



**What is the economic outlook
for OECD countries?**

An interim assessment

Paris, 5th September 2007

**Jean-Philippe Cotis
Chief Economist**

Press Briefing

Jean-Philippe Cotis

OECD Chief Economist

5 September, 2007 – 11:00 a.m. Paris time

1. The turnaround in the US housing market and the woes in its sub-prime mortgage segment were highlighted as a pivotal element of the global business cycle in the May 2007 OECD *Economic Outlook*, and have since triggered a more general reassessment of risks. To date, swift and forceful central bank action has helped contain the ensuing financial market turbulence. While it is too early to gauge to what extent the repricing observed so far – and possible further financial adjustments – will affect prospects for activity, it has happened at a point in time when world economic momentum was still strong. Hence, the May 2007 OECD growth projections for the year as a whole are not revised that much. However, year averages mainly reflect past developments and prospects going forward are now clearly less buoyant and more uncertain. Downside risks have become more ominous, in a context where overall financial market conditions are likely to remain durably tighter.

2. In the United States, durable goods orders and household spending were up going into the third quarter, and profit margins are ample, albeit declining. However, the housing sector is set to exert a longer and more potent than expected drag, and confidence has weakened. As a result, GDP growth is projected to fall distinctly below potential during the second half of this year, following the strong rebound in the second quarter. All in all, our growth estimates may err on the upside, since it has not yet been possible to fully evaluate the negative impact of credit market turbulences on economic activity. In any event, consumer resilience will be tested by mortgage rate resets, tighter credit standards, weaker collaterals and slower job creation.

3. Contrasting with developments across the Atlantic, activity decelerated in the second quarter in the euro area at large and in most of its economies. While consumer confidence is fairly elevated, consistent with receding unemployment, retail sales have remained subdued. Business sentiment has been dented by the financial turmoil, but expectations are still fairly upbeat. Accordingly, growth should pick up to around potential in the euro area, including the three larger economies, in the second half of the year. Nevertheless, the peak of the euro area growth upswing now seems to lie behind.

4. Despite a deceleration in the course of the first half of 2007, the expansion in Japan is set to continue. Although it weakened in the second quarter, business investment should be an important driver, with high capacity utilisation and profits. Household consumption has slowed but should be supported going forward by much-improved labour market conditions. In addition, the negative contribution from stockbuilding in recent quarters suggests that in the near future inventory accumulation should add to growth.

5. The major central banks generally face an economic outlook characterised by scant spare capacity and unemployment rates close to or below their structural levels, as well as high energy prices and rapidly rising food prices. Outside Japan, inflation rates – despite recent easing in some cases – are still at the high end of what is consistent with price stability. At the same time, they are confronting risks to financial stability, which have prompted them to step in with large but temporary injections of liquidity. An important requirement in this respect is to avoid a situation where excess risk taking would be bailed out. Hence, besides short-run liquidity management, monetary policy and interest rate setting should continue to focus on prospects for inflation and economic activity. In that light, there may be a case for some easing in the US federal funds target rate, following the August cut in the discount rate. In the euro area, rising underlying inflation pressures, partly related to the evaporation of labour market slack, would seem to warrant some further tightening once financial market conditions have steadied and the recovery develops as expected. In Japan, it is advisable to wait for market volatility to quiet down and for a durable end to deflation before hiking the policy rate further.

6. Recent developments have revealed serious imperfections in the functioning of US housing markets and, more broadly, in credit markets worldwide. Markets will learn from recent mistakes through the usual “learning-by-doing” process. Such progress may nonetheless be enhanced by improved regulation. There may be a need, for instance, for more encompassing supervision of US sub-prime mortgage markets, with greater attention to non-bank originators which have often evaded effective scrutiny. As well, there may be a case for a more active fight against predatory lending, including through better disclosure and education. More transparency also seems to be called for in credit markets, where securitisation has made risk assessment increasingly difficult for many investors, leading to widespread loss of confidence. Given the swathe of re-ratings in recent months, more pugnacious and inquisitive rating agencies could help bring this about.

7. On the fiscal front, revenue buoyancy has generally continued to surprise on the upside, not least as a lagged reflection of high corporate profits, rapid growth in high incomes and rising asset prices. In some countries, including the United States and Germany, the windfalls translate into faster-than-budgeted consolidation. In many others, however, further efforts are called for in order to regain fiscal room for manoeuvre. Specifically, with rapidly ageing populations, pension and health care system reforms are a matter of urgency.

Real GDP growth in the G7 economies
in %

	Quarter-on-quarter				Year-on-year	
	07Q1	07Q2	07Q3	07Q4	Implied year-average for 2007	EO81
United States	0.2	1.0	0.5 (± 0.4)	0.4 (± 0.6)	1.9 [± 0.4]	2.1
Japan	0.8	0.1	0.5 (± 0.7)	0.5 (± 0.7)	2.4 [± 0.5]	2.4
Euro area	0.7	0.3	0.6 (± 0.3)	0.5 (± 0.4)	2.6 [± 0.3]	2.7
Germany	0.5	0.3	0.6 (± 0.5)	0.5 (± 0.6)	2.6 [± 0.4]	2.9
France	0.5	0.3	0.6 (± 0.4)	0.5 (± 0.5)	1.8 [± 0.3]	2.2
Italy	0.3	0.1	0.3 (± 0.4)	0.4 (± 0.5)	1.8 [± 0.3]	2.0
United Kingdom	0.7	0.8	0.8 (± 0.4)	0.7 (± 0.4)	3.1 [± 0.3]	2.7
Canada	1.0	0.8	0.7 (± 0.4)	0.7 (± 0.5)	2.7 [± 0.4]	2.5
G7	0.4	0.6	0.6 (± 0.5)	0.6 (± 0.5)	2.2 [± 0.4]	2.3

Based on GDP releases and high-frequency indicators published by 31 August 2007. Seasonally and in some cases also working-day adjusted. Aggregations for the G7 use 2000 purchasing-power-parity weights. Associated ±1 standard error ranges are in parentheses.

Underpinnings and status of the interim forecast

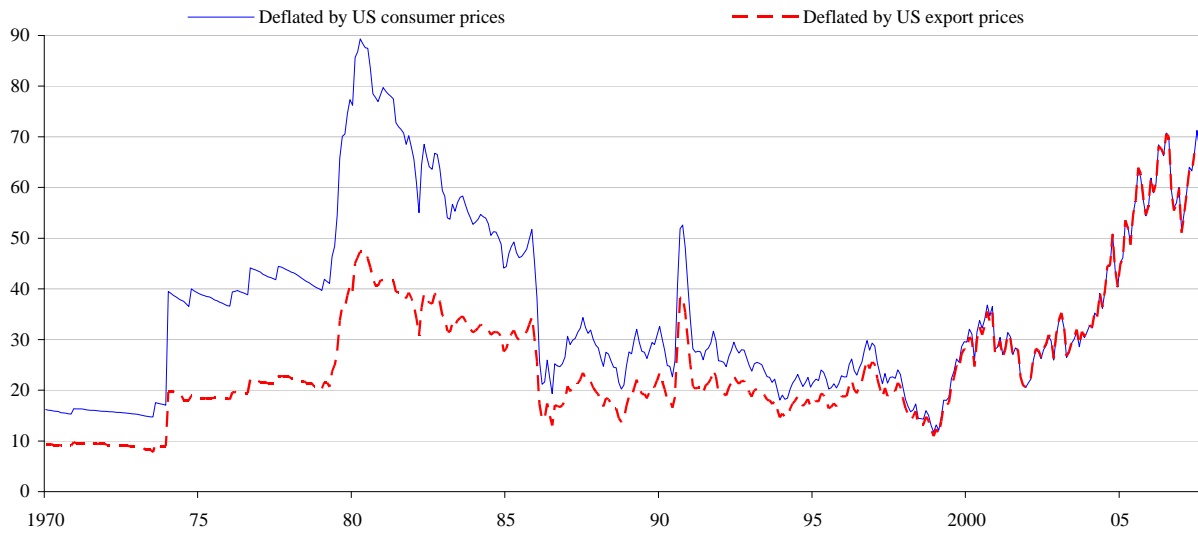
Since March 2003, the OECD has presented a brief overview of the near-term prospects in the major OECD economies between each issue of the *Economic Outlook*.^{*} This interim assessment should not be seen as a full update of the biannual *Economic Outlook* projections, since it rests on a more limited information set, has a shorter horizon and covers a much smaller number of economic variables and countries. However, it helps evaluate to what extent the latest *Economic Outlook* projections for the larger economies are still on track.

