OECD BETTER POLICIES FOR BETTER LIVES

Interim Economic Outlook

16 September 2015

Puzzles and uncertainties

Global growth prospects have weakened slightly and become less clear in recent months. World trade growth has stagnated and financial conditions have deteriorated. The recovery is nonetheless progressing in advanced economies, but the outlook has worsened further for many emerging market economies (EMEs).

Global growth will remain sub-par in 2015. Some strengthening in growth is expected in 2016, but doubts about future potential growth continue to build.

OECD Interim Economic Projections
Real GDP[1]
Percentage change

	2014	2015		2016	
		September 2015 Interim Projections	difference from June Economic Outlook *(percentage points)*	September 2015 Interim Projections	difference from June Economic Outlook *(percentage points)*
United States	2.4	2.4	0.4	2.6	-0.2
Euro area	0.9	1.6	0.1	1.9	-0.2
Japan	-0.1	0.6	-0.1	1.2	-0.2
Germany	1.6	1.6	0.0	2.0	-0.4
France	0.2	1.0	-0.1	1.4	-0.3
Italy	-0.4	0.7	0.1	1.3	-0.2
United Kingdom	3.0	2.4	0.0	2.3	0.0
Canada	2.4	1.1	-0.4	2.1	-0.2
China	7.4	6.7	-0.1	6.5	-0.2
India[2]	7.2	7.2	-0.1	7.3	-0.1
Brazil	0.2	-2.8	-2.0	-0.7	-1.8
Rest of the world[3]	2.8	2.3	-0.2	3.3	-0.3
World	3.3	3.0	-0.1	3.6	-0.2

1. GDP at market prices 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 no different in 2016.
2. Data refer to fiscal years starting in April.
3. Estimated based on revisions to the June 2015 Economic Outlook projections on the basis of changes to external forecasts since June.

The US recovery remains solid, but there are puzzles around developments in other major economies. Growth in the euro area is improving, but not as fast as might be expected. Erratic data in Japan raise questions about the robustness of the recovery there. And growth dynamics in China are difficult to assess, with conflicting signals coming from different indicators.

This leaves the outlook clouded by important uncertainties. One is whether EME vulnerabilities will be exposed by rising world interest rates and/or a sharper-than-expected economic slowdown in China, giving rise to financial and economic turbulence that would also exert a significant drag on advanced economies. Another uncertainty is whether Europe will experience an intensification of centrifugal forces, sapping confidence in the euro area and the EU and hindering the economic recovery that is underway. Finally, there are increasing doubts about the medium-term growth of economic potential in advanced and emerging economies alike, given persistent sluggish investment and weak productivity growth.

Overall, continued policy stimulus is warranted to support global demand, but policy needs differ by country, in that a recovery has progressed well in some advanced economies while demand is weakening in many EMEs.

In the United States, progress on closing output and employment gaps warrants an upward interest rate path, but at a very gradual pace. The timing of the first rate hike is of secondary importance compared to the pace of increase. Clear communication of that pace will help to minimise financial market volatility.

The Chinese authorities face the policy challenge to sustain growth while advancing structural change and managing risks. Additional stimulus may be needed, but it should rely less on debt-financed infrastructure and construction spending, and more on an expansion of social expenditures that will help support consumer spending and adjustment towards a more balanced growth model.

The focus in the euro area should be on improving the transmission of monetary policy via the credit channel in order to make quantitative easing more effective. This implies a further strengthening of the financial system, with continued progress towards banking union and supervisory action to improve the quality of bank assets.

Global growth remains sub-par this year, and a smaller pick-up is now projected in 2016, aggravating doubts about potential growth

- Global growth prospects have weakened modestly since the June OECD *Economic Outlook*. For 2015, global GDP growth is forecast to slow to 3%, well below its long-run average. In per capita terms, this will be the 5th consecutive year of declining global growth rates.

- The slight downgrading of 2015 global growth since June largely reflects the deterioration in the near-term prospects for EMEs and comes despite an upward revision for the United States, including better-than-expected growth in the second quarter. A weakening of import demand in China has both hit export volume growth elsewhere and driven the fall in commodity prices. Some large EMEs have also experienced headwinds from specific domestic and international events. Brazil and Russia are experiencing deep recessions combined with relatively high inflation.

