OECD Economic Outlook

An Interim Report

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11h

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www.oecd.org/OECDEconomicOutlook

Summary of projections

	2008	2009	2010	2008		2009				2010				Q4 / Q4		
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2008	2009	2010
									Per cent							
Real GDP growth																
United States	1.1	-4.0	0.0	-0.5	-6.2	-7.2	-4.3	-1.8	-0.4	0.5	0.9	1.2	1.8	-0.8	-3.5	1.1
Japan	-0.6	-6.6	-0.5	-1.4	-12.1	-10.9	-3.3	-2.8	-0.4	0.0	0.1	0.7	0.9	-4.3	-4.4	0.4
Euro area	0.7	-4.1	-0.3	-1.1	-5.9	-6.8	-4.2	-2.2	-0.8	0.2	0.7	1.1	1.4	-1.4	-3.5	0.8
Other countries[1]	1.9	-3.9	0.3	0.3	-8.6	-5.0	-3.6	-2.3	-0.8	0.8	1.7	2.5	3.1	-1.5	-2.9	2.0
Total OECD	0.9	-4.3	-0.1	-0.7	-7.1	-7.0	-4.0	-2.1	-0.6	0.4	0.9	1.4	1.8	-1.5	-3.4	1.1
Inflation[2]				year-on-year												
United States	3.8	-0.4	0.5	5.2	1.5	0.2	-0.6	-1.8	0.5	0.8	0.6	0.4	0.3			
Japan	1.4	-1.2	-1.3	2.1	1.0	0.0	-0.9	-2.0	-1.7	-1.3	-1.2	-1.3	-1.3			
Euro area	3.3	0.6	0.7	3.8	2.3	1.1	0.6	0.1	0.6	0.9	0.8	0.6	0.5			
Unemployment rate[3]																
United States	5.8	9.1	10.3	6.0	6.9	8.1	9.0	9.5	9.8	10.1	10.3	10.4	10.5			
Japan	4.0	4.9	5.6	4.0	4.0	4.4	4.7	5.0	5.3	5.5	5.6	5.6	5.7			
Euro area	7.5	10.1	11.7	7.4	8.0	9.0	9.7	10.5	11.1	11.5	11.7	11.8	11.9			
Other countries[1]	5.6	7.8	9.4	5.5	6.0	6.8	7.5	8.1	8.6	9.0	9.3	9.5	9.6			
Total OECD	6.0	8.4	9.9	6.0	6.5	7.5	8.2	8.8	9.3	9.6	9.8	10.0	10.1			
World trade growth	2.5	-13.2	1.5	2.4	-23.8	-22.7	-11.8	-4.9	0.4	3.3	4.7	5.9	6.9	-4.8	-10.2	5.2
Fiscal balance[4]																
United States	-5.8	-10.2	-11.9													
Japan	-2.6	-6.8	-8.4													
Euro area	-1.8	-5.4	-7.0													
Total OECD	-3.0	-7.2	-8.7													
Short-term interest rate																
United States	3.2	1.2	0.7	3.2	3.4	1.2	1.2	1.2	1.2	1.0	0.7	0.5	0.4			
Japan	0.7	0.6	0.3	0.7	0.8	0.7	0.5	0.5	0.5	0.4	0.3	0.2	0.2			
Euro area	4.7	1.3	0.6	5.0	4.6	2.1	1.1	1.0	1.0	0.9	0.6	0.4	0.4			

Note: Real GDP growth, inflation (measured by the increase in the consumer price index) and world trade growth (the arithmetic average of world merchandise import and export volumes) are seasonally and working-day (except inflation) adjusted annual rates. The "fourth quarter" columns are expressed in year-on-year growth rates where appropriate and in levels otherwise. Interest rates are for the United States: 3-month eurodollar deposit; Japan: 3-month certificate of deposits; euro area: 3-month interbank rate.

Assumptions underlying the projections include:

- fiscal policies are taken into account if they have been legislated or mandated;
- unchanged exchange rates as from 9 March 2009; in particular 1$ = 98.77 yen and 0.79 €;
- price of oil for a barrel of Brent crude is fixed at 45$;

The cut-off date for other information used in the compilation of the projections is 20 March 2009.

1. OECD countries not included in the Euro area or the 7 major countries.
2. USA: consumer price index, Japan: consumer price index, euro area: harmonised index of consumer prices.
3. Per cent of the labour force.
4. Per cent of GDP.

Source: OECD.

EDITORIAL

GLOBAL RECESSION: HOW SHOULD POLICY RESPOND?

The world economy is in the midst of its deepest and most synchronised recession in our lifetimes, caused by a global financial crisis and deepened by a collapse in world trade. Tight financial conditions and low confidence are weighing on output and employment in OECD and non-OECD countries alike. In turn, shrinking activity and income is further undermining bank balance sheets, magnifying the downturn.

These developments have led us to produce, ahead of this week's G20 Summit in London, an Interim *Economic Outlook*, with a focus on the economic policies required to foster a sustained recovery. It should be stressed upfront that there are exceptionally large uncertainties, associated with any forecast in the current climate, especially those related to the assumptions regarding the speed at which financial conditions improve and the effectiveness of the massive macroeconomic policy stimulus that is already in place or being implemented.

Bearing these uncertainties in mind, we anticipate that the ongoing contraction in economic activity will worsen this year, before a policy-induced recovery gradually builds momentum through 2010. In the United States, Japan, the euro area, as well as for the OECD economy at large, output will drop by between 4 and 7% this year and broadly stagnate next year. The major non-OECD economies are not spared from an abrupt slowdown in growth or an outright recession. World real GDP growth is projected to fall by 2¾ per cent this year and to recover by 1¼ per cent in 2010.

This bleak scenario is driven by the strong, negative response of private global demand to a combination of the credit squeeze, negative wealth effects stemming from lower house and equity prices, and a generalised loss of confidence. One of the consequences of the highly synchronised recession will be an exceptional degree of slack, which will push down inflation rates to close to zero in several OECD countries, and some will experience falling price levels.

This forecast is conditional on the assumption that the stress in financial markets dissipates towards the end of 2009, and carries risks that remain firmly tilted to the downside. The most important risk is that the weakening real economy will further undermine the health of financial institutions, which in turn forces them to curtail lending beyond what is anticipated in the *Outlook's* baseline projections. Another risk is that government actions will prove insufficient to restore stability and confidence in financial markets. There is also the risk that some central and eastern European economies, as well as a growing number of developing economies, may face external-payments and domestic-banking crises, intensifying the global downturn and raising the demand for external funding. Against these risks is the possibility that national and international efforts to resolve problems in financial markets and the large macroeconomic policy stimulae being introduced take hold sooner and prove more effective than anticipated, advancing the start and increasing the pace of the recovery.