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 are run up to and including the following quarter, meaning that they cover the two quarters following the last one for which official data have been published. They use a small, country-specific selection of monthly variables, 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 weight of the different models varies across countries and over time, according to observed forecasting performance. The models used for the US economy have been modified to better capture the influence of developments in the housing sector, with the inclusion of various forward-looking housing indicators. However, they do not fully incorporate the impact of recent financial market turbulence.

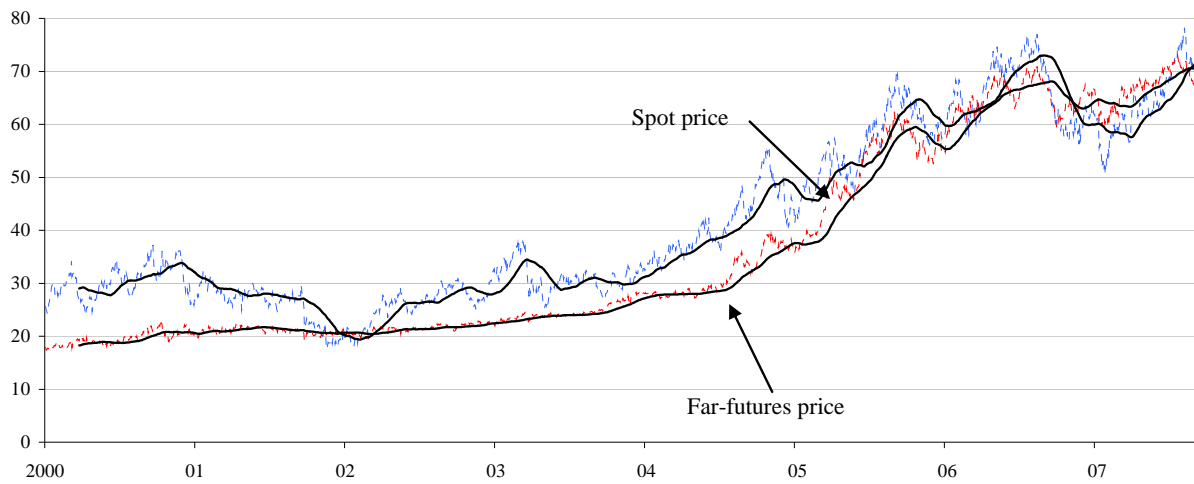
^{*} In the case of the euro area, some of the aggregate data used and shown exclude Slovenia (which, however, accounts for only around 0.3% of euro-area GDP).

^{**} 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.

Spot oil prices remain high and volatile
 Brent crude, price per barrel in 2005 dollars (monthly average)



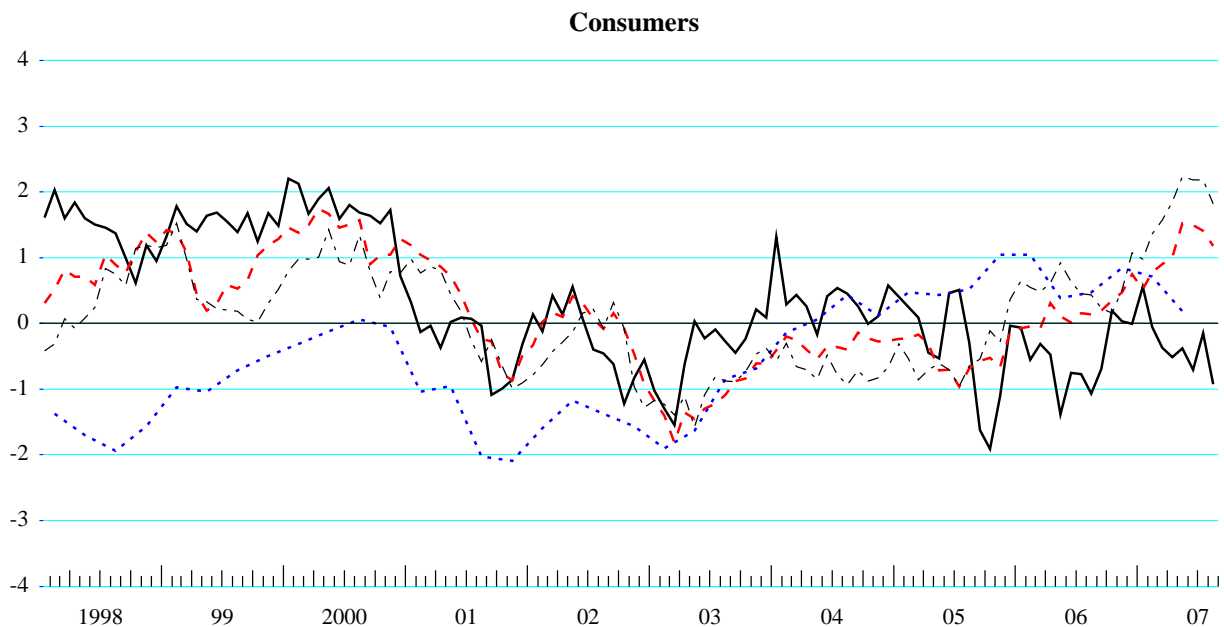
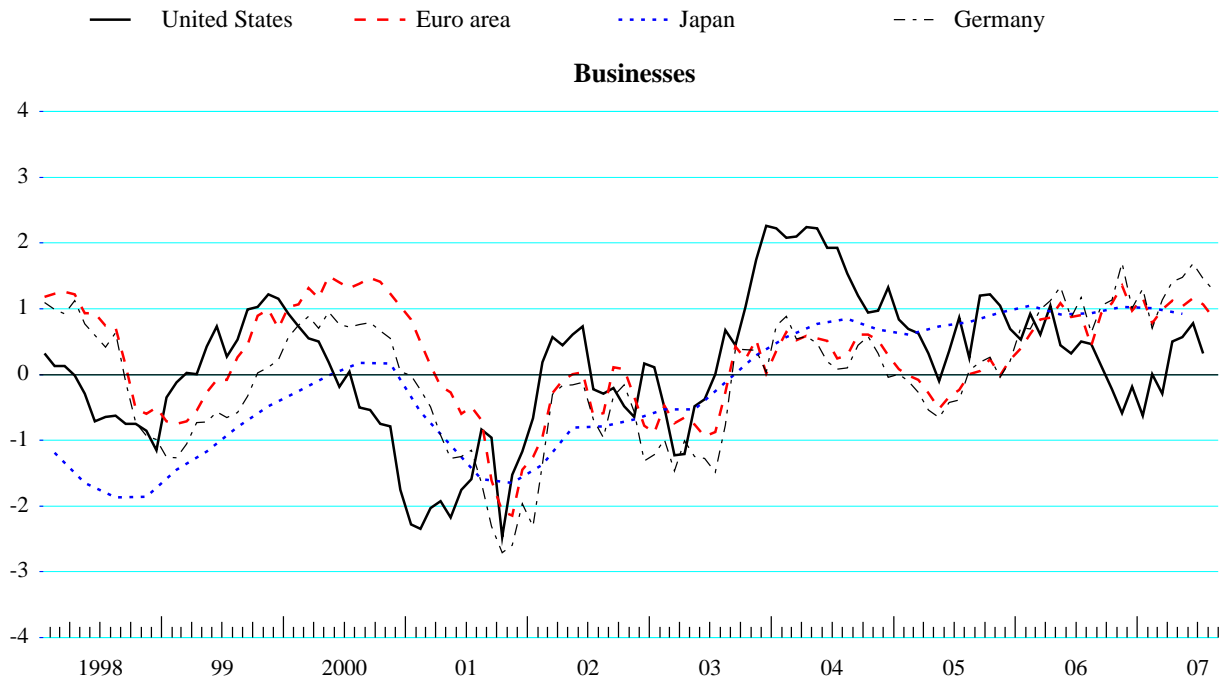
Futures suggest oil prices could stay at high levels
 West Texas Intermediate (WTI), current dollars, daily observations and trend



