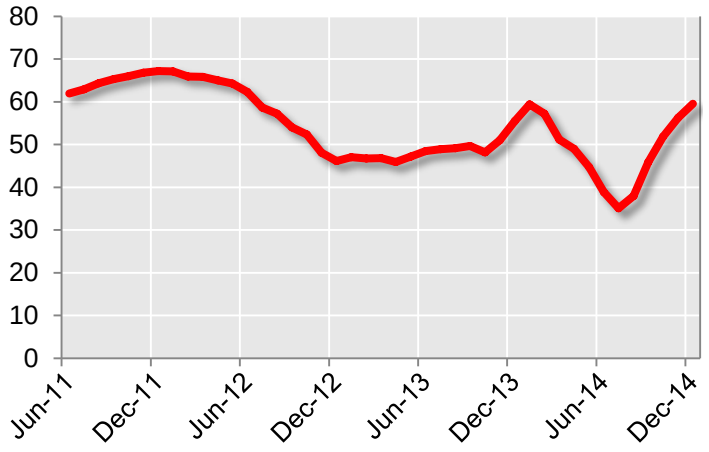
Source: OECD National Accounts database.

Chinese growth is slowing gradually to the official target of around 7%, but managing the slowdown and financial risks will be difficult

- GDP growth in China has gradually slowed over the past year towards the recently announced target of around 7% for 2015. Private demand growth has continued to slow as the economy rebalances, in part due to weakness in the real estate sector. Lower oil prices, fiscal stimulus measures and an easing of monetary conditions are helping to support demand. Inflation is likely to remain weak due to lower commodity prices and the slower growth rate.

China -- gap between floor space started and sold

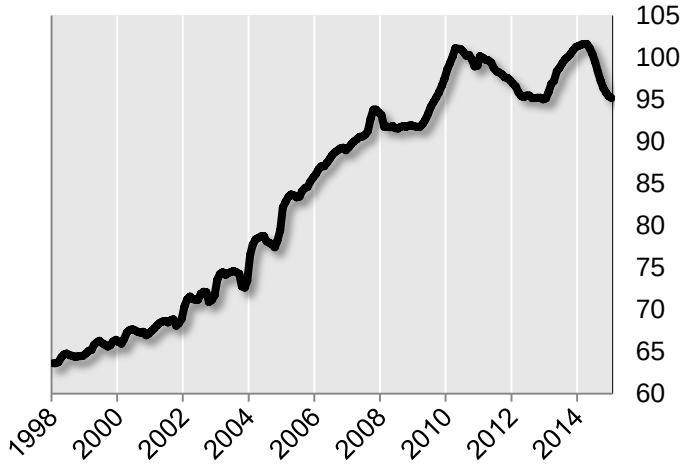
Millions of square meters



Source: CEIC.

China -- real property price

Index 2010=100

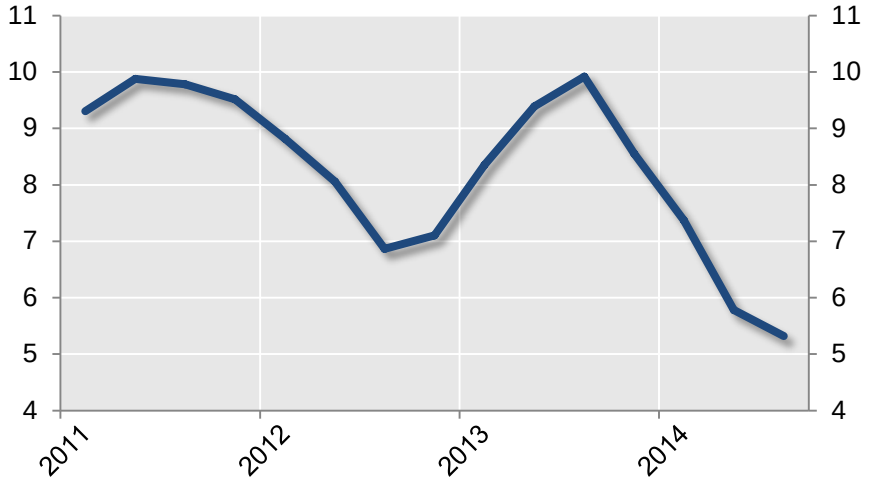


Source: CEIC

- Policymakers face a significant challenge as they seek to meet growth targets while also rebalancing the economy toward domestic demand and at the same time addressing financial risks. Further monetary stimulus and fiscal policy support should be carefully calibrated. Progress on reforms in a range of structural policy areas is needed to ensure sustainable rapid growth. Service sector liberalisation would provide a powerful driver to growth and jobs and help the economy rebalance towards more domestic sources.

