What is the near-term global economic outlook?

Interim Assessment

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Growth is recovering in early 2013

- The global economy weakened again in late 2012, but activity is now picking up in many major economies. One-off factors played a role in the slow growth in the United States in the fourth quarter of 2012, leading to expectations of a rebound in the first quarter of 2013.
- The outlook in the first half of 2013 is for a return to moderate growth in the United States and an acceleration from low levels in Japan, boosted by the announcement of new policy measures.
- In Europe, a meaningful recovery is likely to take somewhat longer. Within the euro area, there is a renewed divergence between growth in Germany, which is likely to pick up strongly over the first two quarters of 2013, and that of other countries, which will remain slow or negative.
- Growth among emerging economies remains much faster than that of advanced countries on average, although with significant differences across countries. Given the substantial share of the world economy now accounted for by emerging economies, they will again drive growth at the global level this year. Annualised growth in China is expected to continue to be well above 8 per cent in the first half of 2013.

GDP growth in the G7 economies

Annualised quarter-on-quarter growth, in per cent[1]

	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2
United States	2.0	1.3	3.1	0.1	3.5	2.0
Japan	6.2	-0.9	-3.7	0.2	3.2	2.2
3 largest Euro countries [2]	-0.2	-0.4	0.4	-2.3	0.4	1.0
Germany	2.0	1.1	0.9	-2.3	2.3	2.6
France	-0.2	-0.4	0.7	-1.2	-0.6	0.5
Italy	-3.7	-3.0	-0.8	-3.7	-1.6	-1.0
UK	-0.3	-1.5	3.8	-1.2	0.5	1.4
Canada	1.2	1.9	0.7	0.6	1.1	1.9
G7	**1.8**	**0.4**	**1.4**	**-0.5**	**2.4**	**1.8**

1. Based on GDP releases and high-frequency indicators published up to 26 March 2013. Seasonally adjusted and, in some cases, also working-day adjusted.

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

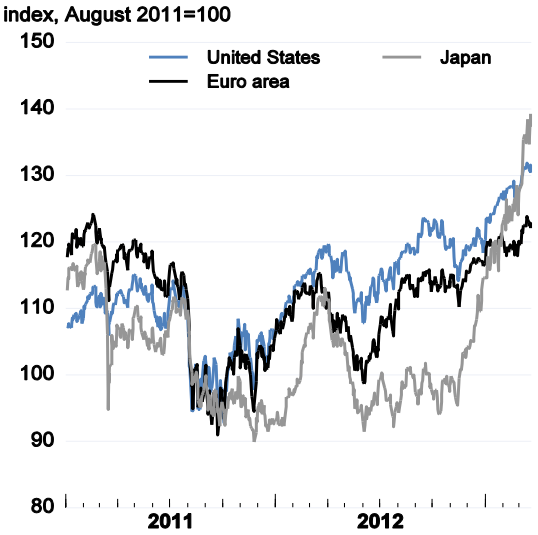
Note: See Appendix for underpinnings and status of the interim forecast.

The buoyancy of financial markets is outpacing the recovery in real activity...

- Uncertainty around the current forecasts remains high. Nonetheless, downside tail risks diminished in late 2012 and early 2013 as a result of actions taken to tackle the fiscal cliff in the United States and the European Central Bank (ECB) announcing its Outright Monetary Transactions programme. In Japan, upside risks have increased following recent policy announcements, notably relating to a new fiscal stimulus package and the raising of the inflation target, which have resulted in a weakening of the yen and a strong rise in equity prices. The government is also planning a new growth strategy by mid-year, which is expected to include new commitments to structural reforms.

- This shift in the balance of risks, together with abundant liquidity, was an important factor behind the marked strengthening of financial markets in recent months. Equity prices in OECD economies have surged, corporate bond spreads have narrowed and, despite a number of negative shocks, sovereign spreads in the euro area periphery moved down substantially in the last quarter of 2012 and have declined further in 2013. Riskier assets have generally gained the most. However, real activity has yet to reflect fully the improvement in financial market sentiment, especially in the euro area. This highlights the risk of asset prices getting out of line with fundamentals, especially as regards corporate securities.