Note: Far-futures prices refer to the New York Merchandise Exchange contract on light crude with the farthest maturity (6 to 7 years). Trends are three-month moving averages.

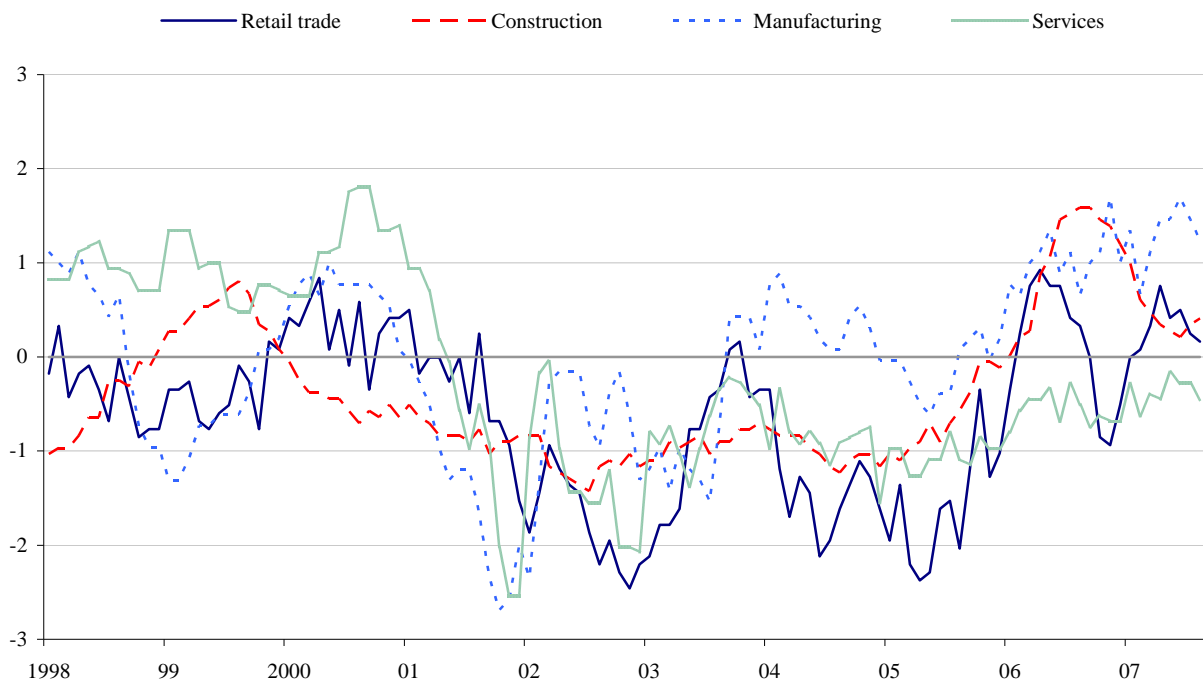
Source: OECD and Datastream.

Business and consumer confidence have been dented somewhat



All series have been normalised at the average for the period starting in 1985 and are presented in units of standard deviation.
Source: OECD Main Economic Indicators.

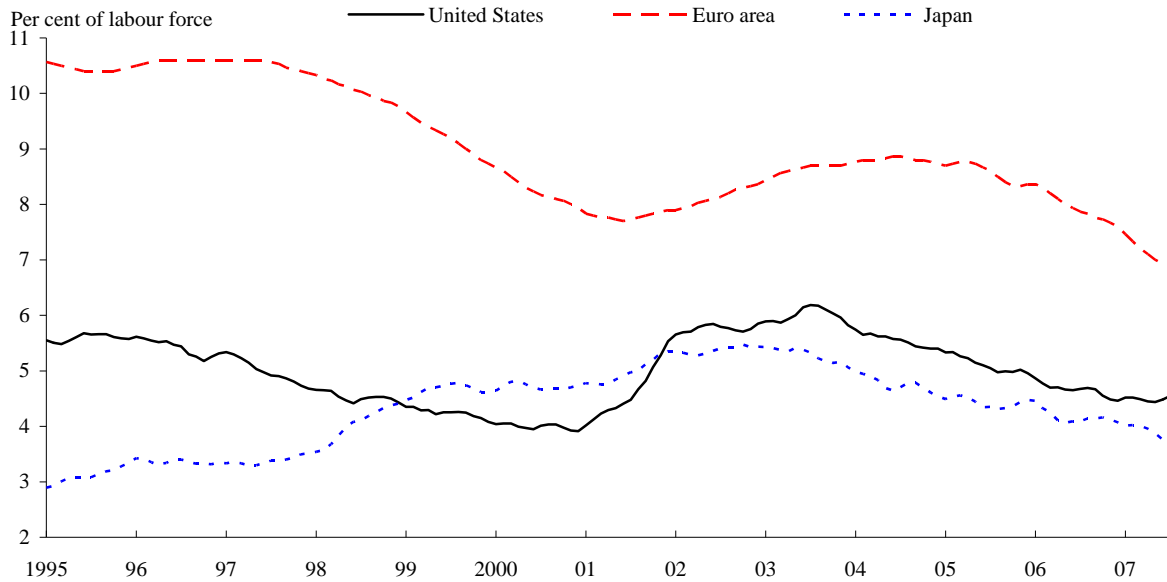
Business confidence has recently edged down in most sectors in Germany



Source: OECD Main Economic Indicators.