China -- real total domestic expenditure

Year-on-year percentage change, 3-quarter moving average



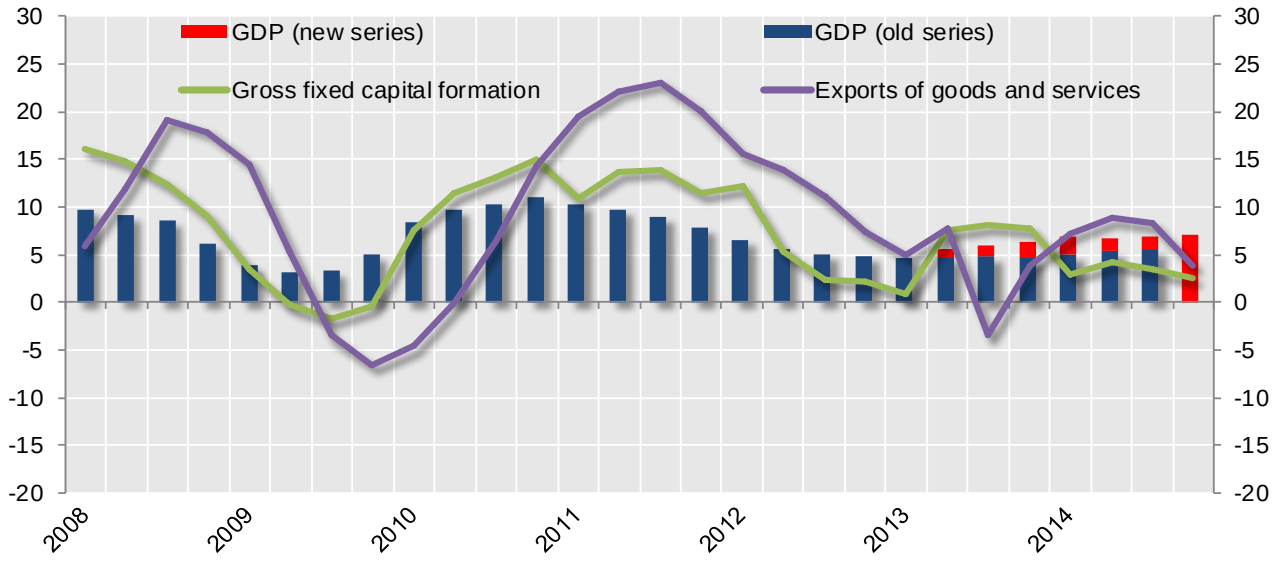
Source: OECD November 2014 Economic Outlook database.

The Indian economy is set to perform strongly, if key challenges can be overcome

- India is now expected to be the fastest-growing major economy in 2015-16, overtaking China. Part of this relative improvement reflects significant revisions to past GDP data, which raise the base growth rate through 2014. The projected acceleration in growth this year is actually smaller than foreseen in the November 2014 Economic Outlook, reflecting sluggish growth of investment and exports. With obstacles emerging to the adoption of growth-friendly structural reforms, maintaining rapid growth will pose a difficult challenge, notwithstanding the strong current momentum.