The impact of the recession on societies will be substantial. Joblessness in all OECD countries will rise sharply, with the rate of unemployment peaking in 2010 or early 2011 and, in many countries, reaching double digit levels for the first time since the early 1990s. The number of unemployed in the G7 countries will almost double from its level in mid-2007 to reach some 36 million people in late 2010. This prospect underscores the need for employment and social policies to complement and reinforce macroeconomic stabilisation efforts to get people into jobs and prevent, as far as possible, any rise in structural unemployment. At the same time, policies to cushion the impact of recession via effective social safety nets and schemes that target those most vulnerable may need to be strengthened for the duration of the recession. But it is vital not to repeat the mistakes of the 1970s and 1980s, when many countries attempted to reduce unemployment by encouraging early retirement, which would only reduce the labour force and cut growth without boosting overall employment.

An essential step to arrest the "economic haemorrhaging" that is ongoing is to devise and implement without delay a coherent strategy that squarely tackles the mess in financial markets. This involves a continuation for the time being with deposit and debt guarantees, insurance schemes and other measures that have helped to create a modicum of stability. But above all, dealing decisively with impaired bank assets and broader concerns about bank solvency is needed to restore credit supply and to restore trust and confidence in financial markets. Doing so calls for action to create transparency about losses and impaired assets, to separate institutions that are viable from those that are not, and, where necessary, to re-capitalise, or as a last resort nationalise, insolvent financial institutions. Efforts are also needed to win broad public acceptance that the cost of these necessary measures will be large and will only be further increased by not acting promptly.

Additional macroeconomic stimulus is also critical to cushion the fall in aggregate demand. Conventional monetary policy should be used fully by keeping or bringing policy rates near zero and committing to keep them at that level for some time to come. The monetary authorities should also be ready to implement or expand their use of direct measures to support credit creation, enhance liquidity in markets and to limit deflationary pressures. In the medium term, central banks should reassess current monetary policy frameworks and their ability to respond to destabilising credit booms and asset price bubbles. Here the biggest challenge will be determining how to put a larger weight on financial stability concerns without weakening the commitment of monetary policy to maintain price stability.

Discretionary fiscal stimulus is already playing an important role in OECD and many non-OECD countries. The need and scope for more ambitious fiscal stimulus than currently planned depends on country-specific circumstances, in particular the size of the negative impact of the crisis, the importance of automatic stabilisers and the level of public debt. Against these criteria, governments in some countries should consider further discretionary fiscal expansion.

On current plans, and considering the deep recession, government indebtedness is projected to rise substantially, and concerns in this regard are already putting upward pressure on bond yields in many countries. Keeping such pressures in check will hinge on establishing credibility for a return to fiscal sustainability. Designing stimulus measures that are explicitly temporary or easily reversed, strengthening fiscal frameworks, and acting now to address long-term fiscal sustainability concerns relating to pensions and health spending would all be helpful in establishing such credibility. As well, action to contain the negative impacts of the recession on long-term sustainable production will limit the associated structural weakening of public budgets.

Because fiscal stimulus in one country has effects in others, there is a role for international co-ordination to achieve the right amount of stimulus. While explicit fiscal coordination is unlikely to be achieved, a common understanding of the severity of the recession and the required policy response should be aimed for. On financial market emergency actions, more coordination will be a desirable component of any exit strategy, as individual countries acting on their own may find it difficult to unwind in an orderly way the exceptional measures that are currently needed.

Beyond these immediate policy actions, the financial system must be reformed in a way that prevents the recurrence of similar crises in the future while at the same time preserving the vital role of financial markets in marshalling and allocating capital and monitoring its use. First, financial emergency measures that have added to moral hazard, additional risk taking and larger financial institutions, should be withdrawn or reformed. Second, large and internationally co-ordinated efforts need to focus on the market and regulatory failures that together caused this global financial crisis. Among the issues that have to be addressed and corrected are the unprecedented lack of transparency in the trading of financial instruments and financial institutions' balance sheets; the extent of distortive government interventions (including the role of government-sponsored enterprises and mortgage-loan guarantees); the inadequate compensation schemes that bias incentives towards excessive risk taking; the misguided reliance on external ratings and bad internal models of risk measurement and management; the inconsistencies and the pro-cyclical nature of banking regulation; and the fragmented structure of financial supervision.

In some countries, governments have introduced support measures for non-financial sectors, or even individual firms. In addition, some support packages have privileged domestic lending by financial institutions or introduced restrictions on government procurement from abroad. However, this distorts competition and resource allocation by delaying the exit of non-competitive producers, unless support is made contingent on ambitious and credible restructuring plans that are subject to strictly enforced time limits.

These support measures can also act as an obstacle to trade, risking retaliatory protectionist measures that would prove very costly. To date, border measures to protect domestic markets have been limited. The G20 declaration last November undoubtedly played a role in bringing about this outcome. In a few countries, however, border and behind-the-border measures that may curtail trade have been introduced. A confirmation and extension of the standstill agreement by all countries would demonstrate a commitment to competitive and open markets.

While some have dubbed this severe global downturn a "great recession", it will remain far from turning into a repeat of the 1930s' Great Depression, thanks to the quality and intensity of government policies that are currently being undertaken. The Great Depression was deepened by terrible policy mistakes, ranging from contractionary monetary policy to beggar-thy-neighbour policies in the form of trade protection and competitive devaluations. In contrast, this recession has broadly elicited the right policy.

To sum up, governments -- individually and collectively -- will have to persevere in doing the right thing in eight policy areas. These are: *i)* address even more forcefully the lingering financial crisis by adopting the measures required to stabilise systemically important institutions, reduce market uncertainty and illiquidity, and restart bank lending. This implies removing toxic assets and promoting bank recapitalisation; if necessary, by nationalisation; *ii)* in those countries that still have room to manoeuvre, continue monetary and fiscal easing as the recession deepens; *iii)* avoid disguised trade protection measures in the form of support and subsidies of domestic real-sector firms, both during the crisis and afterwards; *iv)* once sustained recovery is attained, be prepared to reverse quickly and forcefully financial emergency measures, as well as fiscal and monetary stimulus, to ensure medium-term macroeconomic and financial stability; *v)* work hard together to reach an internationally-agreed global framework for better financial-market regulation and supervision; *vi)* counter-cyclicality of bank behaviour should be strengthened by adopting adequate macro-prudential regulation, complemented by strongly counter-cyclical fiscal and monetary policy rules; *vii)* continue the drive toward world trade integration, both unilaterally and multilaterally through completion of the Doha Round, while ensuring further integration of world financial markets; and *viii)* pursue structural reforms to make domestic product and labour markets more competitive in order to raise long-term growth prospects and strengthen resilience to adverse shocks.