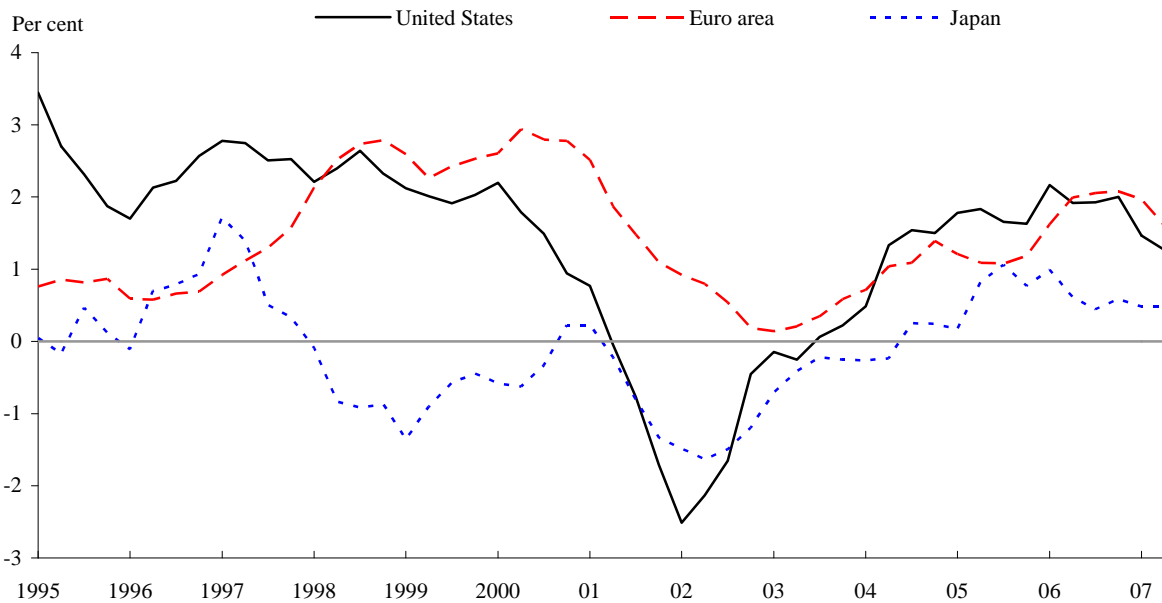
Unemployment has declined substantially in recent years but is edging up in the United States

3-month moving average of standardised unemployment rate



Business sector employment creation has slowed on both sides of the Atlantic

Year-on-year growth

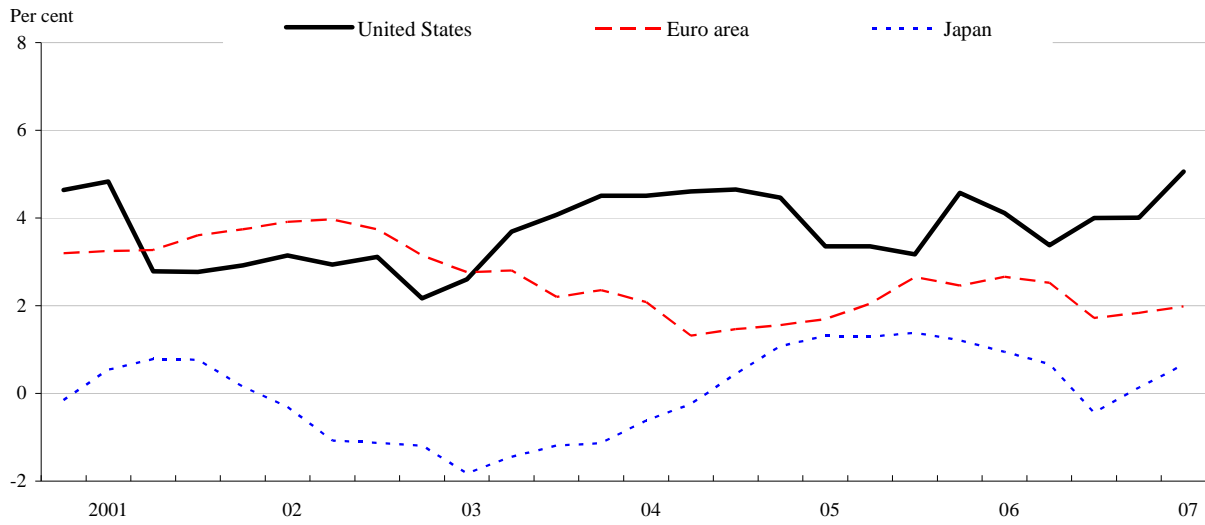


Note: Employment growth for the euro area in 2007Q2 and for Japan in 2007Q1 and Q2 is an OECD estimate.

Source: OECD Main Economic Indicators.

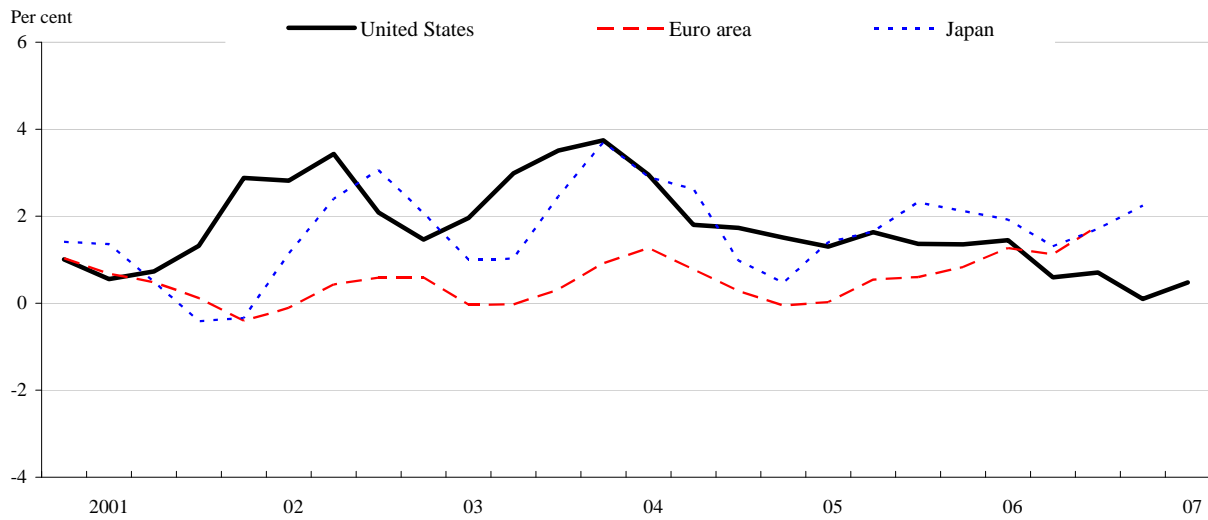
Nominal hourly compensation of employees has picked up

Year-on-year change, total economy



Labour productivity developments diverge across regions

Year-on-year change, total economy

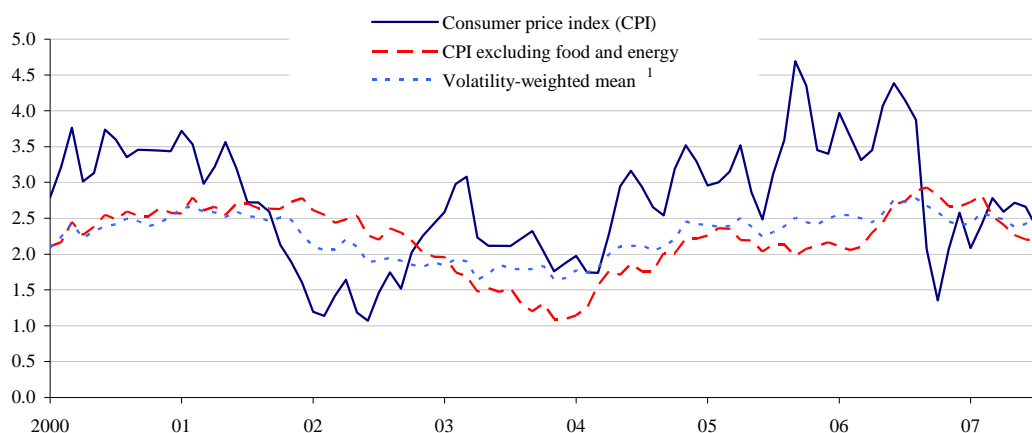


Source: US Bureau of Labour Statistics and OECD Economic Outlook database.