India -- GDP, exports and investment

Volume, 4-quarter moving average, year-on-year percentage change



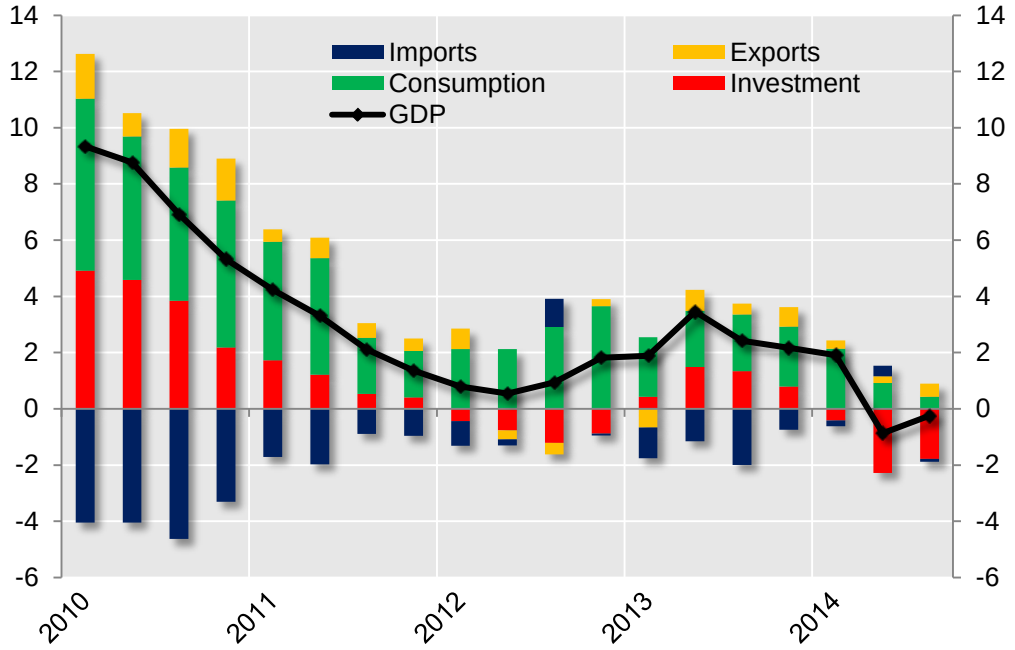
Source*:* Indian Central Statistics Office; and OECD calculations.

The outlook has worsened for commodity-exporting economies

- The main class of countries for which near-term growth prospects have worsened since the November 2014 Economic Outlook is the commodity exporters. The Interim projections are significantly lower for oil-exporters Canada and Brazil, with short-term growth prospects in Brazil also being restrained by monetary and fiscal tightening and increasing political uncertainty. Growth has already slowed in many other oil-exporting countries, and with the fall in commodity prices going well beyond oil, exporters of metals, coal and some agricultural commodities also face less favourable growth prospects this year.

Brazil -- contribution to GDP

Volume, year-on-year percentage change



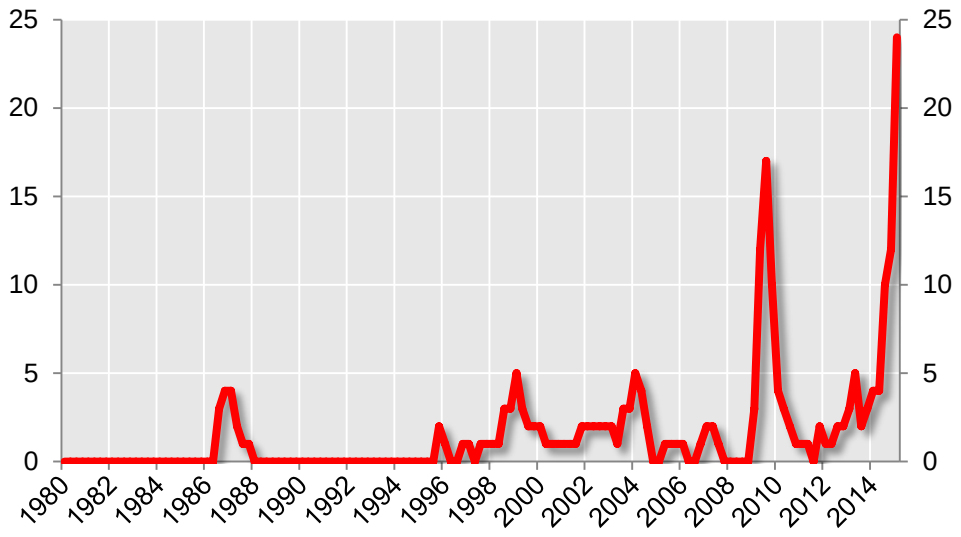
Source: Brazilian Institute of Geography and Statistics (IBGE); Datastream.

Abnormally low (and in some cases negative) inflation and interest rates underline the exceptional nature of the current conjuncture

- The current economic environment is highly unusual, with inflation at negative rates in many countries and nominal interest rates around historic lows across much of the world. To a degree, these two interrelated phenomena are welcome (in that, in principle, the lower interest rates could support investment, and for a given evolution of nominal incomes a dip in inflation boosts real incomes). But for both inflation and interest rates, the extent of the decline and the current rates in many countries give rise to growing concern.