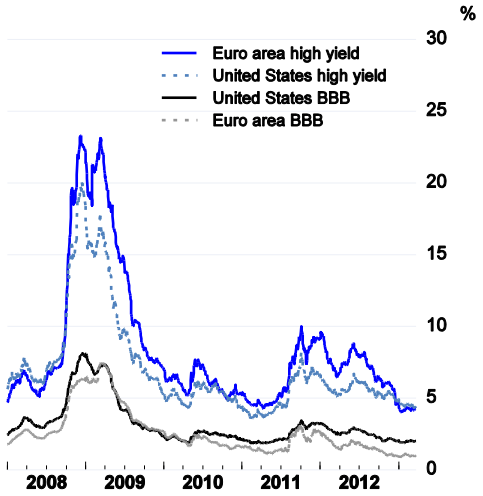
Equity markets



Note: S&P 500 Composite for the United States, Nikkei 225 for Japan, FTSE Eurotop 100 for euro area. Last observation: 21-03-2013.

Source: Datastream.

Corporate bond spreads



Note: High-yield bonds (Merrill Lynch indices) less government bond yields (10-year benchmark bonds); corporate BBB-rated bond yields (Merrill Lynch - average for 5-7 & 7-10 years) less average government bond yields of same maturities. Last observation: 22-03-2013.

Source: Datastream; OECD calculations.

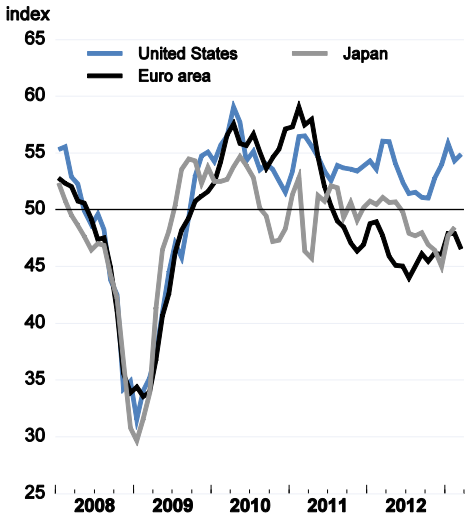
...while confidence has improved, although it remains weak in some areas.

- The improvement in financial markets is supported to some degree by confidence indicators in the United States, where business surveys have been pointing to strengthening growth. In Japan, there has been an upturn in business sentiment, though so far to lower levels than in the United States. Consumer confidence in both economies has improved in recent months, while remaining below historical averages.

- In the euro area, the area-wide purchasing managers index (PMI Composite Output Index) weakened in March and remains well below the dividing line between expansion and contraction. The PMI for Germany is signalling positive growth, but PMIs are at a very low level for France and the euro area periphery. Consumer confidence in the euro area remains weak.

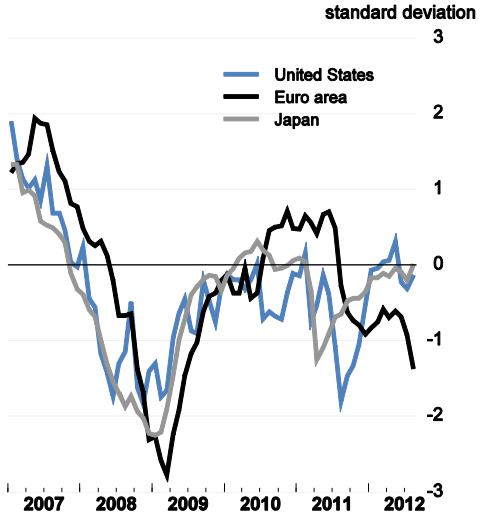
Business Confidence

PMI indicators



Source: Markit Economics Limited.