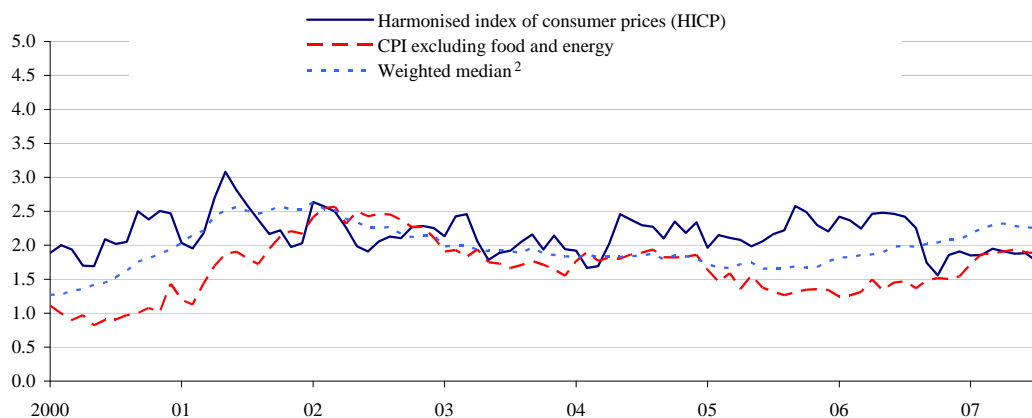
Core inflation is on the high side except in Japan

Year-on-year percentage change

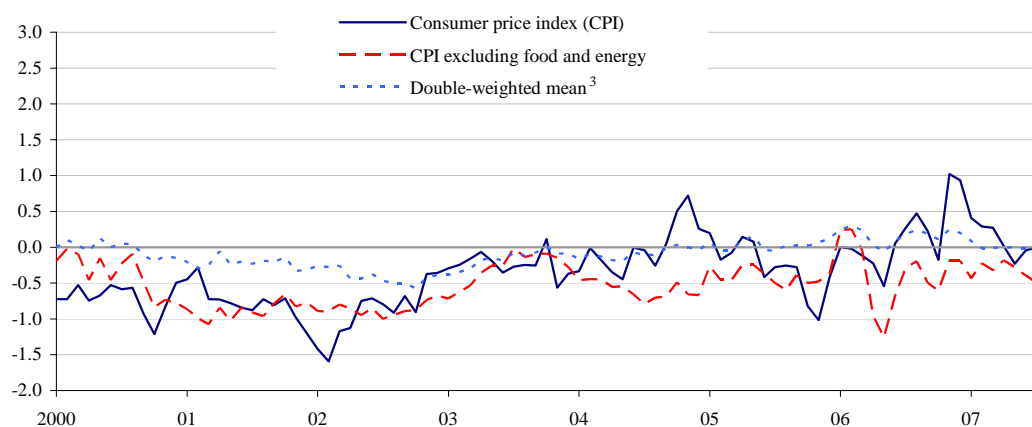
United States



Euro area



Japan



1. The volatility-weighted mean refers to an average of price increases of CPI components weighted by the inverse of the standard deviation of the price second difference.

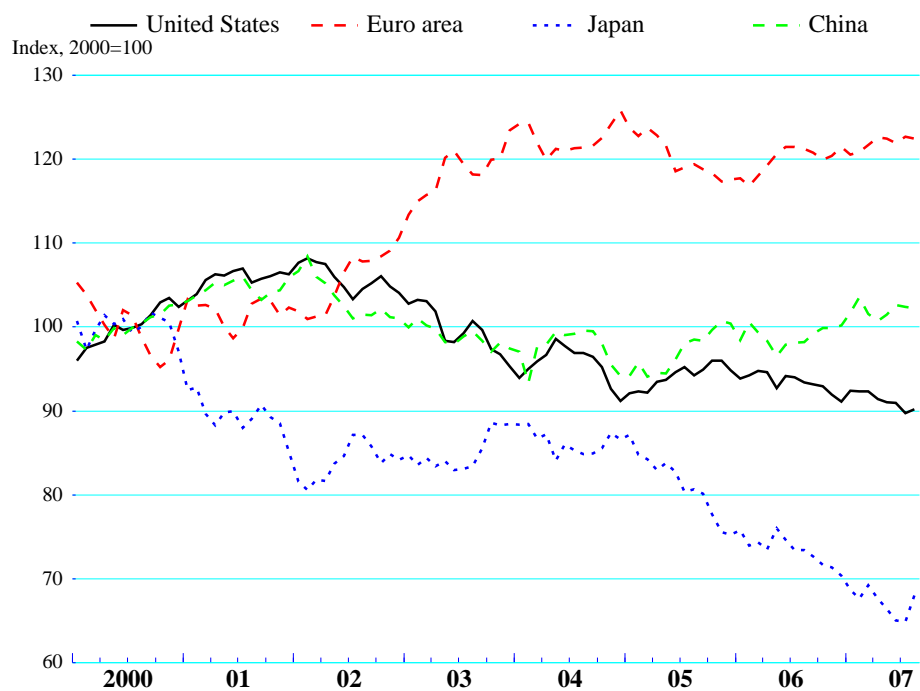
2. The weighted median is, each month, the middle element in the distribution of CPI price changes, that is, the one leaving 50% of the components (in terms of CPI weights) on each side.

3. The double-weighted mean combines original CPI expenditure-based weights and weights related to volatility. It is an average of price increases weighted by the original CPI weights divided by the standard deviation of the price second difference.

Source : OECD Main Economic Indicators and OECD calculations.