- Global growth is still expected to strengthen in 2016, though by slightly less than foreseen in June. Much of the improvement reflects a continuing gradual recovery in advanced economies. Growth in the United States is expected to remain solid, while growth rates should accelerate further in the euro area and Japan.

- The 2016 picture is more mixed among the major EMEs. India is projected to continue to grow strongly, broadly in line with 2015, while commodity-exporting EMEs like Brazil and Russia should see some improvement in 2016 if commodity prices do not fall further. With adroit policy selection and implementation, China's slowdown is projected to be only gradual.

- A number of major uncertainties cloud the outlook. The key risk to global growth is a larger-than-expected slowdown in China. Combined with financial turmoil, potentially exacerbated by the first tightening step in US monetary policy, this would have serious repercussions on the global economy. In particular, some EMEs, already hit by terms of trade losses and/or a deterioration of financial conditions, are vulnerable to further financial shocks through the channels of debt exposure.

- Repeated disappointments on global growth in recent years and the continued sluggishness of investment growth in many economies (discussed in detail in the June 2015 *Economic Outlook*) suggest that medium-term potential growth rates may be lower than previously thought.

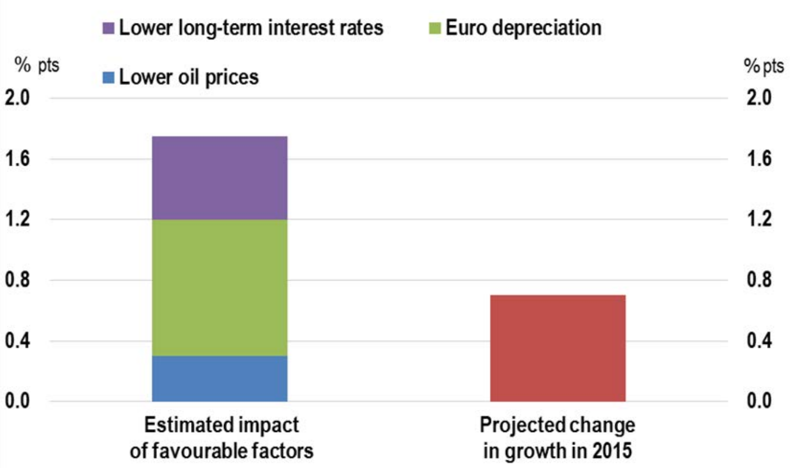
The pace of recovery in some advanced economies is disappointing given favourable factors

- Growth in the advanced economies is picking up from 2014 to 2015 and into 2016, reflecting a gradual cyclical recovery. In the United States, quarterly growth rates have been volatile, largely reflecting one-off factors, but underlying growth remains solid. Consumption growth is underpinned by steady job gains and falling unemployment. Business investment has begun to recover, although it has been held back by a big drop in energy investment and remains well below a normal recovery pace. Housing investment continues to lag compared with previous cycles. Underlying inflationary pressures remain subdued, in part as a result of past appreciation of the US dollar and flat wages.

- Growth in the euro area as a whole is improving, but the recovery remains less advanced than in the United States. Unemployment remains high and underlying domestic price pressures are weak. The increase in euro area growth rates this year (and especially the unexpectedly strong growth in some of the countries hardest-hit by the crisis) is encouraging, but less than would have been hoped given the tailwinds from lower oil prices, a weaker euro and lower long-term interest rates. OECD simulations suggest that the improvement in the euro area growth rate has been around one percentage point lower than would have been expected based on the impulse from these favourable factors.

Projected change in GDP growth rate in 2015 compared to estimated impact of favourable factors