30 March 2009

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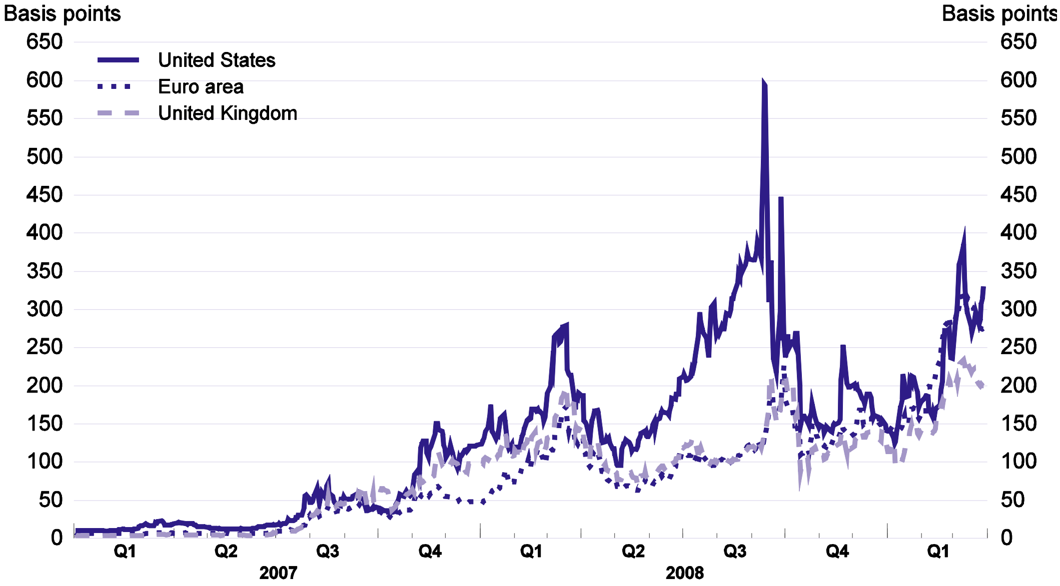
Chief Economist

Bank credit default swap rates remain high

Last observation: 27 March 2009

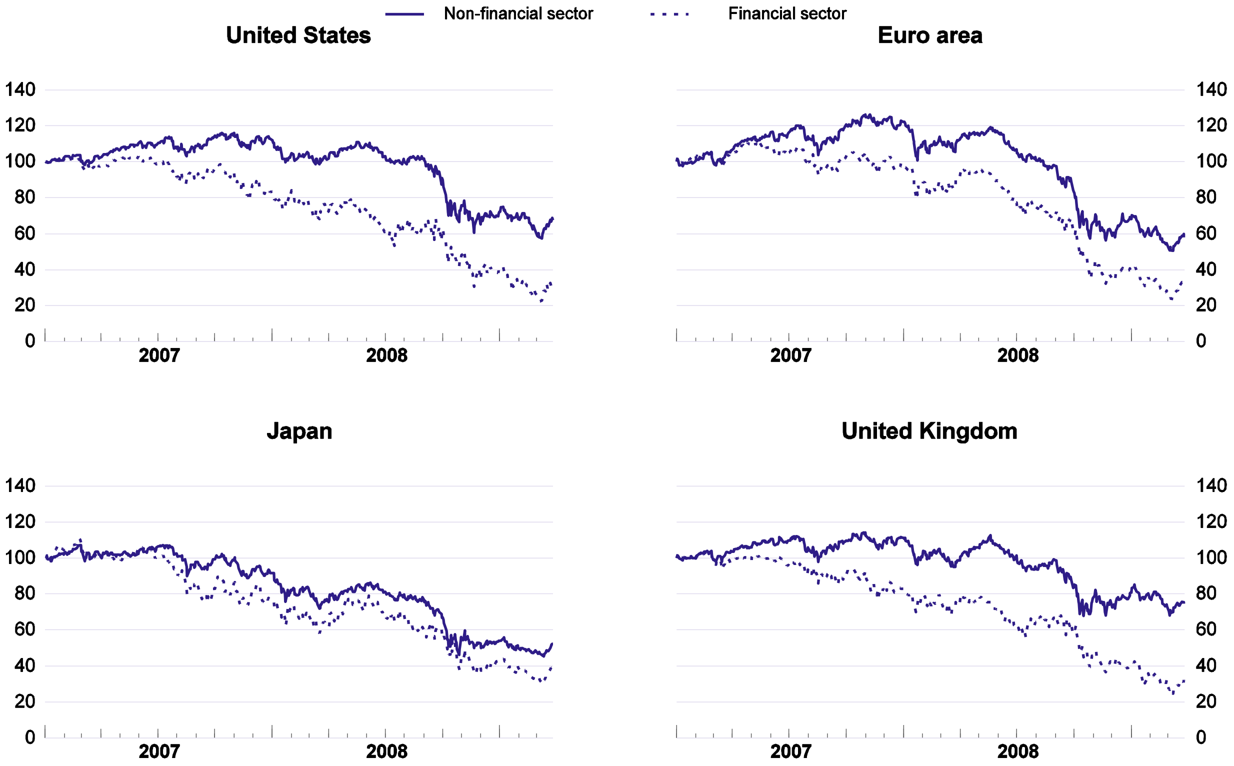


Note: Averages of 5-year credit default swap rates on senior bonds across the largest banks.

Source: Datastream.

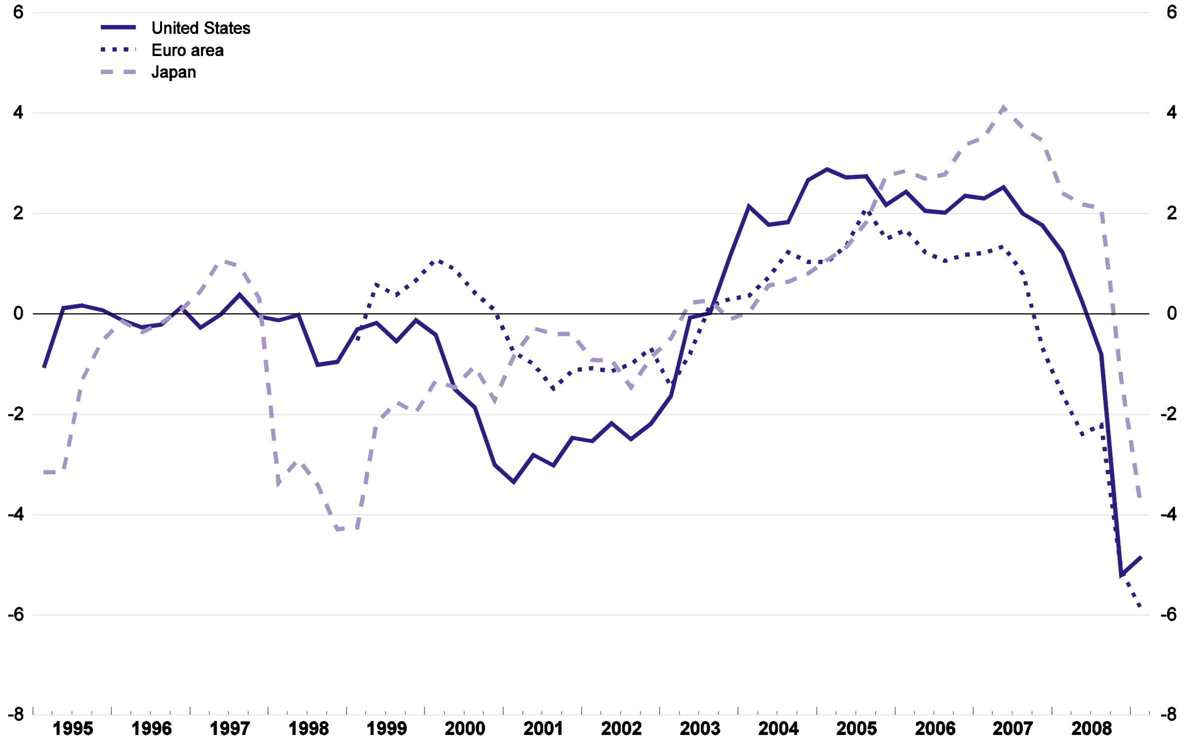
Stock markets have slightly increased from very low levels

Share price indices, 1 January 2007 = 100, last observation: 27 March 2009



Source: Datastream.