Consumer confidence



Note: Normalised at period average and presented in units of standard deviation. Values above zero signify levels of consumer confidence above the period average.

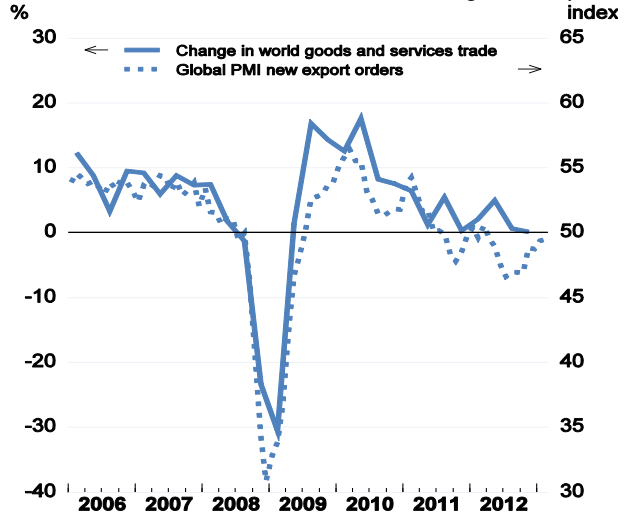
Source: OECD Main Economic Indicators.

World trade has slowed...

- World trade volume growth decelerated during 2012, alongside slowing real activity in advanced economies. The export orders sub-index of the global PMI have yet to signal a rebound, but the improvement in OECD output in the first half of 2013 combined with continued growth in non-OECD economies should be reflected in a pick-up in trade volumes. The increase in world trade volumes in January according to the CPB World Trade Monitor is consistent with such a resumption of trade growth.

World trade

World goods and services trade and Global Manufacturing New Export Orders Index



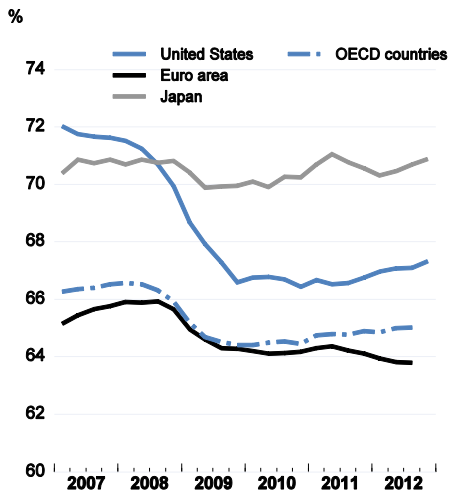
Note: Values greater than 50 signify an increase in new export orders.
Source: OECD Quarterly National Accounts database and Markit Economics Limited.

... and employment rates have not recovered much from post-crisis lows.

- Labour market slack remains substantial in many OECD countries, and the employment situation has continued to deteriorate in the euro area, contributing to depressed consumer confidence. Especially in Europe, the rise of long-term unemployment, with more of the unemployed moving off unemployment insurance onto less generous social benefits, is worsening poverty and inequality.
- Even in the United States, where job growth has been reasonably strong in recent quarters, the proportion of the working-age population in employment remains well below pre-crisis levels and has risen only slightly from its post-crisis lows. In Japan, the unemployment rate has been declining since mid-2009, but is still around 4¼ per cent, compared to its low-point of 3.7% in 2007.

Employment rate

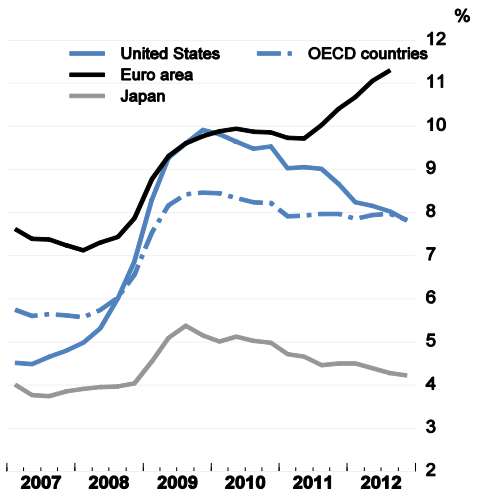
Percentage of working age population (15-64)



Source: OECD Main Economic Indicators.