Percentage points

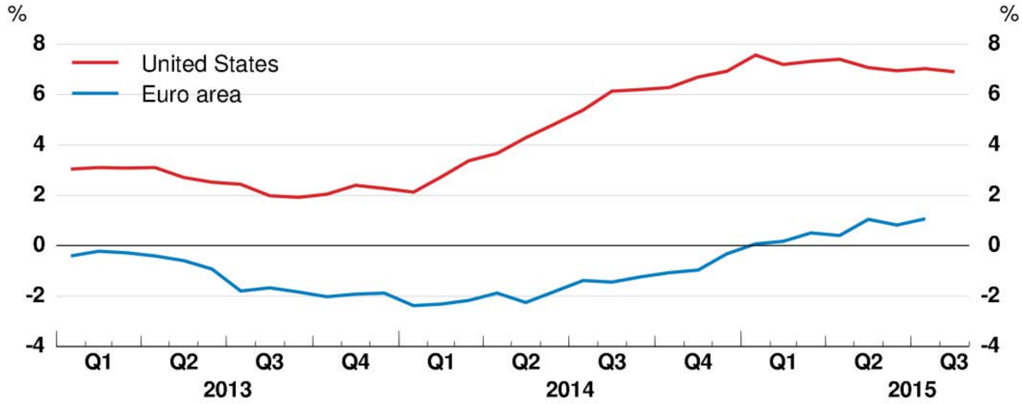


Note: Estimated impact of favourable factors calculated using the NiGEM model.
Source: OECD National Accounts Database; OECD calculations

- The lack of progress in easing the private sector debt burden since the crisis is one reason the pick-up in growth may have been disappointing. The debt overhang discourages new bank lending flows. Much more progress has been made in deleveraging since the crisis in the United States, where bad loans were recognised and written down to a greater degree. Until debt burdens in the euro area are eased, even such credit as is available is unlikely to spur net new spending. And the flow of new credit has been meagre. Year-on-year credit growth in the euro area as a whole has only recently turned positive, and in most euro area countries it remains below zero. While significant progress has been made in repairing the banking system, this is incomplete and the effects of these actions may take time before they result in increased lending.

Bank credit to non-financial corporations

Year on year percentage change



Source: ECB; Datastream

- Quarterly GDP growth in Japan has been erratic. Activity and employment appear to be on an improving path since the 2014 post-tax-hike contraction and the Bank of Japan's re-calibration of its monetary easing. On the other hand, inflationary pressure is virtually nil and tightening labour markets have yet to feed into the higher wages needed to sustain a stronger recovery in consumption and meet inflation objectives. Exports were growing solidly until recently, but despite further yen weakness they fell sharply in the second quarter.

- Among other advanced economies, developments largely support the global recovery with economies either continuing to expand or recovery gaining momentum. However, commodity-exporting countries like Australia and Canada continue to face strong headwinds from the falling prices of key exports such as oil, coal and metals.

- Business investment remains subdued across the board, holding back global trade growth and continuing to keep productivity growth in check. This can largely be explained by weak aggregate demand, both domestic and foreign, although on-going uncertainty and a slowing of progress in structural reforms have also contributed. Falling real tax-adjusted interest rates and high equity prices have had relatively little pass-through to real investment, especially in countries where credit supply has been constrained by an incomplete repair of bank balance sheets.

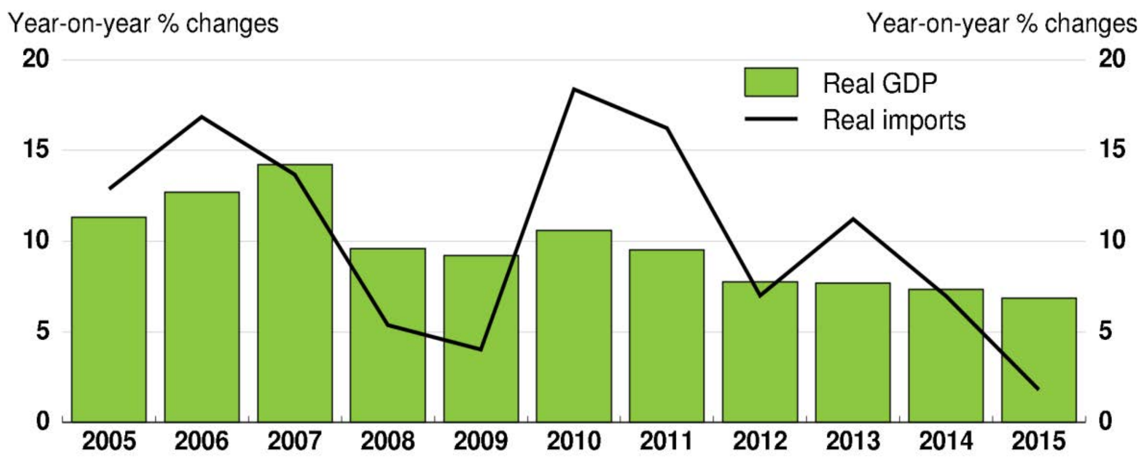
A key puzzle for global GDP revolves around China's growth