Financial conditions are tight

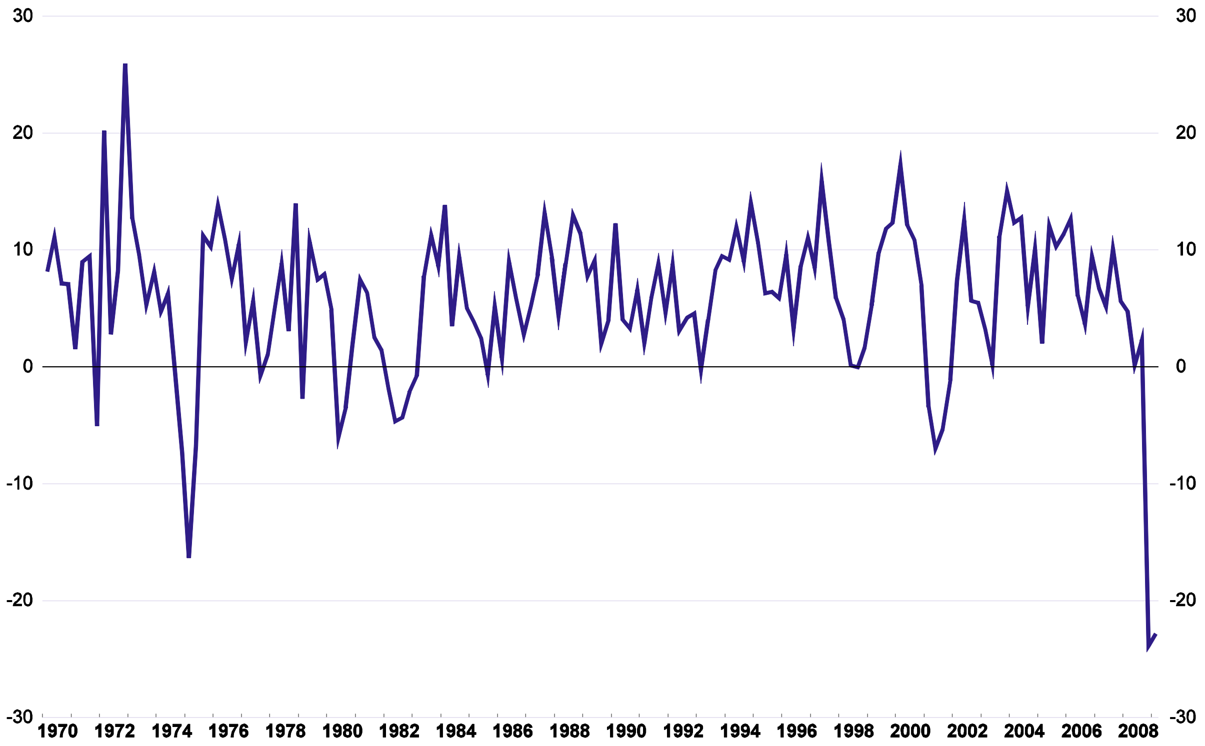


Note: A unit decline in the index implies a tightening in financial conditions sufficient to produce an average reduction in the level of GDP by 1/2 to 1% after 4-6 quarters. See details in Guichard *et al* (2009).

Source: OECD.

World trade growth has plummeted

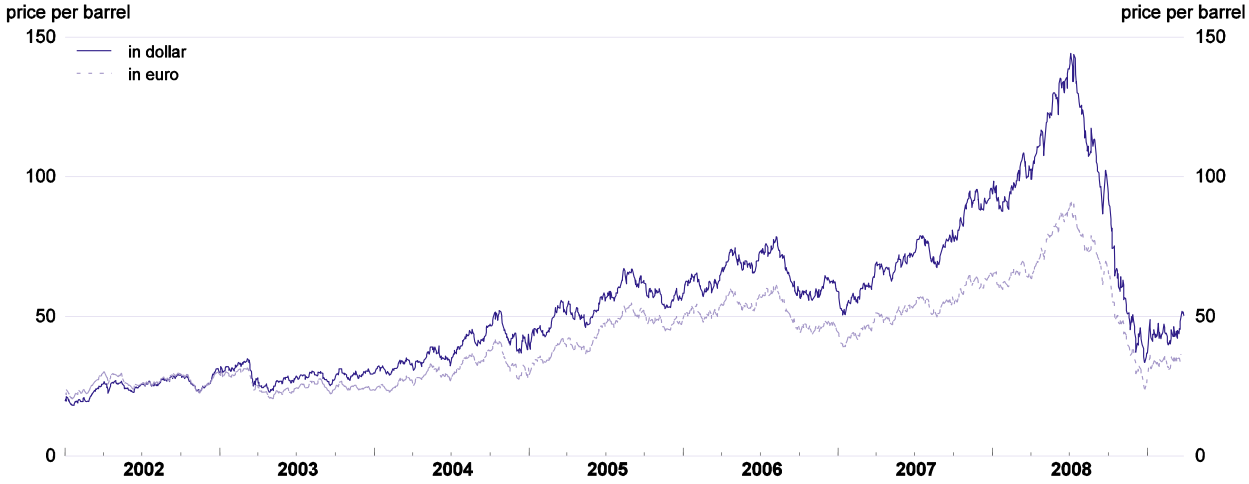
Annualised quarter on quarter growth (%)