Unemployment rate

Percentage of labour force



Source: OECD Main Economic Indicators.

Policies must continue to support global demand, while putting in place the conditions for a sustainable recovery

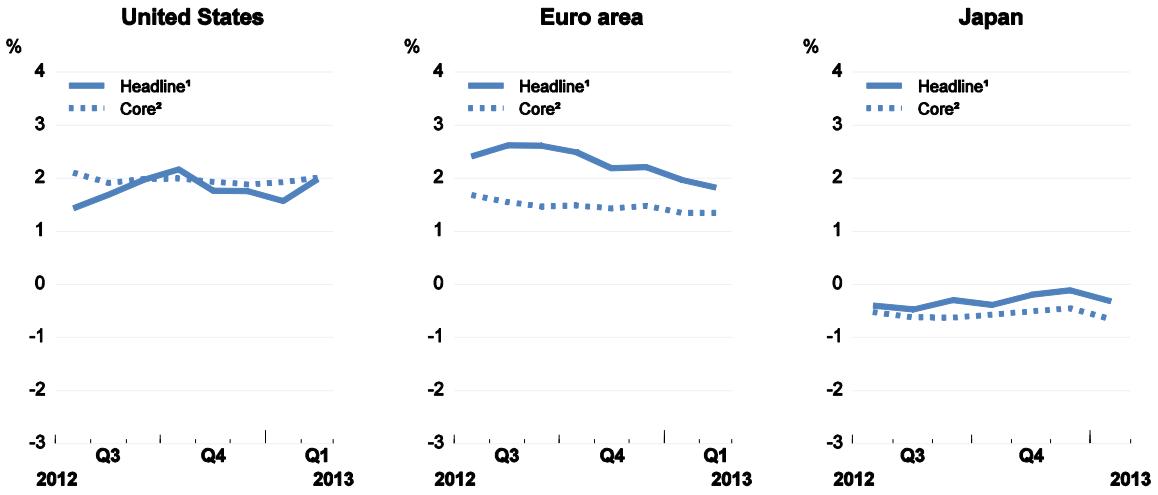
- As self sustained recovery is not fully assured, bold policy action to support activity remains necessary in all major OECD economies. Demand in many countries still faces strong headwinds from private-sector deleveraging, necessary fiscal consolidation and impaired bank credit provision.

Monetary stimulus remains necessary, while the public finances are strengthened...

- Given limited fiscal space in most OECD countries, monetary policy remains a key instrument for supporting demand, even though monetary stimulus may not always be sufficient and carries its own risks. In some economies, especially within the euro area, the transmission of monetary easing to the real economy is impaired. The recent increase in the price of risky assets is likely in part to reflect easy monetary conditions. The pace of the rise in some asset prices underlines the risk of investor sentiment getting out of phase with economic fundamentals or of policy encouraging excessive risk-taking. Nonetheless, in most major OECD economies low underlying inflation rates give room for monetary policy action, and exceptional measures should remain in place for now and in some cases be pursued further.

Consumer prices

12-month percentage change



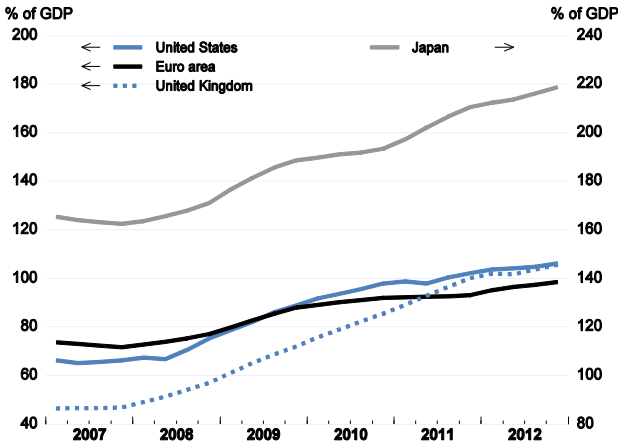
Note: 1. Headline is Headline CPI for the United States and Japan, and Headline HICP for the euro area. 2. Core is CPI excluding food and energy for the United States and Japan, HICP excluding energy, food, alcohol and tobacco for the euro area.