The dollar and yen have been weakening over the past three years

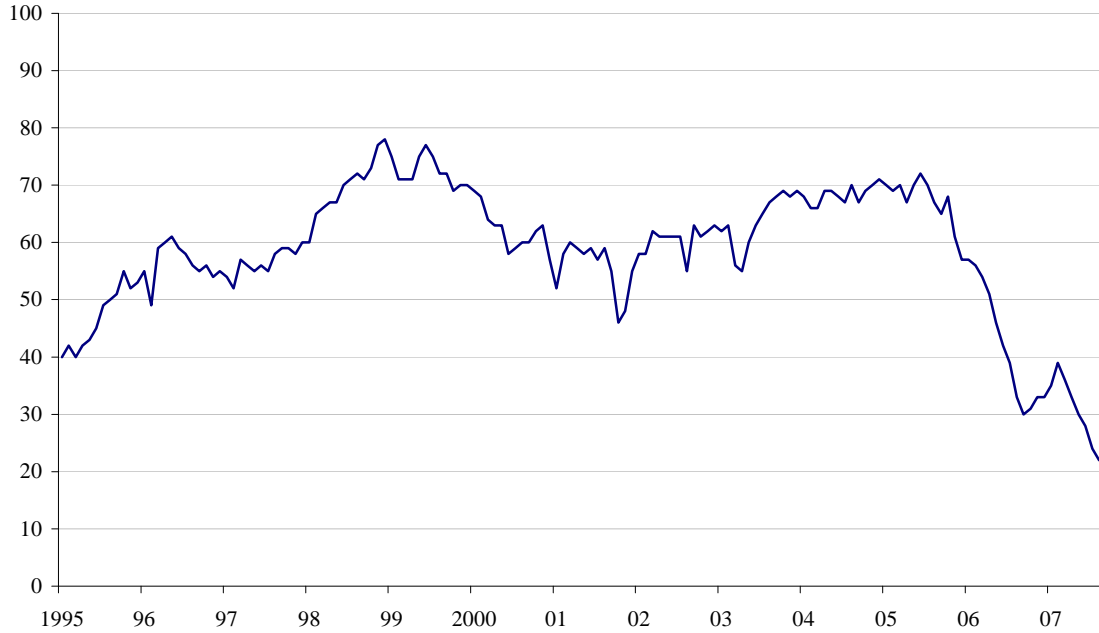
Real effective exchange rates



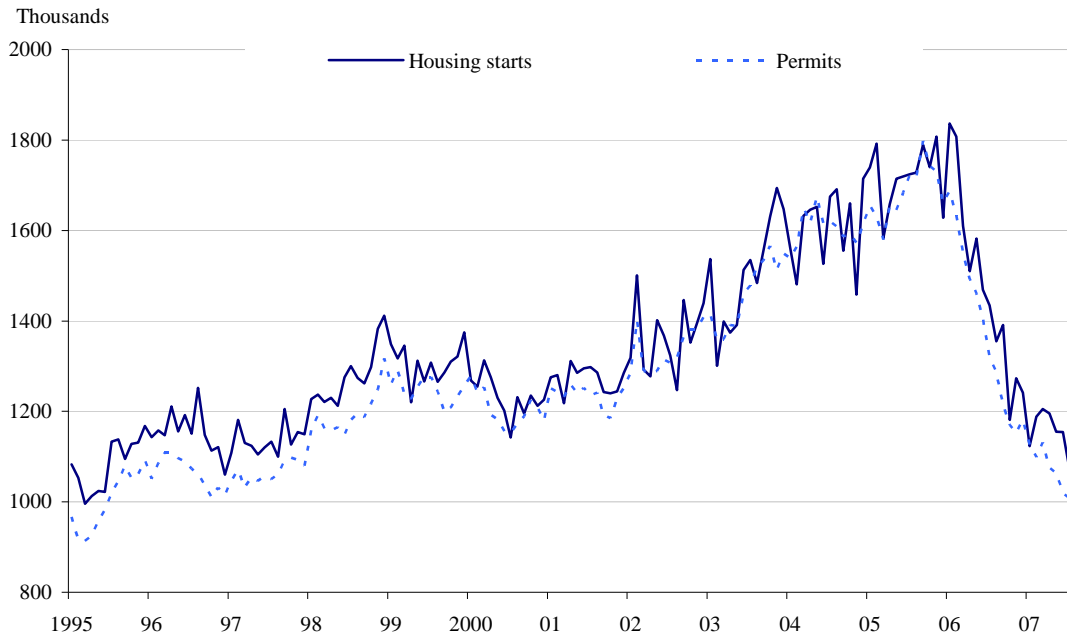
Note: The real effective exchange rate is based on the consumer price index.
Source : OECD.

The United States housing market is adjusting

Housing market index (builder sentiment)



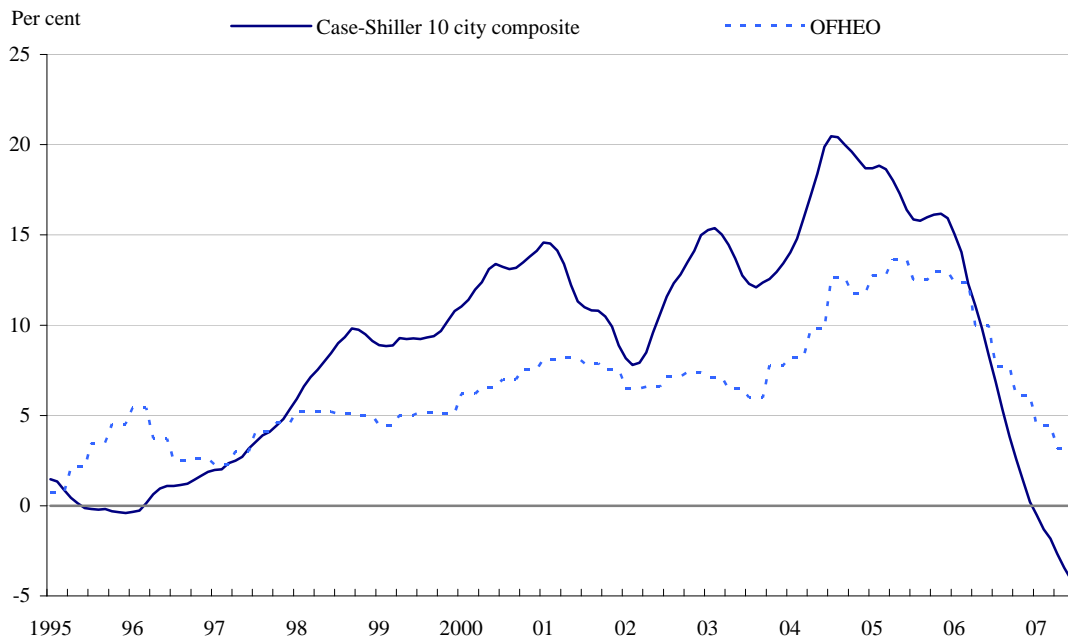
Housing starts and permits



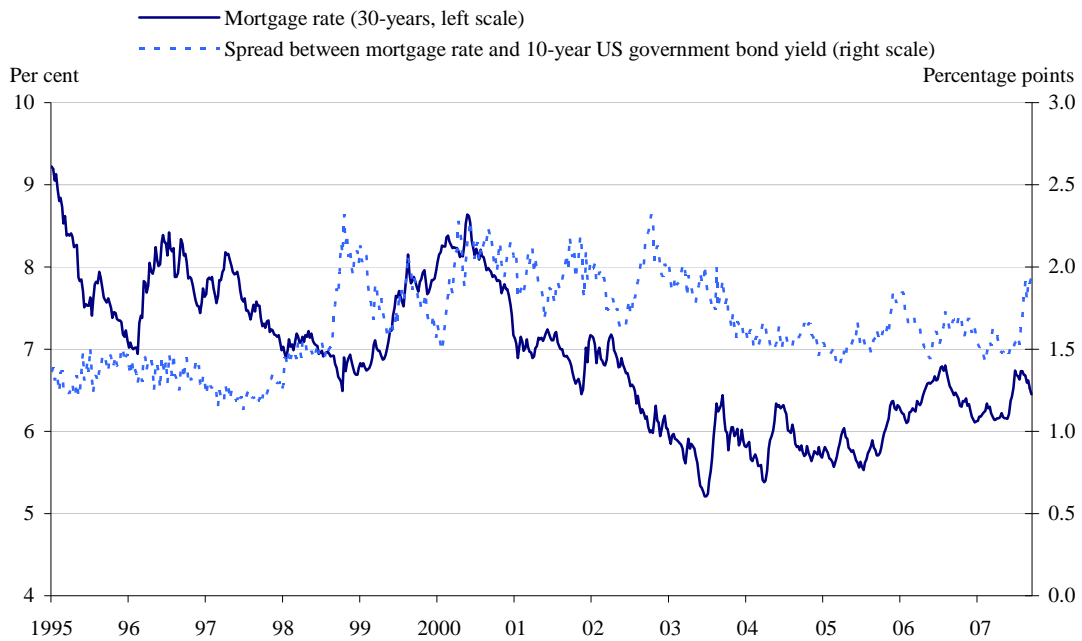
Note: Data refer to single-family houses and are seasonally adjusted.