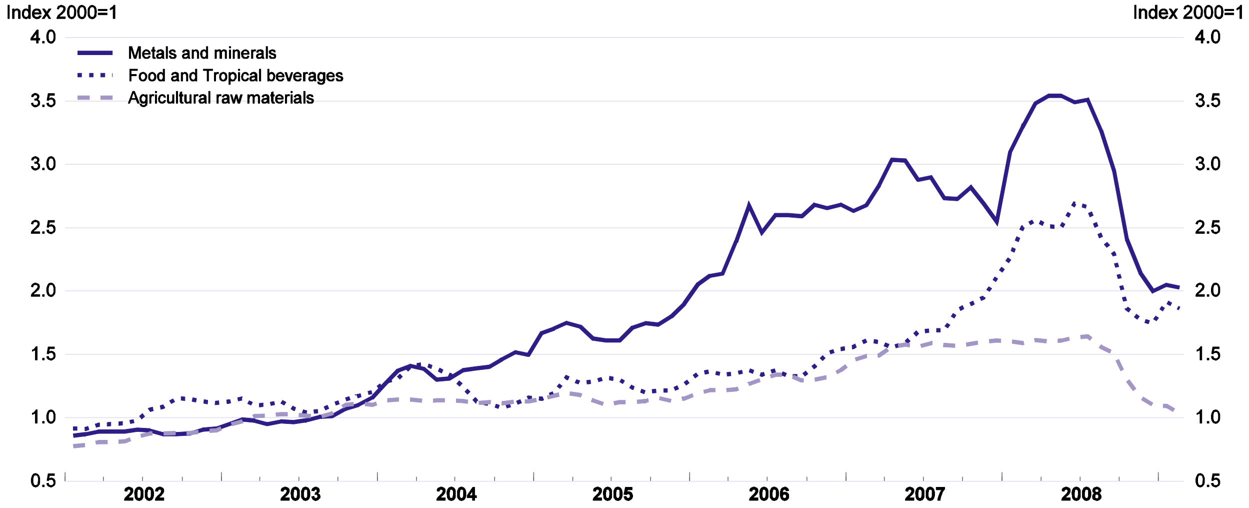


Note: 2009q1 is an estimate.

Source: OECD.

Oil and other commodity prices have tumbled

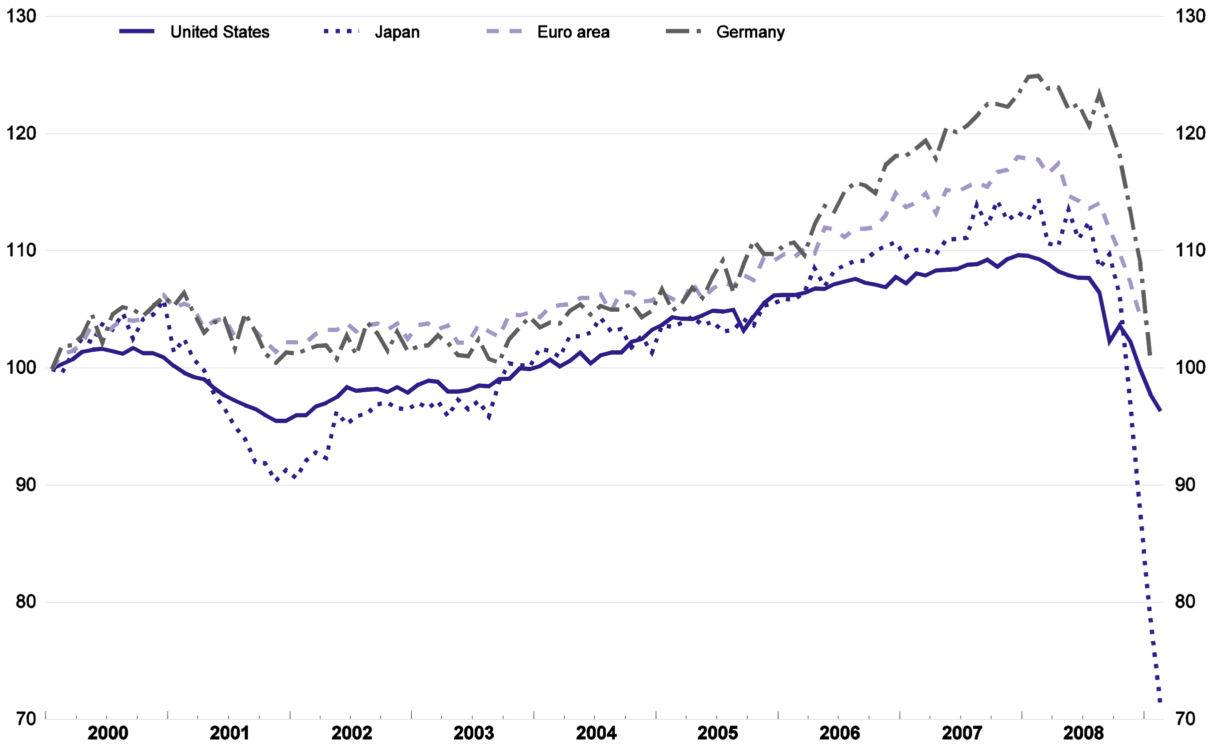




Source: OECD, Main Economic Indicators database.