Source: OECD Main Economic Indicators.

- Fiscal consolidation remains necessary in most OECD countries. Credible medium-term fiscal plans are needed in the United States and Japan. While consolidation is needed in many euro area countries, the average ratio of public debt to GDP is lower in the euro area than in other major OECD economies and rising more gradually. In all major OECD economies, the automatic stabilisers should be allowed full play around adjustment plans to accommodate any weaknesses in demand. Consolidation measures should be chosen to have the best balance between their effect on short-run growth, long-term growth and inequality. In particular, the most disadvantaged groups must be protected to mitigate the worsening of social tensions in a context of high unemployment rates in many countries.

General government gross debt

Percentage of GDP



Note: For the euro area, Japan, and United Kingdom, the values from 2012 Q1 onwards are calculated using OECD estimates of gross debt and the actual value of GDP according to national accounts statistics.

Source: OECD National Accounts database and OECD calculations.

.... and structural reforms should be pursued to strengthen the growth outlook.

- Stronger, more sustainable and fairer growth can be achieved through structural reform. Action is already under way in some countries. Many OECD countries have the potential to reduce costly distortions in the tax system and widen the tax base. In the euro area and Japan, there is scope to reduce restrictive product market regulations that limit competition and hold back investment. Regulatory and institutional barriers to labour market participation should be reduced, while improving programmes to help the unemployed find work.

In the United States, the need for further exceptional measures is waning...

- Monetary easing appears to be feeding through to the real economy as household consumption has picked up and the housing sector has begun to rebound, despite fiscal headwinds. The forward guidance from the Federal Reserve, whereby policy rates will be kept low as long as unemployment remains above 6.5 and projected inflation remains below 2½ per cent, appears well judged in current circumstances, providing assurance that monetary conditions will be supportive of demand while it is needed.
- The point where the costs of further quantitative easing (QE) outweigh the benefits is likely to be within sight, but skilful judgement will be required to gauge the speed at which asset purchases can be phased out.
- Fiscal policy should avoid disruptive outcomes in the near term, such as a failure to raise the debt ceiling, while agreement is needed on a credible plan to reduce the deficit over the medium term and address long-term cost pressures on health care and pensions.

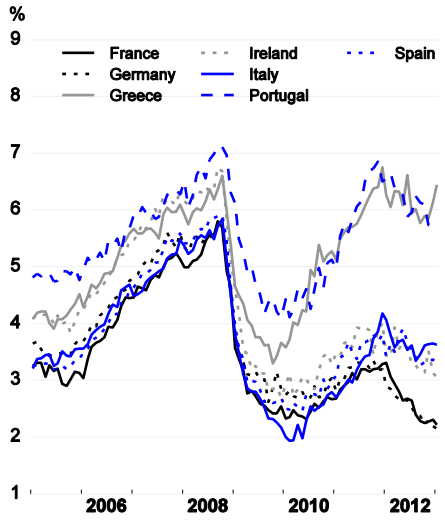
... while more aggressive policy action is required in Japan to follow through on the plan to escape deflation.

- The prospect of more aggressive easing, with the Bank of Japan's adoption of a 2% inflation target, has resulted in a 20% depreciation of the yen in real effective terms and a surge in equity prices. These have boosted the near-term growth and inflation outlook. This shift in stance and the effects of its announcement are welcome, but implementation will require more aggressive quantitative easing policies. Asset purchases should be increased, along with the share of long-term government and corporate bonds in interventions. An expansionary monetary policy stance should be maintained until inflation has durably reached the 2% target.
- A credible plan to attain the government's long-term fiscal targets is needed. The announced fiscal expansion of 2¼ per cent of GDP will add to that challenge, despite scheduled sales tax increases in 2014-15. Controlling expenditures is key, particularly for social security. Monetary, fiscal and structural policies must be applied in a mutually reinforcing way to tackle the high level of public debt while supporting growth.