Source: National Association of Home Builders and US Census Bureau.

House prices are heading down
Year-on-year percentage change



Mortgage rates have moved up since spring



Source: Macro-Markets LLC, Office of Federal Housing Enterprise Oversight and US Federal Reserve.

The equity price correction has not been that large to date

Latest observation 31 August 2007

United States

Wilshire 5000



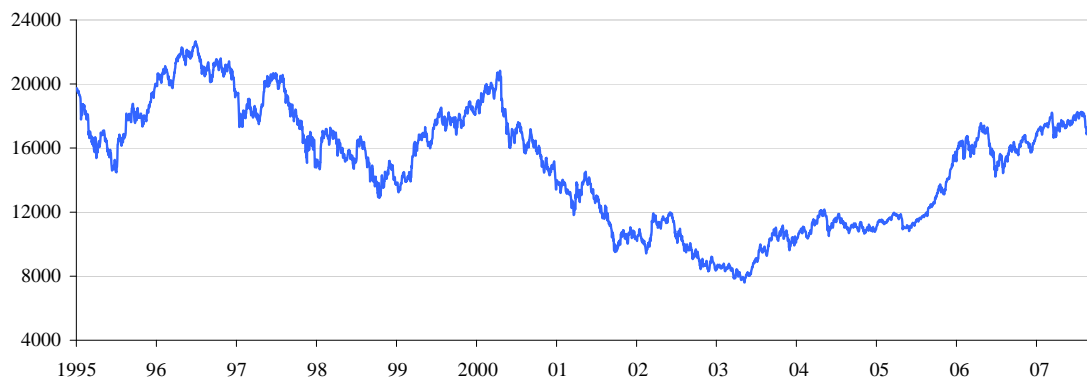
Euro area

FTSE Eurotop 100



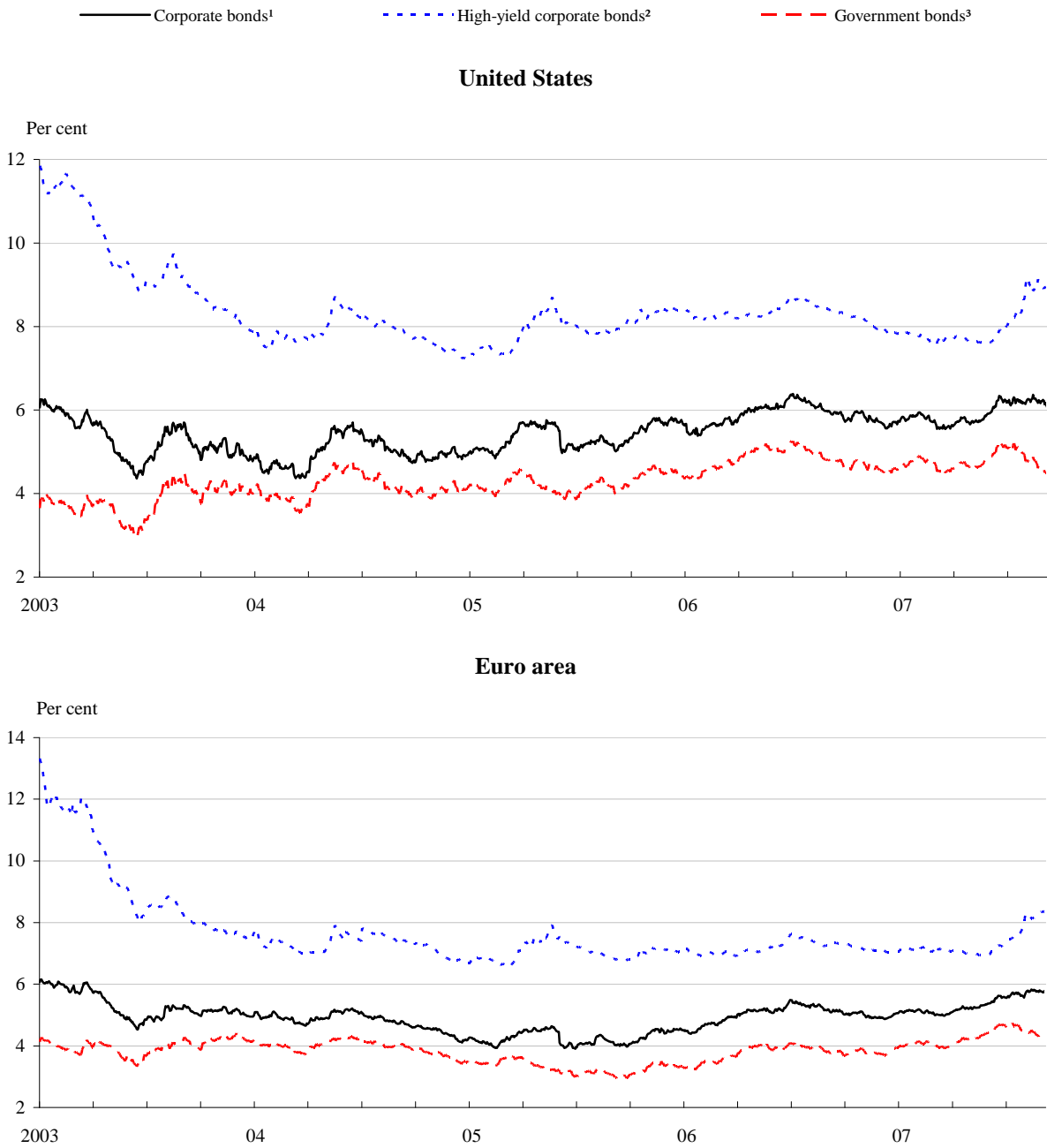
Japan

Nikkei 225



Source: Datastream.

Spreads between corporate and government bond rates have widened



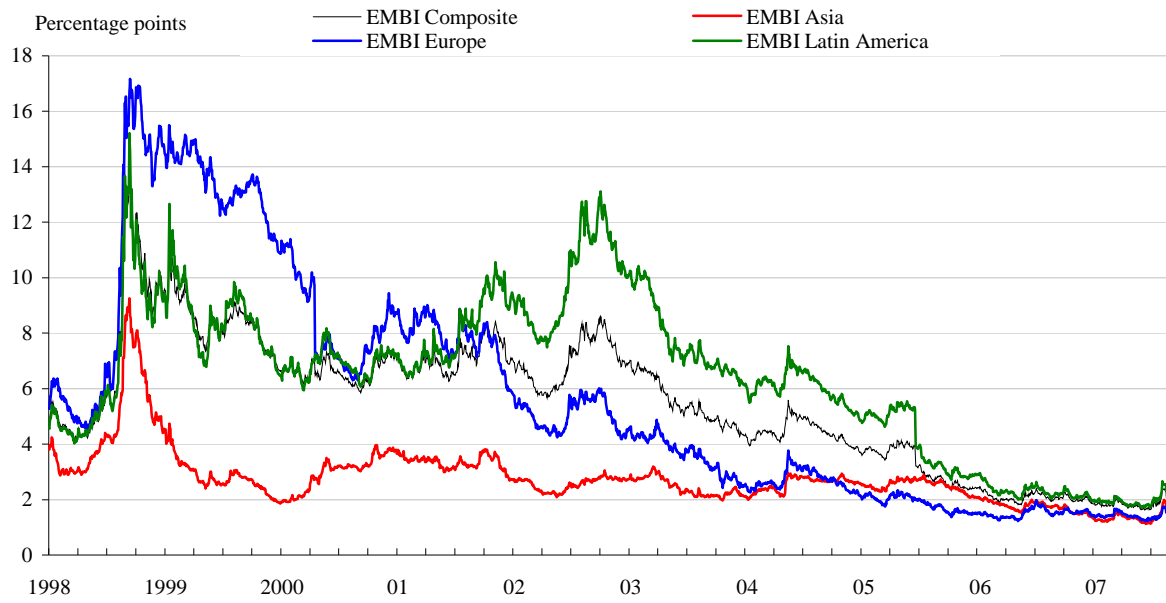
1. Merrill Lynch corporate BBB rated 7-10 year bonds.

