What is the economic outlook for OECD countries?

An interim assessment

Paris, 29 March 2012
11h00 Paris time

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Growth is expected to be firmer through the first half of the year

- Short-term prospects have improved relative to the situation prevailing in late 2011, but indicators still suggest a fragile recovery. The forecasts for the first half of 2012 point to a decoupling of GDP growth between Canada and the United States on the one hand, and Europe on the other: Robust growth is projected for the former, whereas in Europe the outlook remains weak.
- In the United States growth prospects continue to firm. The rebound in equity prices, stronger consumer confidence, and growth in nonfarm payroll employment have lifted projected activity.
- Activity in Japan is projected to rebound strongly in the first quarter, thanks in part to firmer industrial production, which was adversely affected by external shocks in late 2011, and a weaker yen. Second quarter growth is projected to be more moderate.
- The situation for the three largest euro area countries in aggregate is expected to remain fragile, with negative growth projected for the first quarter of 2012 and a moderate rebound in the second quarter.
- Recent positive indicators suggest that activity in Germany may accelerate through the first half of the year. Activity in France is projected to be broadly flat. In Italy weak industrial production and household sentiment are suggestive of recession for the first two quarters of the year. That said, the most recent indicators have been more positive, resulting in slightly better projected growth for the second quarter.

GDP growth in the G7 economies

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

	10Q4	11Q1	11Q2	11Q3	11Q4	12Q1	12Q2
United States	2.3	0.4	1.3	1.8	3.0	2.9	2.8
Japan	-0.6	-7.0	-1.3	7.1	-0.8	3.4	1.4
3 largest Euro countries[2]	1.5	3.6	0.8	1.2	-0.8	-0.4	0.9
Germany	1.9	5.5	1.1	2.3	-0.7	0.1	1.5
France	1.6	3.5	-0.1	1.3	0.6	-0.2	0.9
Italy	0.7	0.5	1.2	-0.7	-2.6	-1.6	-0.1
UK	-2.0	1.0	-0.2	2.3	-1.2	-0.4	0.5
Canada	3.1	3.7	-0.6	4.2	1.8	2.5	2.5
G7	1.4	0.2	0.6	2.6	1.1	1.9	1.9

1. GDP releases and high-frequency indicators published by 28 March 2012. Seasonally and in some cases also working-day adjusted.

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

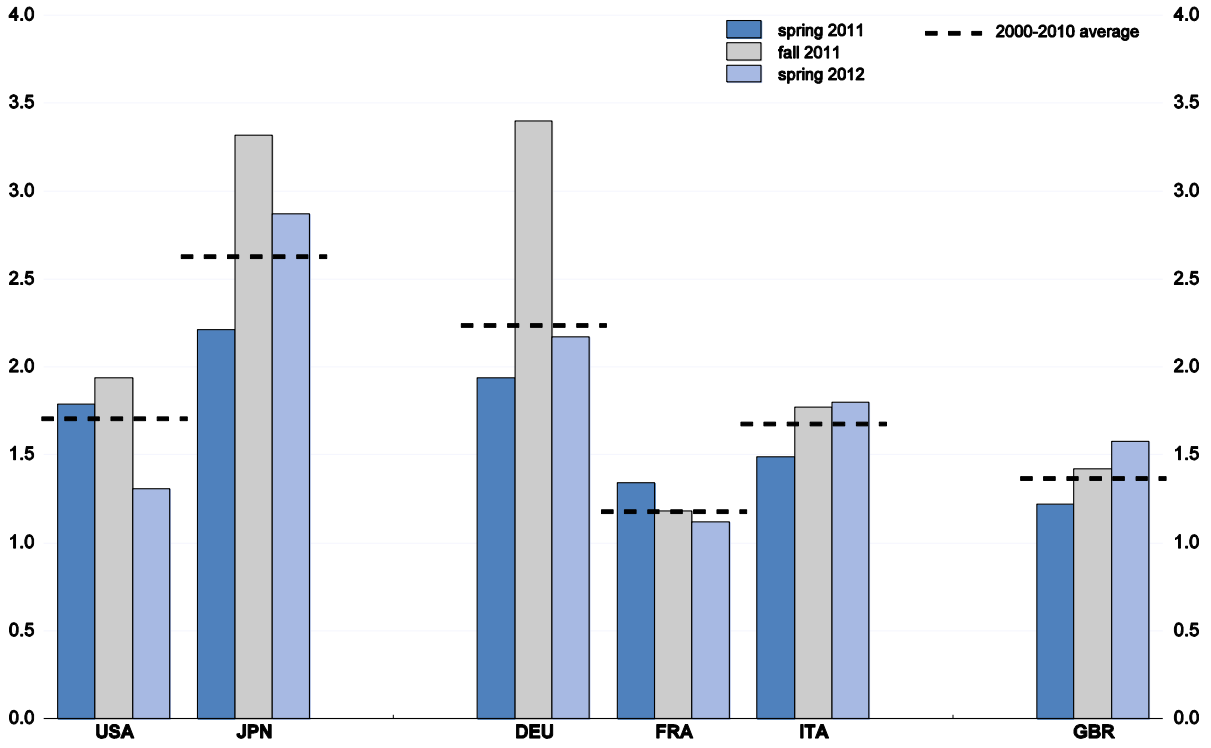
Note: See Appendix for underpinnings and status of the interim forecast.