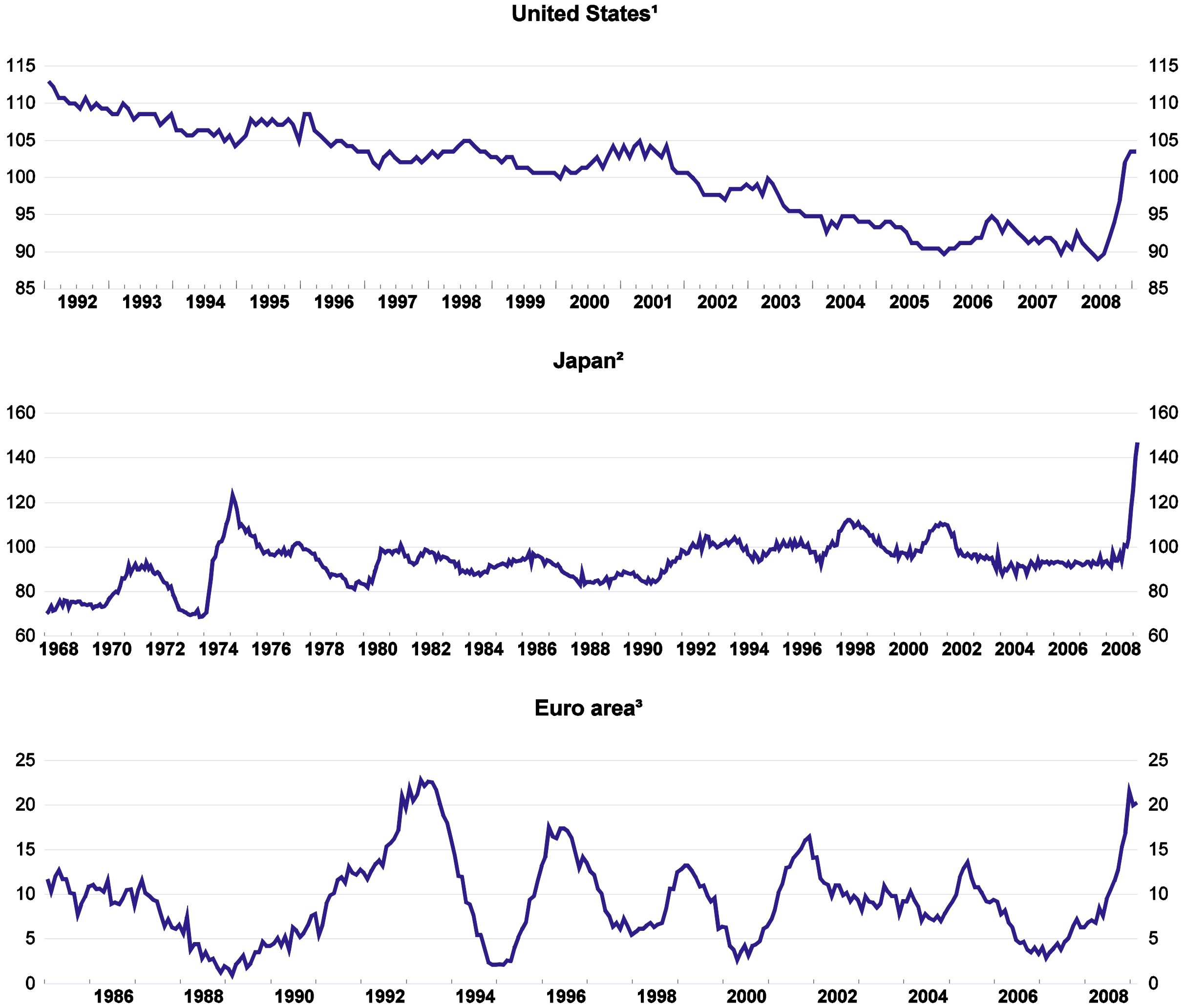
Industrial production has plunged

Index, January 2000 = 100



Source: Datastream.

Inventories have risen steeply

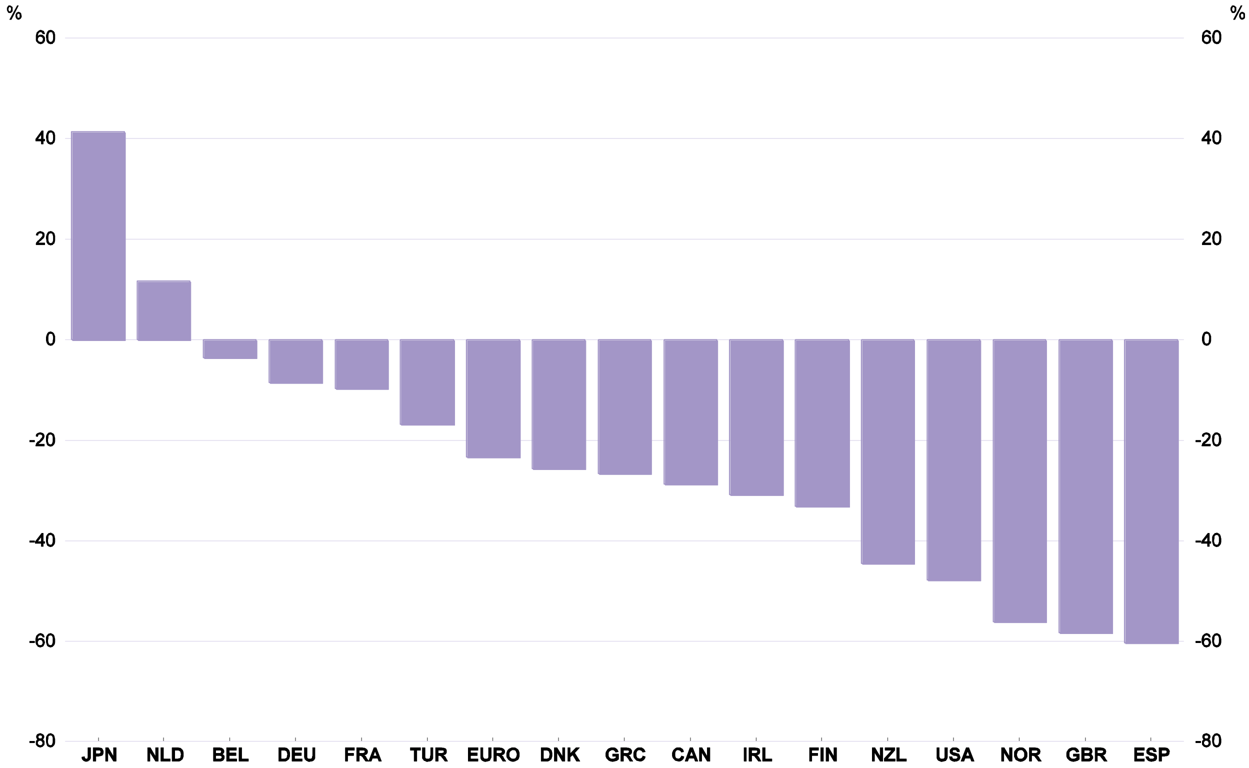


1. Inventory/sales ratio, index January 2000 = 100, seasonally adjusted, total business.
2. Inventory/shipments ratio, index January 2000 = 100, seasonally adjusted, mining and manufacturing.
3. Stock of finished goods, balance of index diffusion, seasonally adjusted, industry survey.

Source: Datastream.

Residential permits are falling sharply

Latest data, year-on-year growth rate[1]