Stronger monetary and financial support is needed to exit from recession in the euro area...

- The euro area remains vulnerable to negative tail risks because feedback loops between banking system fragility and government debt burdens have not been fully severed. It is essential that the credit transmission mechanism be repaired. Rapid progress must be made to implement a comprehensive system of common banking supervision with clear crisis resolution and support mechanisms, as part of a process of returning banks to good health. The recent Cypriot crisis, while an exceptional case, shows the importance of addressing banking crises directly and decisively, but also of putting in place the right institutions at the euro area level to maintain banking system stability.
- There is a strong case to ease monetary policy further, given weak demand and inflation well below the ECB's objective. Policy rates are already very low, but some scope remains to reduce them further. More specific forward guidance could be given by the ECB. Further thought should be given to how to expand quantitative easing. The risk of undue inflationary pressure associated with monetary easing is small, as the transmission mechanism is impaired, especially in the periphery countries where banks face high funding costs. Aggregate euro area bank lending is still contracting.
- Existing commitments to structural budgetary consolidation should be met, while allowing automatic stabilisers to operate fully. This implies that nominal deficit targets are likely to be missed.

Euro area - the cost of credit



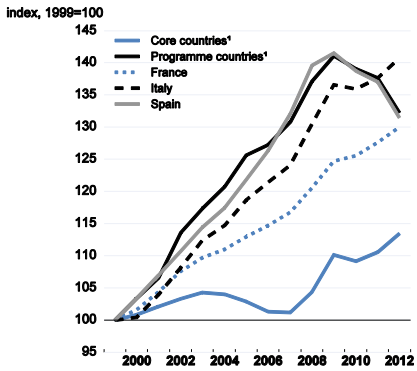
Note: Cost of credits is defined as interest rates on new loans to non-financial corporations (all maturities) with the exception of Greece, where it refers to new loans with maturity of up to one year.

Source: European Central Bank.

… but euro area countries are making progress towards rebalancing.

- While growth in the euro area has continued to disappoint, the underlying rebalancing of the economy is well underway. That process still has some way to go, however.
- Considerable progress has been made on reducing structural budget deficits, and in most euro area countries the largest part of the fiscal adjustment required after the crisis has already been undertaken.
- Structural reforms, notably in Greece, Ireland, Italy, Portugal and Spain, provide a solid base for a recovery in competitiveness and an increase in employment when demand turns around.
- The short-term costs of these adjustments would be reduced by an improved supply of credit in debtor countries and structural reforms that help to rebalance activity and demand in surplus economies.

Euro area unit labour costs

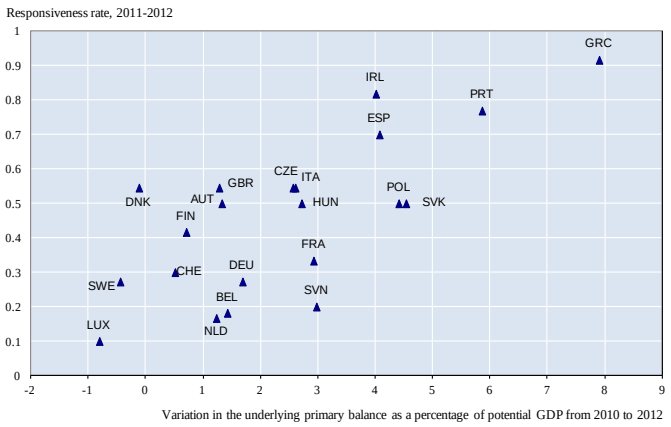


Note: 1. Core countries are here taken to be Germany, the Netherlands, Austria and Finland. Programme countries are Greece, Ireland and Portugal. 2. Economy-wide unit labour costs. 2012 incorporates estimates in the Economic Outlook. Country groupings constructed as a chain-linked aggregates using nominal GDP weights.