Uncertainty around the near-term projections is lower than in the autumn

- The risk of extreme events (tail risk) has fallen over the past few months, but uncertainty around these forecasts remains large. Hence, this is no time for complacency, not least since there remains a lot of unfinished policy-implementation business.
- The fall in tail risk since the autumn is particularly pronounced in the United States and Germany. This likely reflects greater fiscal certainty for the current year and reduced tension in the euro area, respectively.

Evolution of uncertainty around GDP forecasts

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



1. The standard deviation combines two sources of uncertainty. First, 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 allows some explanatory variables to have more weight in explaining GDP during a sharp downturn (or recovery) than in more normal times.

Note: See Appendix for a more detailed description of the methodology.

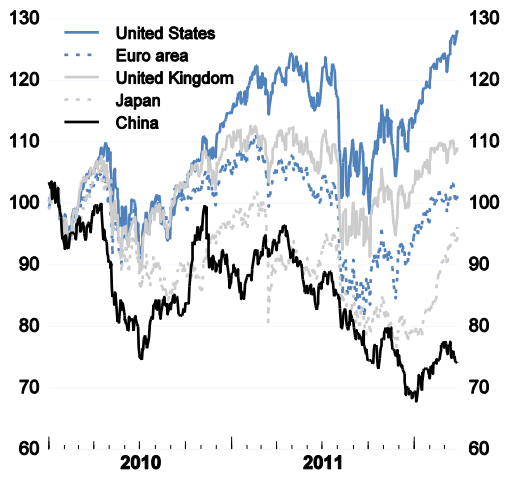
Source: OECD

Financial market developments reflect lower perceived risk and differentiated activity trends

- Greater confidence is reflected in the rebound in world equity prices since the beginning of the year and a decline in money market and corporate bond spreads.
- Confidence in the financial sector still has a way to go to fully recover, with bank credit default swap rates declining in recent months but remaining high by historical standards.
- Better prospects for activity have led to a rise in government bond yields, particularly in the United States, where the rise in equity prices has also been particularly strong.

Equity prices have rebounded

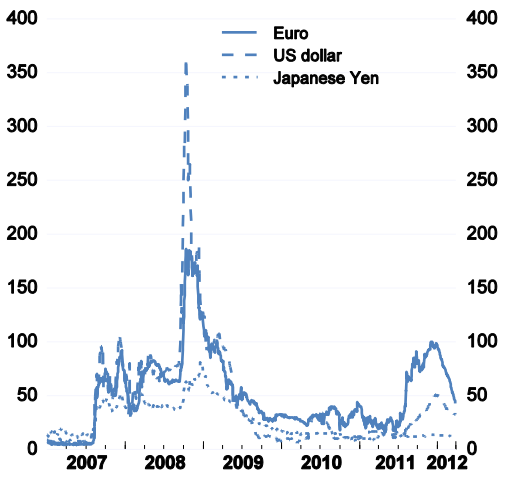
January 2010 = 100



Note: Wilshire 5000, FTSE Eurotop 100, FTSE 100, Nikkei 225, Shanghai Composite. Last observation: 27-03-2012.
Source: Datastream.