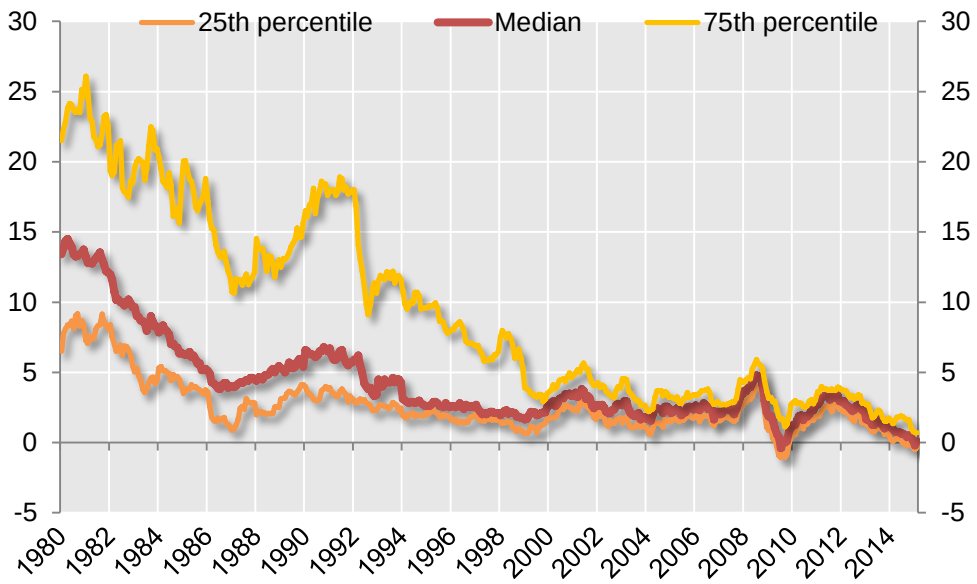
- Year-on-year inflation is already negative in a larger number of countries than at any time in recent decades, and that number is likely to grow before the effects of the oil price decline start to drop out in the second half of the year. It is possible that 12-month inflation will be negative in the five largest economies at some point in the first half of 2015, which would be unprecedented.

Number of countries with negative 12-month headline inflation rate



Source: OECD Main Economic Indicators database.

Headline inflation in OECD countries



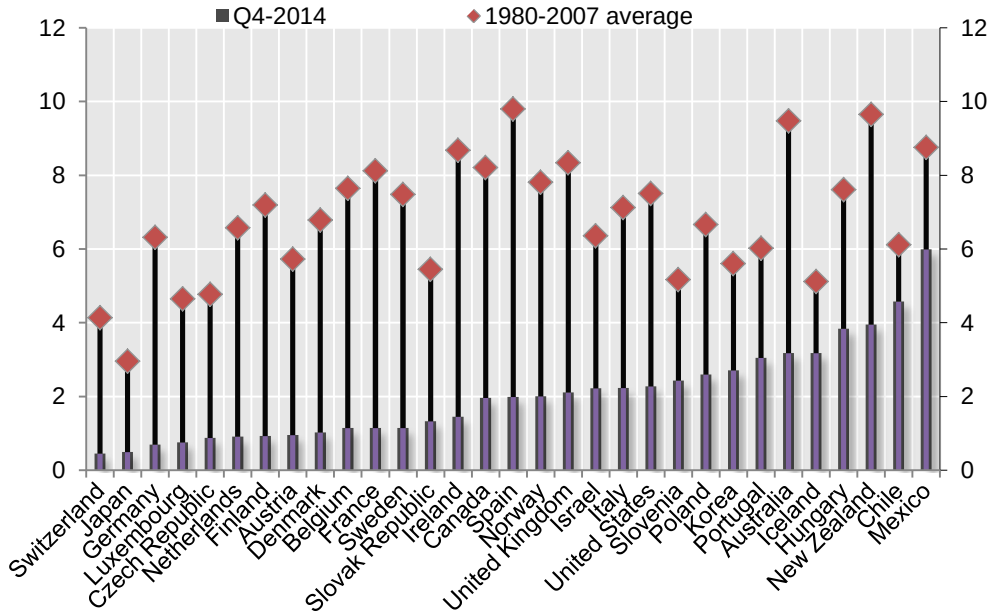
Source: OECD Main Economic Indicators database.