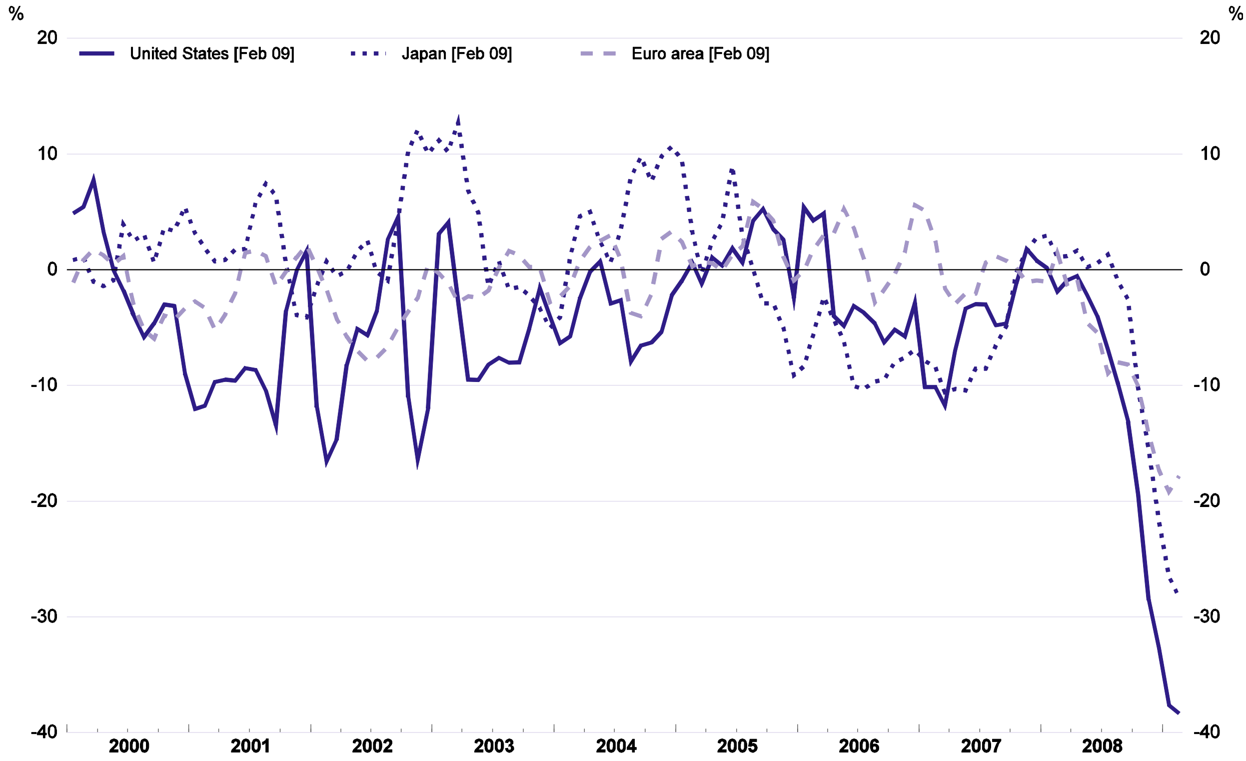


1. Monthly data mostly ending between October 2008 and January 2009; three-month average over the last year three-month average, seasonally adjusted.

Source: Eurostat; and OECD, Main Economic Indicators database.

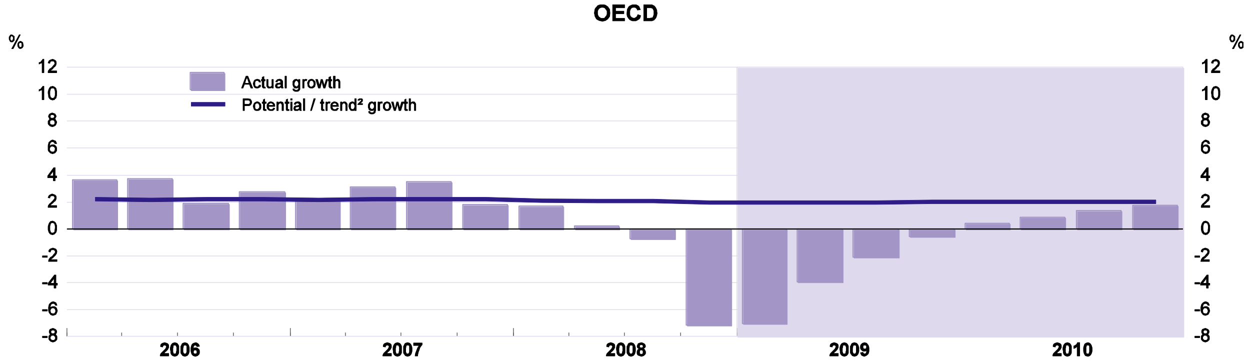
Car sales have plummeted

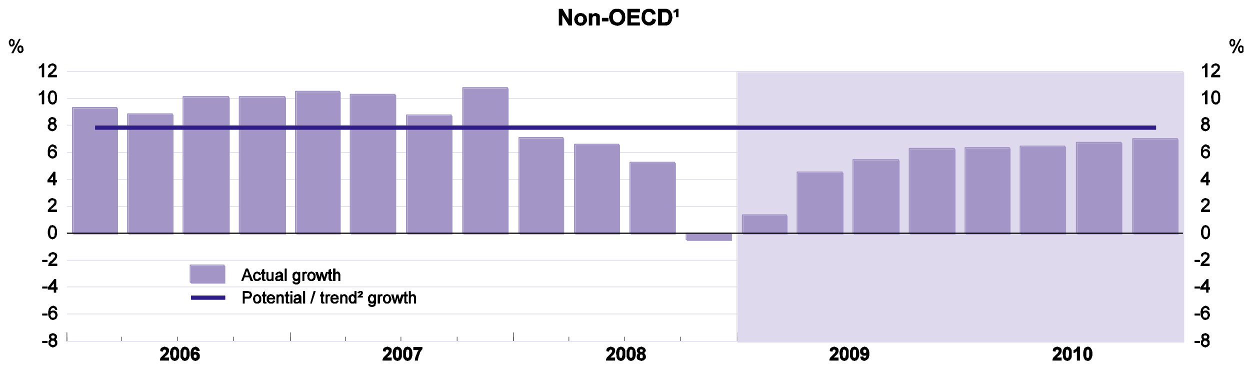
Year-on-year growth rates, three-month moving average



Source: Datastream.

The cycle is global





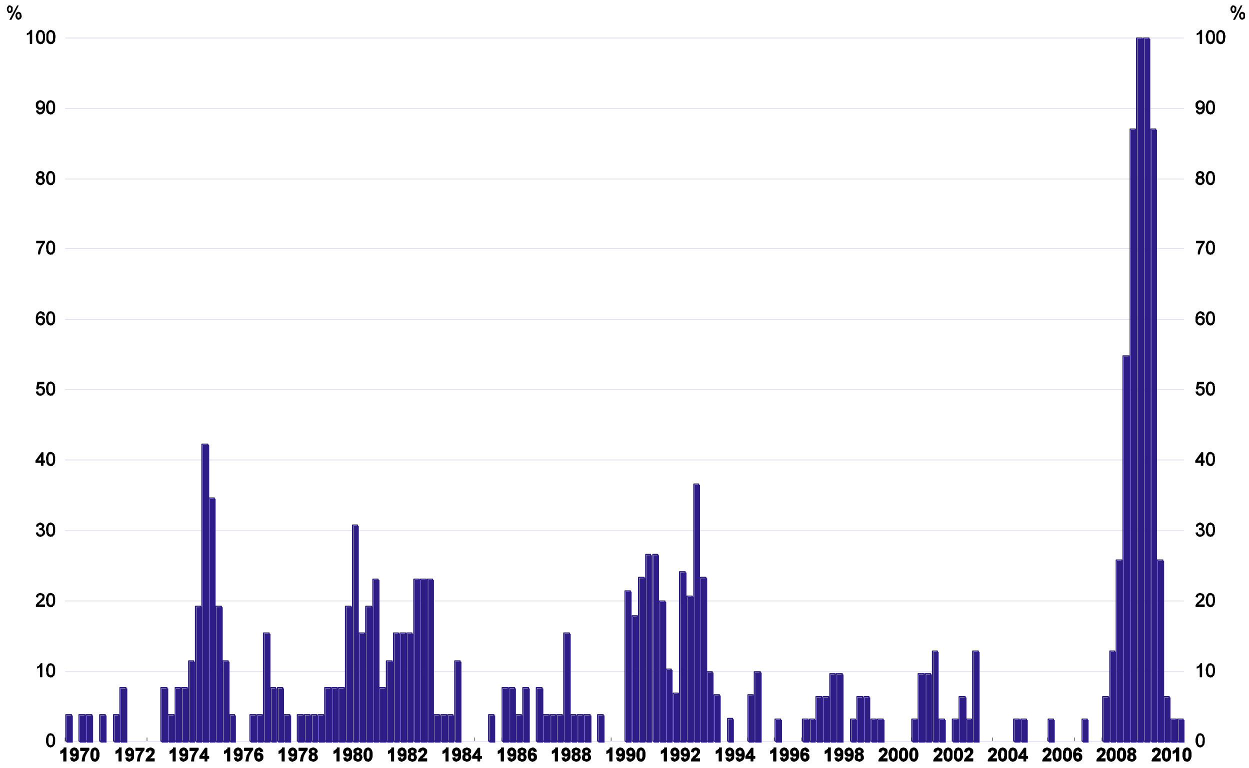
1. The non-OECD region is taken here to be a weighted average, using 2000 GDP weights and PPPs, of Brazil, China, the Russian Federation and India which together accounted for about half of non-OECD output in 2000.