2. Merrill Lynch indices of high-yield bonds.

3. 7-10 year government bonds.

Source: Datastream.

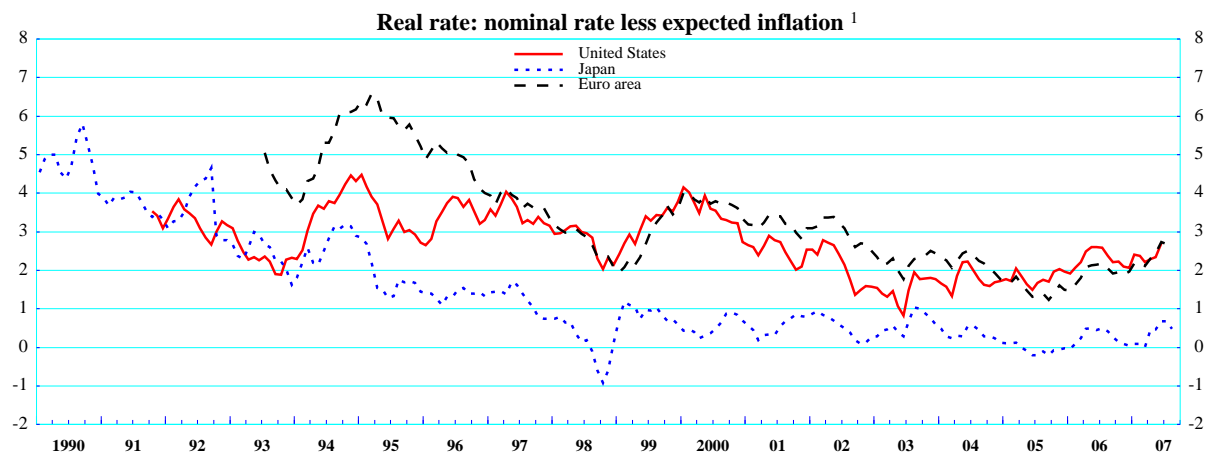
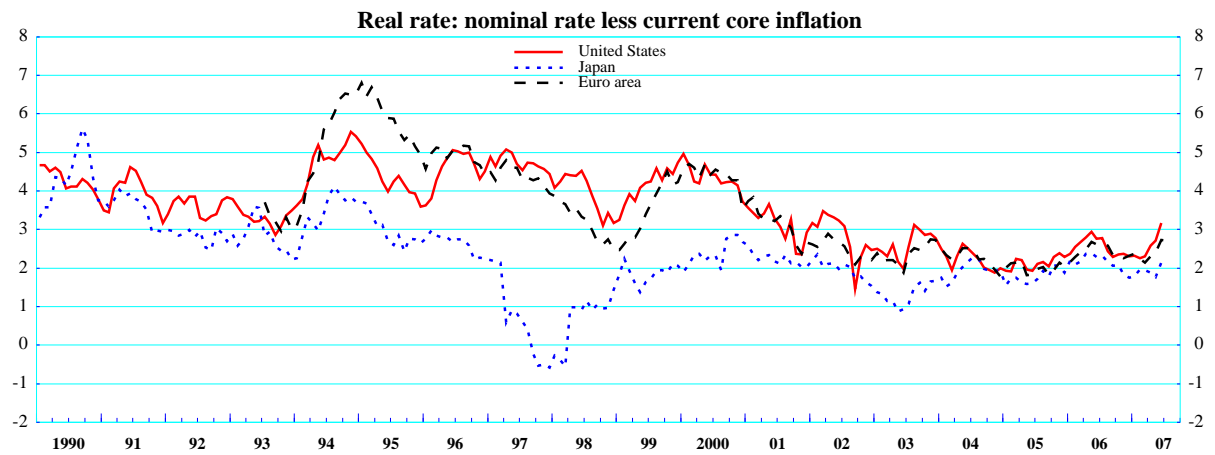
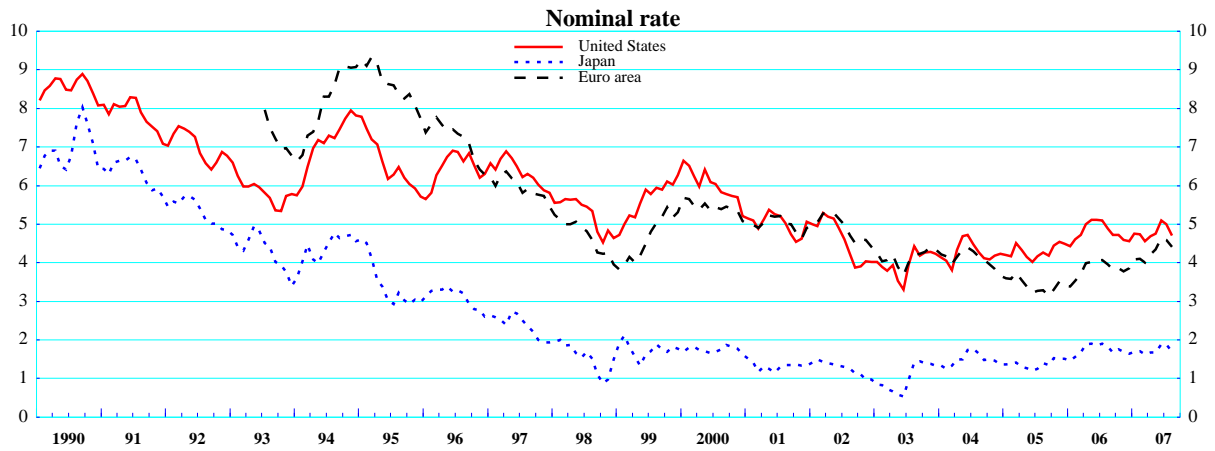
Emerging market bond spreads have not widened very much



Note: Data are spreads over US T-bond yields.

Source: Datastream.

Nominal and real long-term interest rates



1. Expected average rate of CPI inflation over the next 10 years for the United States, based on the Survey of Professional Forecasters (SPF) by the Federal Reserve Bank of Philadelphia. Expected HICP inflation rate 5 years ahead for the euro area based on the SPF by the ECB. Expected average rate of CPI inflation 6-10 years ahead for Japan based on Consensus Forecasts.
Source: OECD, Main Economic Indicators; US Bureau of Economic Analysis; Federal Reserve Bank of Philadelphia; ECB; Consensus Forecasts.