Money market spreads are moderating

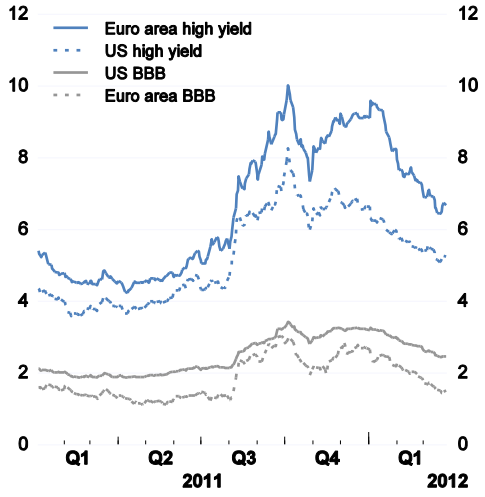
Basis points



Note: Three-month spreads. Spread between three-month EURIBOR and EONIA swap index for euro area; spread between three-month LIBOR and overnight indexed swap for the United States and Japan. Last observation: 27-03-2012.
Source: Datastream.

Corporate bond spreads have fallen

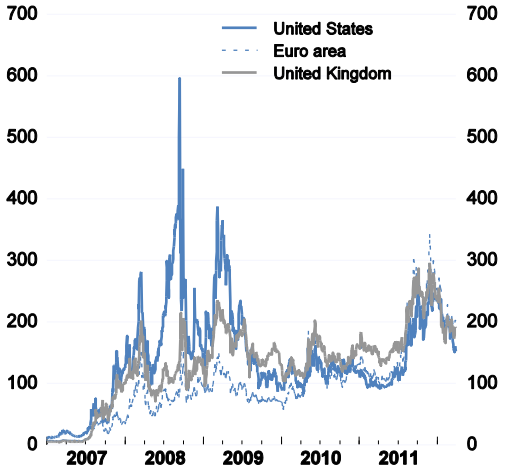
Percentage points



Note: High-yield bonds (Merrill Lynch indices) less govt. bond yields (10-year benchmark bonds); corporate BBB rated bonds yields (Merrill Lynch - average for 5-7 & 7-10 years) less average govt. bond yields of same maturities. Last observation: 26-03-2012. Source: Datastream; and OECD calculations.

Bank credit default swap rates have come down

Basis points



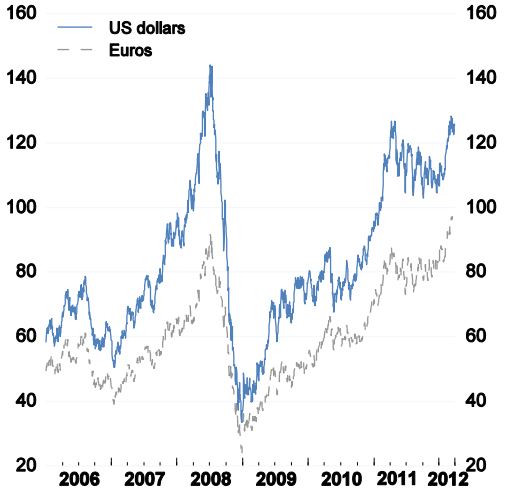
Note: Annual rates of five-year credit default swap contracts on very large banks. Last observation: 26-03-2012.
Source: Datastream.

Oil prices pose a threat to the recovery

- Oil prices have climbed recently, with the price of Brent crude increasing by more than $10 per barrel since early February 2012. This reflects supply disruptions at a moment of low OECD inventories and limited OPEC spare capacity.
- The recent oil price increase will likely add around ¼ of a percentage point to inflation in the OECD economies and take off between 0.1 and 0.2 per cent from average OECD GDP over the next year.
- Other commodity prices have also increased in recent months. This follows a period of substantial falls that have helped to ease inflationary pressures, particularly in emerging markets economies.

Oil prices have spiked recently

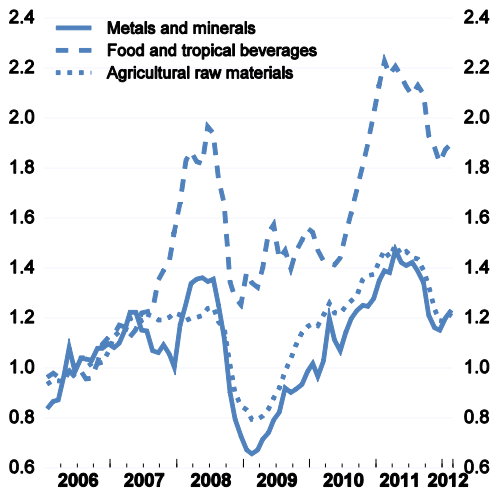
Crude oil (Brent price)



Last observation: 27-03-2012.
Source: OECD Main Economic Indicators; and Datastream.