- Recorded GDP growth in China has remained close to 7% in year-on-year terms up to the second quarter of 2015. Urbanisation and the easing of restrictions on entry in service sectors are generating many new jobs and driving an increase in the share of services in GDP, but the key question is whether expanding sectors can absorb resources fast enough to achieve official growth targets while facilitating the necessary rebalancing of the economy. Some heavy industries suffer from significant overcapacity and are restructuring. Real estate activity and business investment have slowed.

- Faced with signs of a slowdown, the authorities have announced new fiscal stimulus measures and a range of monetary and financial policy changes to support asset prices, credit and activity. One risk is that the measures are insufficient to achieve target growth rates, while another is that they further impair financial reforms and impede restructuring by allowing declining industries to add further excess capacity.

- Indicators are giving conflicting signals both about how restructuring is progressing and also the underlying pace of economic activity. Recent external trade data suggest a marked slowdown, since the implied deviation from the usual relationship between imports and GDP is implausibly large. In addition, producer price inflation is negative and consumer price inflation remains low.

China: real GDP and import volumes



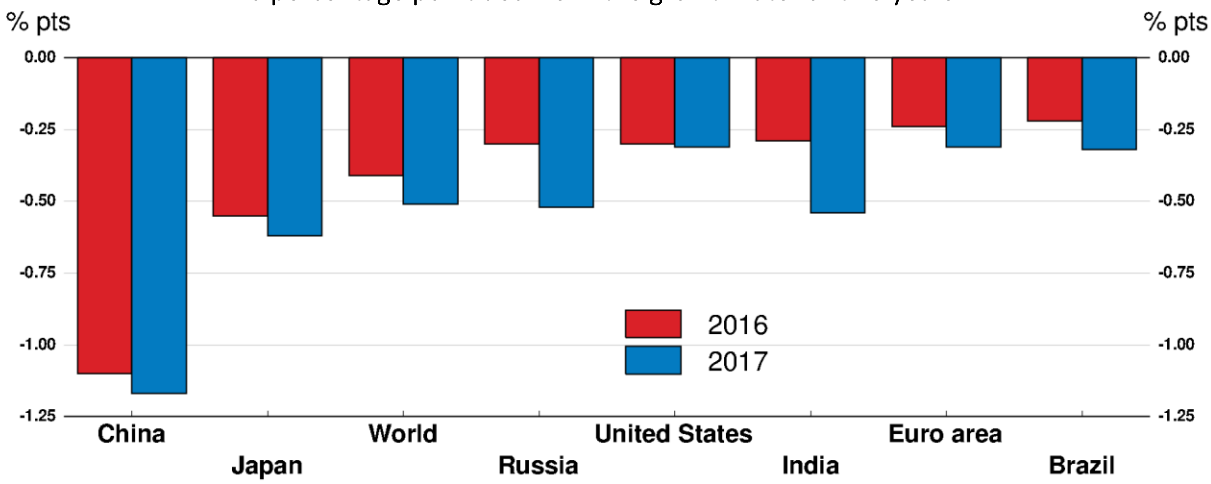
Note: 2015 is year-on-year change in the first half.
Source: OECD National Accounts Database.

- Weakening Chinese import growth helps to explain the global trade slowdown and the fall in commodity prices. The effects can be seen in the weakening of growth in countries which trade intensively with China and/or are dependent on commodity exports.

- The sharp correction in Chinese share prices since June has generated waves in financial markets elsewhere. The direct impact of the correction on the Chinese economy is not expected to be great, however. Share ownership rates are low, and the correction followed a very rapid increase in stock prices that started in late 2014, leaving prices still higher than a year ago.

- The impact of a larger-than-expected slowdown in Chinese demand through direct trade and investment links would be significant, especially for those countries most heavily exposed. This would not, however, derail the global recovery unless combined with a large and widespread correction in global financial markets. A NiGEM model simulation of a two percentage point decline in the growth rate of China's domestic demand for two years – combined with adverse financial shocks – shows a large effect on global GDP growth.