Source: OECD Quarterly National Accounts database and Economic Outlook 92 database.

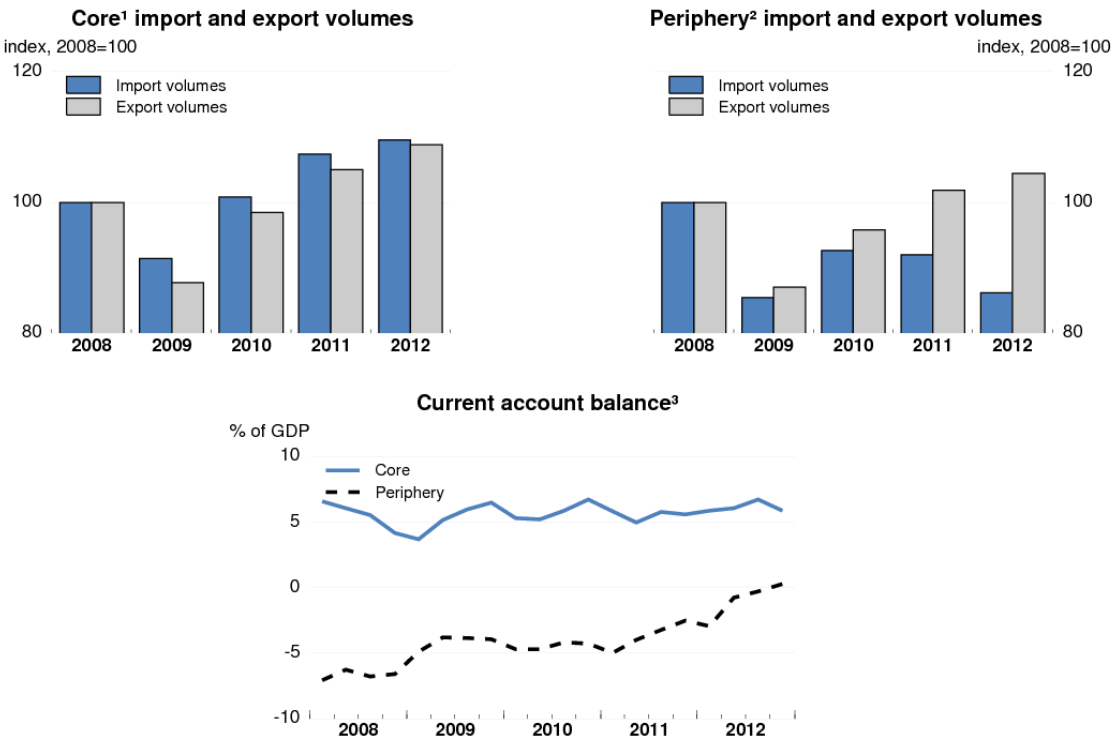
Fiscal consolidation and structural reform efforts

Change in Going for Growth responsiveness rate 2011-12 and change in underlying primary balance as a percentage of potential GDP, 2010-12



Source: OECD Economic Outlook database and OECD calculations.

Import and export volumes and current account balance



Note: 1. The core is here taken as comprising Austria, Finland, Germany and the Netherlands. 2. The periphery is here defined as Greece, Italy, Ireland, Portugal and Spain. 3. Current account balance is the sum of current account balances as a percentage of the combined GDP across the countries.

Source: OECD National Accounts database, Economic Outlook 92 database and OECD calculations.

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.