Non-oil commodity prices below recent peaks

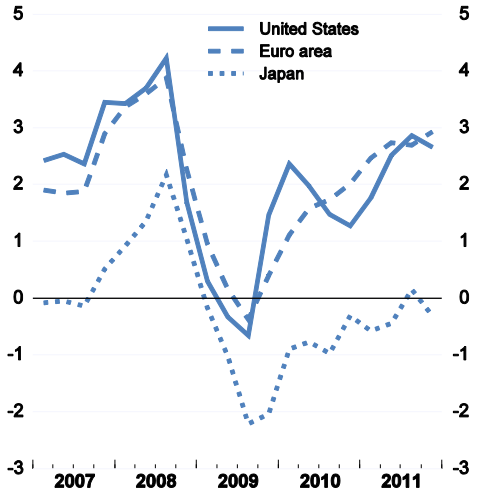
Non-oil commodity prices (index 2006 = 1)



Source: OECD Main Economic Indicators; and Datastream.

OECD headline inflation has trended up

Headline inflation, 4-quarter percentage change



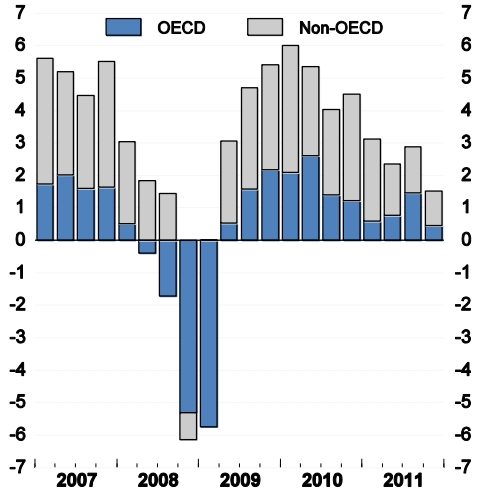
Note: USA, deflator of personal consumption expenditures; Euro area, harmonised index of consumer prices; Japan, CPI.
Source: OECD Main Economic Indicators.

Emerging market economies are weakening

- There have been recent signs of a slowing in activity in a number of emerging market economies, notably in China.
- The slowdown in world trade growth reflects weakening demand, particularly in Europe and OECD Asia.
- While some counter-cyclical measures are already in place in a number of emerging market economies, considerable policy ammunition is available if further action is required to support activity.

World output growth has slowed

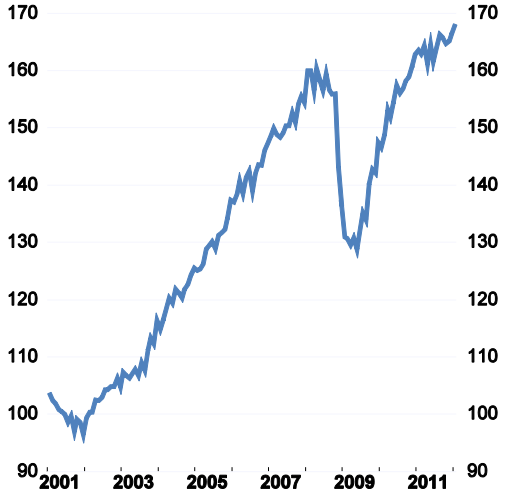
Contribution to annualised quarterly world real GDP growth, percentage points



Note: Uses moving nominal GDP weights, based on national GDP at purchasing power parities. Last observation: Q4 2011.
Source: OECD Quarterly National Accounts.

Word trade growth has moderated

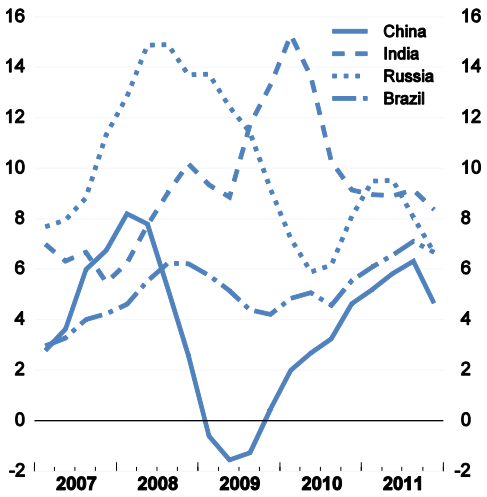
CPB indicator of world merchandise trade, 2001 = 100



Source: CPB.