- In many countries, mainly in Europe, the danger of inflation remaining far below target for an extended period has increased. Maintaining a stable moderate positive rate of inflation has a number of advantages for the functioning of the economy, including avoiding aggravating the real burden of nominal debts (important when some sectors and groups are already heavily indebted) and facilitating the adjustment of relative prices without forcing downward moves in some prices and nominal wages. Keeping inflation close to the official target is also important for the credibility of central banks, helping to keep expectations anchored. Thus, the dangers associated with the excessively low rates of inflation seen in many economies at present are growing.

- Similarly, while it is both expected and desired to have low interest rates when many central banks are reacting to below-target inflation and below-potential output with accommodative monetary policy, the extent of the decline appears in some cases to be flashing a warning signal. Mispricing of risk was at the heart of the previous financial crisis, and such mis-pricing may be in evidence again. It is remarkable that a growing number of national governments are able to sell medium-term bonds at negative nominal interest rates. At the same time, global equity indices have reached new peaks in recent months, and spreads between risk-free rates and higher-risk instruments remain compressed, despite some recent increase.

10-year government bond yields

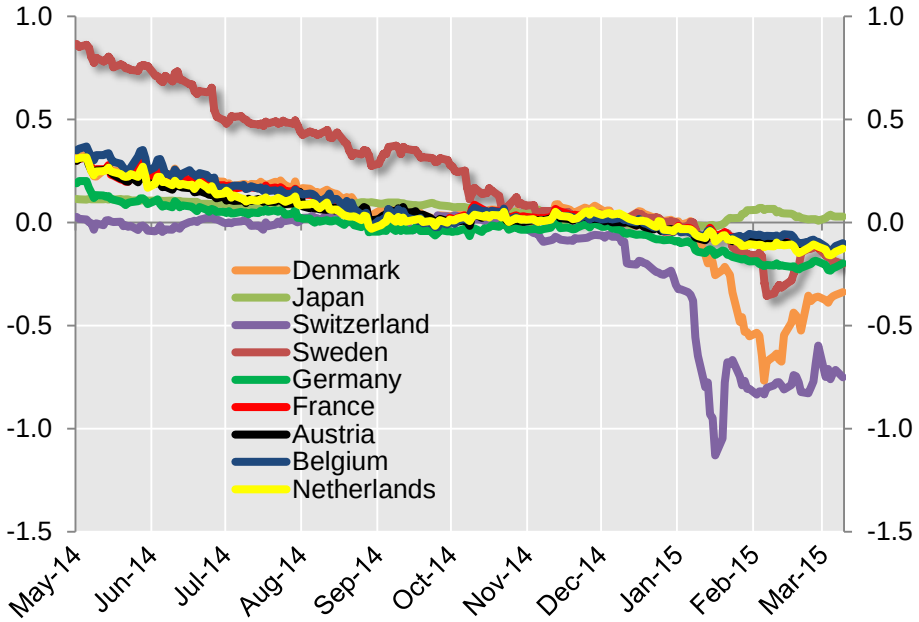
Per cent



Source: Datastream.

3-year government bond yields

Per cent



Source: Datastream

- Growing risks associated with abnormally low nominal interest rates should not deter the major central banks from continuing with their highly accommodative stance. Given the extraordinary circumstances prevailing since the global crisis, exceptional measures to support demand and resist disinflationary tendencies have been needed. But, the failure of monetary easing alone to spur strong growth in fixed investment, with booms in financial investments instead, implies that policy-makers should not rely exclusively on monetary policy. Balanced policy packages, including fiscal and structural elements as well as monetary ones, are needed to give the necessary support to demand and job creation while moderating risks to financial stability.

The OECD *Interim Economic Assessment*

The OECD *Interim Economic Assessment* is a partial update each March and September of the OECD's twice-yearly *Economic Outlook* published in November and May/June. Revised projections for annual GDP growth are provided for the United States, Japan, the euro area, Germany, France, Italy, the United Kingdom, Canada, Brazil, China and India.

The revised projections are based on a simplified version of the process used to prepare the *Economic Outlook*, based on models and judgement. Near-term developments are assessed using the OECD's short-term indicator models.