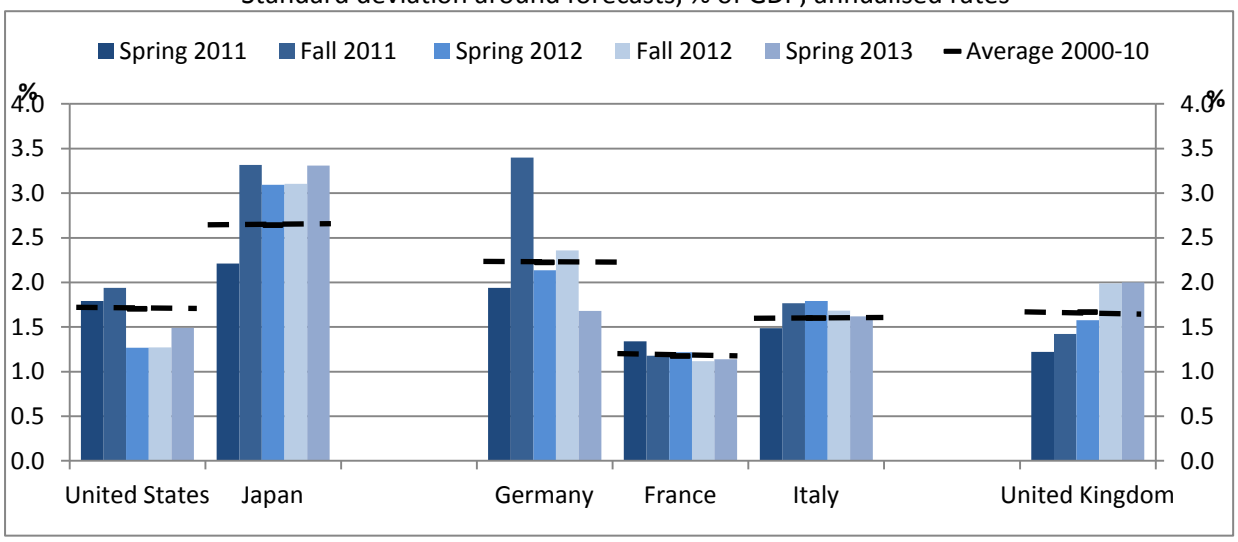
In this context, the main tool is a suite of indicator-based models that serve to forecast real GDP for each of the G7 economies.[1] These models cover the two quarters following the last one for which official data have been published, with the different models receiving equal weights in the computation of the published forecast. 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 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 standard deviation around forecast

Risk can be assessed using the standard deviation around the forecasts. This combines two sources of uncertainty. The first source stems from the disagreement between the three models used to forecast GDP (based on soft-, hard- and mixed-indicators). The intuition is that when predictions from using soft and hard indicators diverge, uncertainty is higher. The second source is the uncertainty around the GDP forecasts of each individual model. This uncertainty arises because the relationship between the indicators and GDP is imperfectly known, and may vary depending on the underlying state of the economy. This type of uncertainty is estimated by forecasting the percentiles (100 intervals of equal probability) of the distribution of future GDP conditional on the indicators. The percentiles are estimated using quantile regressions which allow each explanatory indicator to have a different weight in explaining each percentile.[2] This allows some explanatory variables to have more weight in explaining GDP during a sharp downturn (or recovery) than in more normal times. The standard deviation around each individual model is computed using these estimated percentiles. The global standard deviation, taking into account the two sources of uncertainty, combines the three model-specific sets of estimated percentiles.

Uncertainty around GDP forecasts

Standard deviation around forecasts, % of GDP, annualised rates[1]



1. The standard deviation combines two sources of uncertainty. First, there is uncertainty due to differences in forecasted GDP between the three models (soft-, hard- and mixed-indicator models) that are used to make the projections. Second, uncertainty around the GDP forecasts of each individual model is derived using quantile regressions, which allow some explanatory variables to have more weight in explaining GDP during a sharp downturn (or recovery) than in more normal times.

Source: OECD

1 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 Papers*, No. 515, 2006.

2 Laurent, T. and T. Kozluk (2012), "Measuring GDP Forecast Uncertainty Using Quantile Regressions", *OECD Economics Department Working Papers*, No. 978, 2012.