Emerging market inflation is moderating

Headline inflation, 4-quarter percentage change



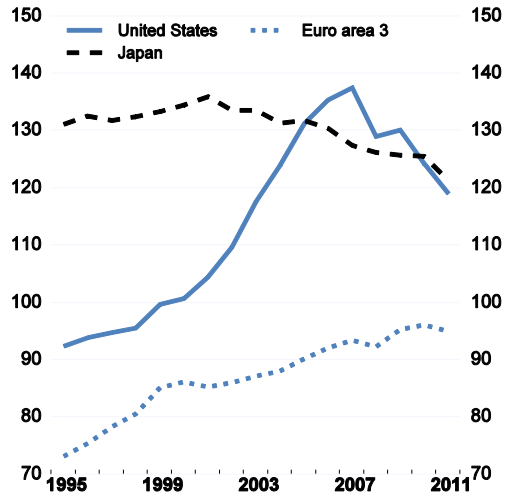
Note: Based on consumer price index. India, industrial workers CPI.
Source: OECD Main Economic Indicators.

Fundamentals are firming in the United States

- Deleveraging by the household sector is underway in the United States. However, the housing market is still fragile and negative equity continues to weigh on households.
- The firmer labour market outcomes and the rebound in equity prices are underpinning the recovery. The improved outlook is also reflected in better consumer confidence. Other indicators such as motor vehicle sales, industrial production and credit growth also point to a pickup in activity.

US household deleveraging well underway

Household gross debt as per cent of net disposable income



Note: Data for USA and Japan are not consolidated. For 2011 Q3 data are growth rates (2010 end of year to 2011 Q3) of balance sheets published by US Federal Reserve, Bank of Japan, and ECB. Euro area 3 is Germany, France and Italy.
Source: OECD Annual National Accounts.
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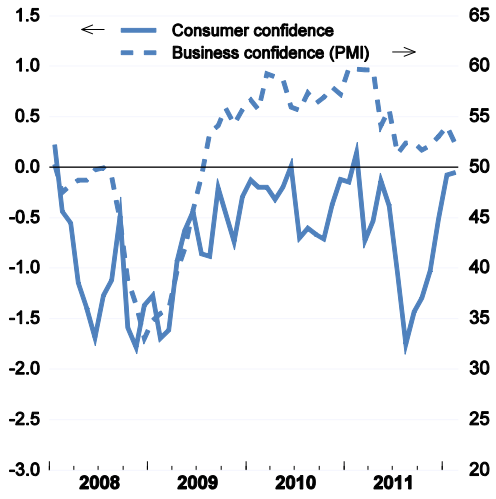
Confidence in the US is recovering

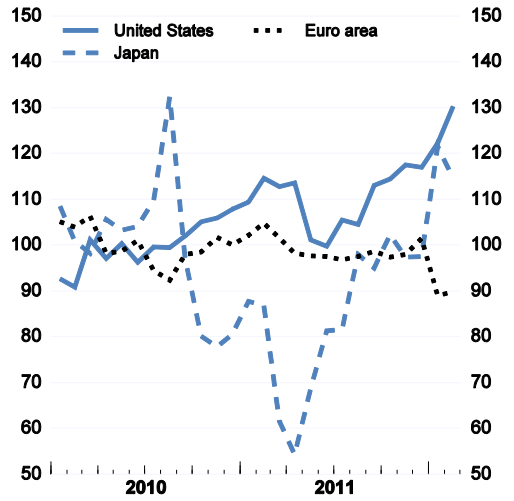
Indices



Note: Consumer confidence: standard deviation normalised at period average; values above zero signify consumer confidence above the period average. Business confidence: Purchasing Managers Index (PMI) for manufacturing; values greater than 50 signify an improvement in economic activity.
Source: OECD Main Economic Indicators; Markit Economics Ltd.