GDP growth impact of an adverse domestic demand shock in China
Two percentage point decline in the growth rate for two years



Note: Also assumes a reduction of 10% in global equity prices and a 20 basis point increase in the equity risk premium in all countries.
Source: OECD Economic Outlook database; OECD calculations

Growth in EMEs has slowed, and many are vulnerable to further adverse shocks

- Growth in many major EMEs has continued to slow and forecasts have again been revised downwards for 2015 and 2016. The slowdown has been sharpest in countries heavily dependent on commodities and/or with close trade links to China, notably in East and South-East Asia. In 2014, over a third of all merchandise imports in China came from regional trading partners. The main exception to the worsening picture is India, where growth is supported by strong consumer spending and public investment in infrastructure.

- Financial conditions have deteriorated in some EMEs. Especially among commodity exporters, the worsening of the terms of trade has been associated with weakening currencies. In addition, most equity markets were caught up in the August turmoil provoked by the sharp share price declines in China, combined with the anticipation of tighter US monetary policy. Portfolio rebalancing away from EME assets has resulted in a widening of sovereign bond spreads and a decline in equity prices of more than 10% since early May. Bank lending conditions have also continued to tighten in most economies. Currency depreciation, whilst acting to offset commodity price declines in the major commodity-producing economies, has raised the cost of servicing debt denominated in foreign currencies and added to underlying inflationary pressures.

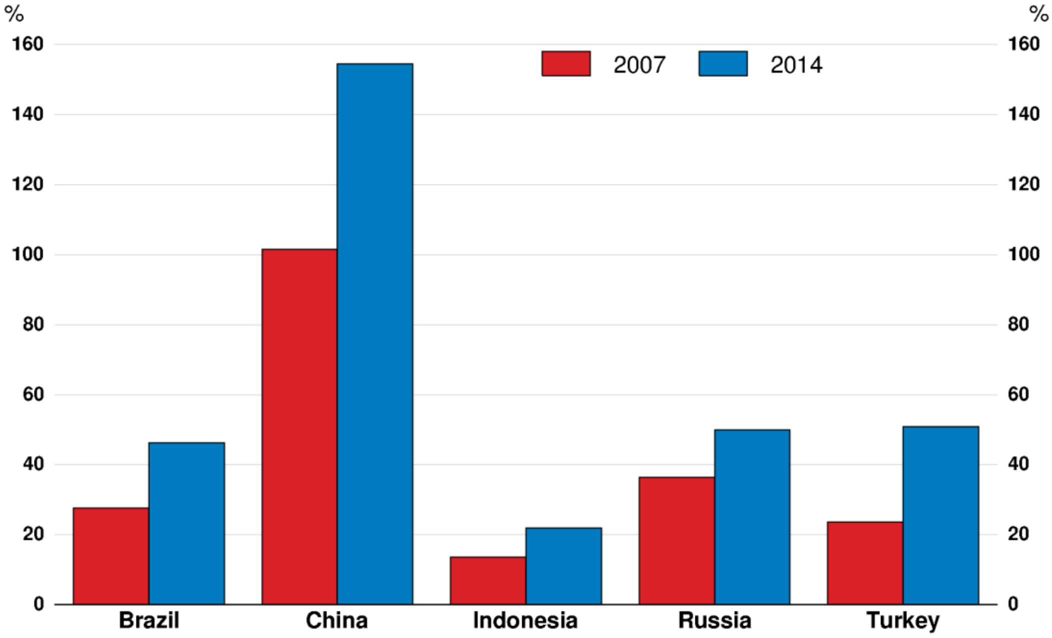
- Since the start of the financial crisis, foreign currency debt has risen in several large EMEs, although it appears to be lower in relation to GDP compared to the pre-Asian-crisis period (1996-97). Moreover, the structure of foreign gross liabilities has improved, with an increasing share of foreign direct investment (FDI) and a corresponding decline in the share of debt liabilities.

- Current account and fiscal deficits have widened to high levels in Brazil and South Africa, and to a lesser extent in Indonesia. EMEs that received large portfolio debt inflows in the aftermath of the financial crisis are more prone to capital reversals.