US car sales have picked up

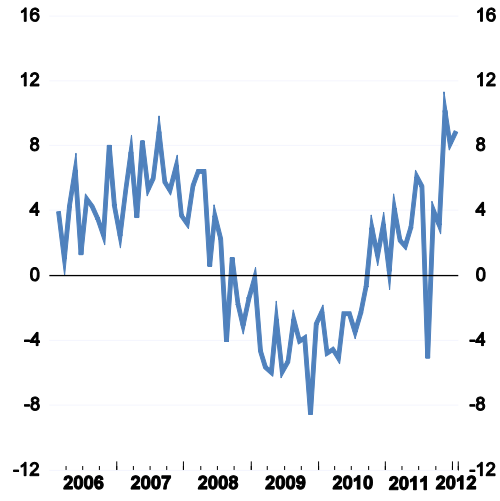
New car sales (2010 = 100)



Source: Bureau of Economic Analysis; Japan Automobile Manufacturers Association; and European Central Bank.

Credit growth in the US is recovering

Annualised monthly rate of change of stock, in per cent

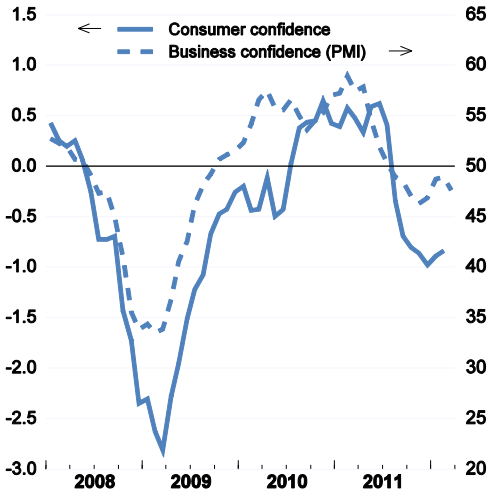


Note: Total US consumer loans. Data are seasonally adjusted.
Source: Datastream.

Activity in the euro area is fragile

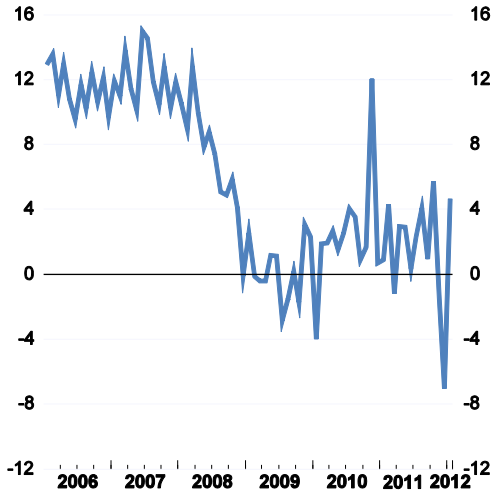
- Confidence remains weak in the euro area as a whole and recent indicators point to further falls in activity. The required rebalancing, both in terms of addressing cost disparities as well as on the demand side, is in progress in some countries but remains far from complete.
- Despite recent initiatives in the euro area, both by area-wide institutions such as the ECB, and by individual countries, sovereign debt yields remain high in a number of countries. Yields on Greek debt are lower since the debt restructuring but remain high. In other stressed euro area countries sovereign debt yields have also come off their peaks, reflecting a decline in the perceived risk of contagion within the region and more confidence in national policy responses.
- Fiscal consolidation is underway in a number of countries. This is essential to restore confidence. However, despite very accommodative monetary policy, this fiscal contraction is damping demand.
- Growth in lending in the euro area remains weak and has recently decelerated even further, despite recent ECB interventions.

Consumer and business confidence remain weak in the euro area
Indices



Note: Consumer confidence: standard deviation normalised at period average; values above zero signify consumer confidence above the period average. Business confidence: Purchasing Managers Index (PMI) for manufacturing; values greater than 50 signify an improvement in economic activity.
Source: OECD Main Economic Indicators; and Markit Economics Limited.

Credit growth in the euro area is showing little sign of recovery
Annualised monthly rate of change of stock, in per cent



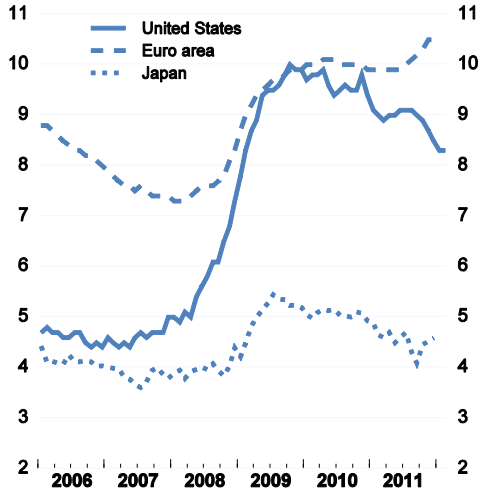
Note: Euro area bank loans to the private sector. Data are seasonally adjusted and adjusted for the impact of securitisation.
Source: ECB.

Divergence in activity across the OECD is reflected in recent labour market developments

- In the United States the unemployment rate continues to trend downwards and employment growth has accelerated markedly. This contrasts with the situation in the euro area where the average unemployment rate has begun to climb once again. That said, labour market conditions within the euro area vary considerably.
- Despite improved outcomes in the United States, the unemployment rate remains high and long-term unemployment is at historically high levels. This is a critical policy challenge, both in the United States, and in many euro area countries, including in the better performing countries.

Unemployment rates are diverging

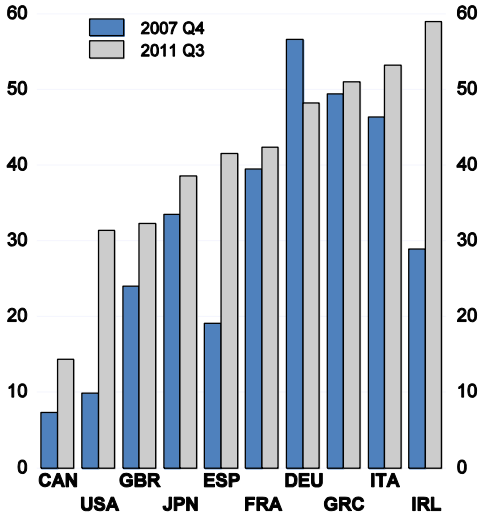
Unemployment rate,
percentage of labour force



Source: OECD Main Economic Indicators; and Eurostat.

Long-term unemployment is widespread

Share of people unemployed for more than
12 months in total unemployment



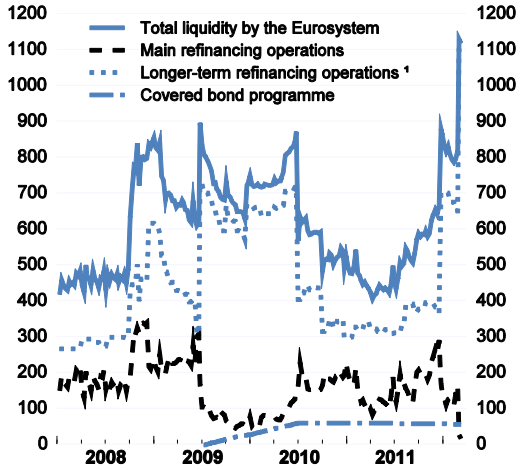
Note: Series are smoothed using a three-quarter centred moving averages. 2011Q4 for Canada and United States.
Source: OECD (2012), Quarterly Labour Market Indicators Database, Directorate for Employment, Labour and Social Affairs, January, Unpublished data.

Policy has a critical role to play in determining the outlook, particularly in light of the fragility of the world economy

- Monetary policy remains very supportive, with policy rates in most large OECD countries at very low levels. This policy setting will be warranted for a considerable time to come, as will maintaining support through quantitative measures.
- In the euro area, the use of the central bank balance sheet and the provision of liquidity by the eurosystem have played an important role in avoiding the worst.
- There is scope for monetary policy easing in emerging market economies, in light of the recent signs of softening in economic activity and declining inflation.
- Fiscal consolidation is ongoing in a number of countries including within the euro area. This should continue at a pace that reflects country-specific circumstances. In the United States the expiration of tax cuts and automatic spending cuts will lead to a sharp fiscal retrenchment in 2013, unless policymakers take measures.
- There has recently been an acceleration in structural reform activity, particularly in countries facing fiscal and labour market challenges. The OECD's *Going for Growth 2012* publication examines in detail progress in the implementation of reforms over the past five years and the role the crisis has played in shaping reform patterns.