- Given the substantial rise in corporate debt burdens in recent years, further asset price falls combined with exchange rate swings would create financial distress for many EME corporates.

Non-financial corporate debt exposures in EMEs

Per cent of GDP



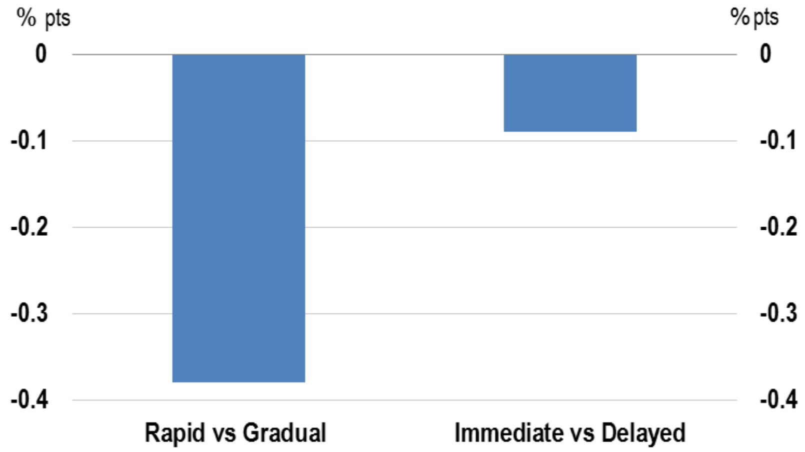
Source: BIS; OECD National Accounts Database.

Policy needs to support demand overall, but choices need to be consistent with financial stability and reviving long-run growth

- Global macroeconomic policy should remain supportive of demand. Advanced economies should continue accommodative monetary and fiscal policies to ensure that the recovery gains momentum, and spills over to strengthen employment, business investment and trade. The absence of strong price pressures creates space for monetary policy, and fiscal policy choices can be stimulative without adding to debt burdens. In the euro area and Japan, highly accommodative monetary policies should remain until inflation has shown clear signs of moving durably towards the official target.

- The US Federal Reserve will need to begin to raise its policy rate soon from its near-zero level, given the solid growth of the US economy and concerns over asset price distortions. Given that signals do not point to strong price pressures and weaknesses in domestic and global activity remain, rates should need to rise only at a gradual pace. In this context, the timing of the first rate rise will make little difference to the outcome.

Estimated difference in impact on US GDP in 2017 of (i) rapid vs gradual rate rises and (ii) immediate vs delayed first rate increase



Note: "Rapid" rise scenario roughly corresponds to the most recent 'dot plot' forecasts published by FOMC members, while the "Gradual" rise scenario approximates to current market expectations for the US Federal Funds rate. "Immediate" scenario has the first interest rate rise in September 2015, while in the "Delayed" scenario the first increase is in January 2016. Estimated impacts calculated using NiGEM model.
Source: OECD Main Statistical Database; OECD National Accounts Database; Datastream; OECD calculations

- Maintaining sustainable growth in China and rebalancing the economy, as well as addressing vulnerabilities in the financial system will be a major challenge. The authorities have already introduced additional fiscal stimulus, as well as measures to ease monetary and financial conditions and policies aimed at creating more favourable conditions for investment. China's authorities should use the room they have to provide further policy stimulus and avoid a sharp slowdown. However, it is important that stimulus fosters sustainable growth and not just a further increase of leverage and excess capacity. Beyond fiscal and monetary policy, a range of other policies would help, including services liberalisation and expanding social expenditures to support consumption growth and the rebalanced growth model.

- Many EMEs are experiencing weaker external demand growth and more difficult and volatile financial conditions, and these pressures may increase. Monetary and fiscal policies should be supportive of activity, and due attention should be paid to fiscal choices that support sustainable growth. Exchange rate adjustment should be allowed to take place, but the associated financial risks need to be managed. Macro-prudential measures have a role to play in this regard.

The OECD *Interim Economic Outlook*

The OECD *Interim Economic Outlook* is a partial update each September and March 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, China, India and Brazil. Projections for world GDP growth are also updated, based on Interim projections for the above countries and changes in external forecasts, applied to the last Economic Outlook projections, for the rest of the world.

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.