Liquidity injections have been helpful in the euro area

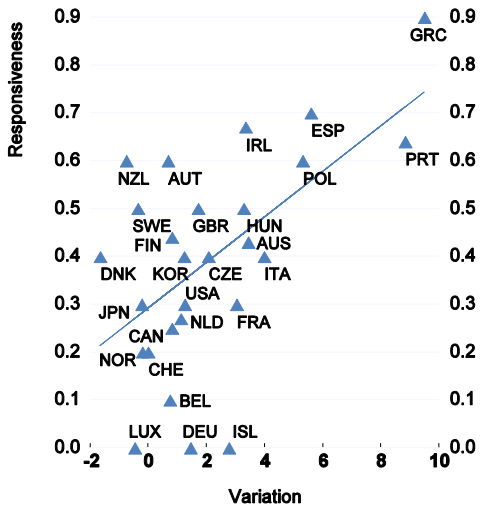
Liquidity provided to euro area banks and money-markets funds, euro billions



1. Includes financing under the special one-month, three-month, and one-year operations.
Note: Liquidity provided under the Securities Market Programme is not included because it is systematically sterilised.
Source: Datastream.

Fiscal sustainability concerns have given impetus to reform

Overall responsiveness to *Going for Growth* priorities and fiscal consolidation effort



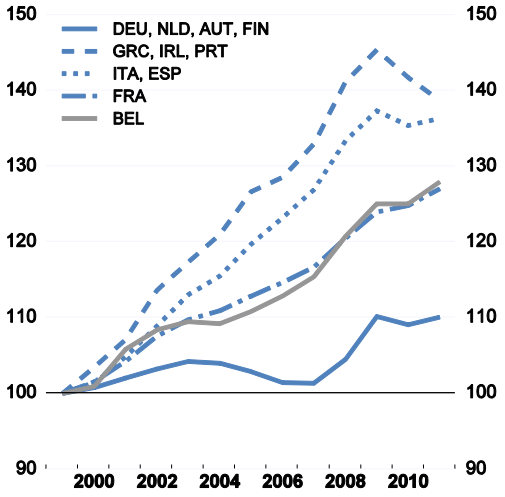
Note: Horizontal axis: variation in the underlying primary balance as a percentage of potential GDP from 2010 to 2012; vertical axis: responsiveness rate to *Going for Growth* reforms priorities, 2010-2011. Correlation coefficient: 0.57; statistically significant at the 1% confidence level.
Source: OECD Quarterly National Accounts; OECD Main Economic Indicators; and OECD Economic Outlook 90 Database.

Unfinished business in the euro area

- To restore confidence, an increase in the size of the firewall is needed.
- Measures to shore up the financial sector in Europe remain to be implemented, including recapitalisation of weak banks.
- The underlying causes of the euro area sovereign debt crisis are deep structural factors that led to a loss of competitiveness in the high debt countries and stubborn current account imbalances within the currency union, as well as weak overall growth. An array of structural reform measures are required to address these fundamental imbalances, in both surplus and deficit countries, and to boost growth overall.
- These reforms include improved fiscal and financial governance frameworks, strengthening the Single Market, as well as reforms to product market regulation, labour market institutions and tax systems. While the full gains from these reforms would take time to materialise, many reforms would boost activity even in the short run. These issues are covered in depth, along with further detailed policy recommendations, in the recently published 2012 edition of the OECD's *Euro Area Survey*.

Euro area unit labour cost convergence has started

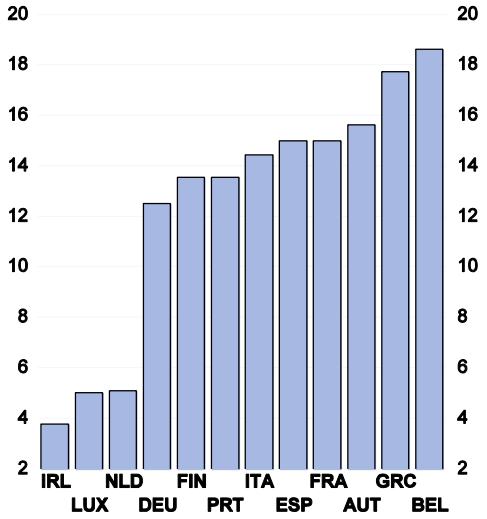
Euro area unit labour costs, Index 1999=100



Note: Economy-wide unit labour costs. 2011 incorporates projections from the November 2011 *OECD Economic Outlook*. Country groupings constructed as a chain-linked aggregate using nominal GDP weights.
Source: OECD Quarterly National Accounts Database.

Large potential gains from a broad package of reforms

Overall GDP per capita gains over 10-year horizon, in per cent



Note: Estimated cumulative GDP impact from reforms specified in Bouis and Duval (2011).
Source: OECD.

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.* 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

The standard deviation 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. 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.

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* 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.