2. Trend growth for the non-OECD area is the average over the period 2000-07.

Source: OECD.

The downturn is the most severe and synchronised in post-war history

Proportion of all OECD economies experiencing at least two consecutive quarters of downturn[1]

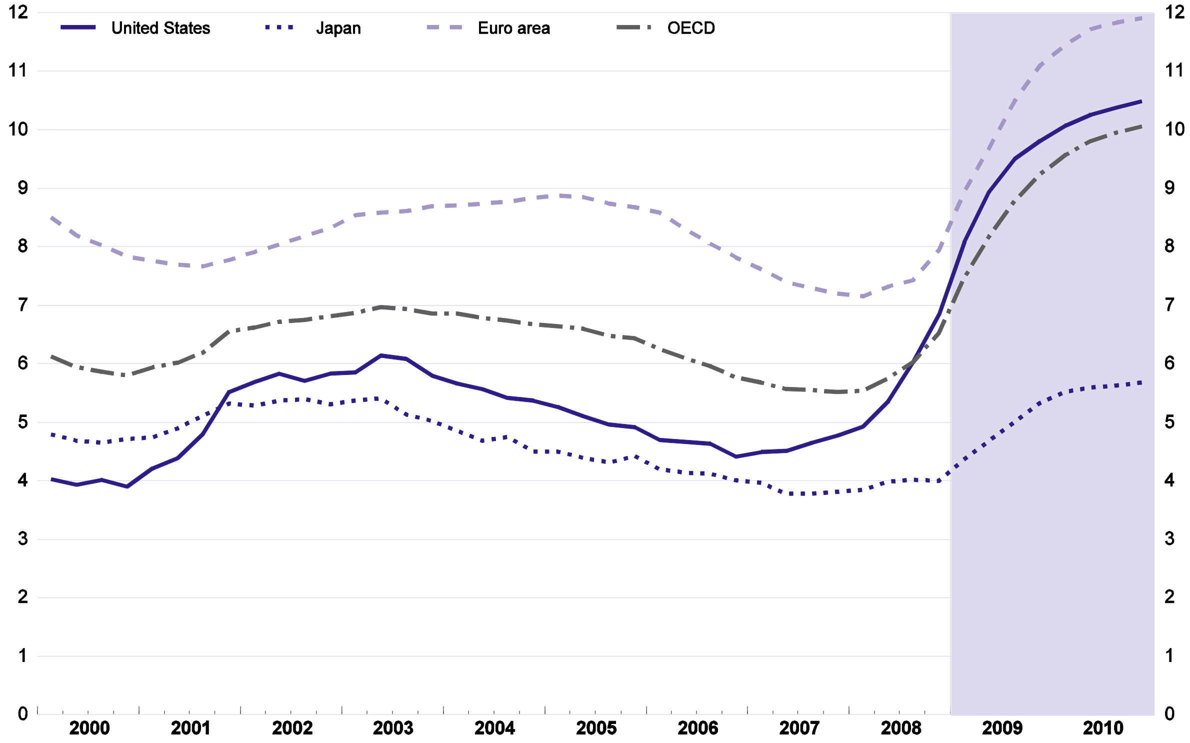


1. The last historical observation is for 2008q4.

Source: OECD.

Unemployment will rise substantially

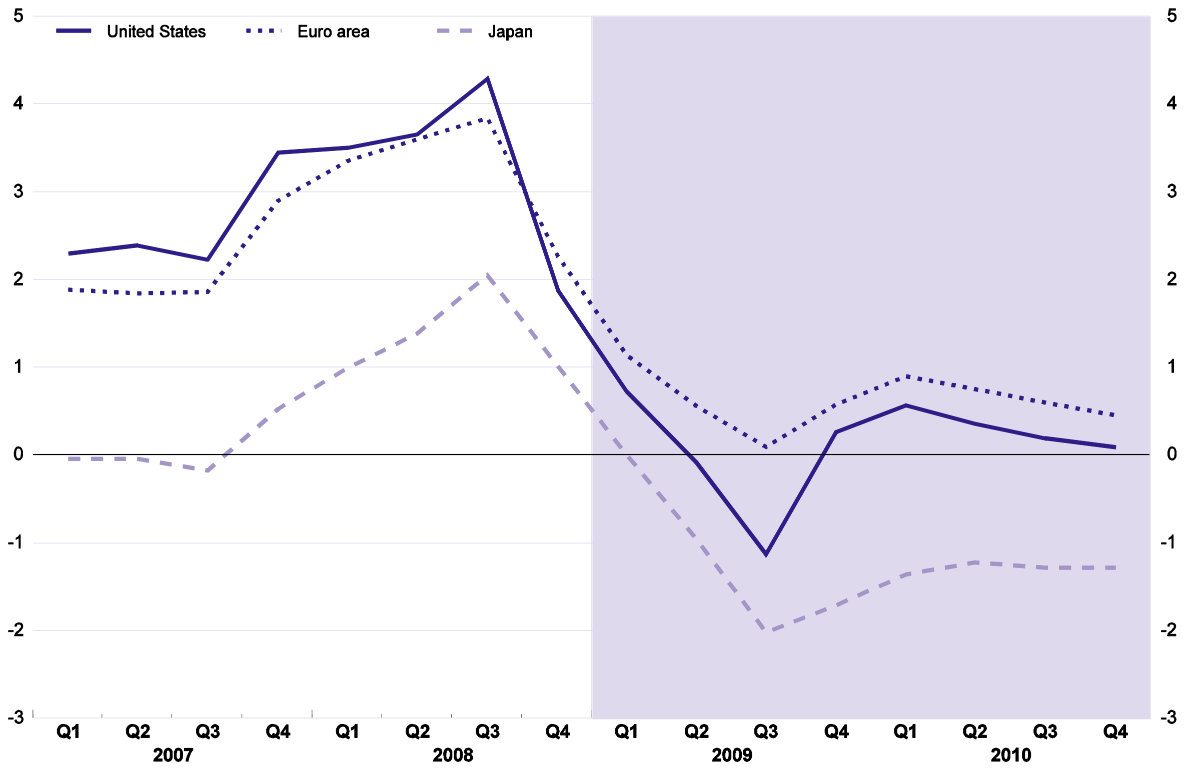
Percentage of the labour force



Source: OECD.

Inflation will fall to very low levels

Year-on-year growth rate, %

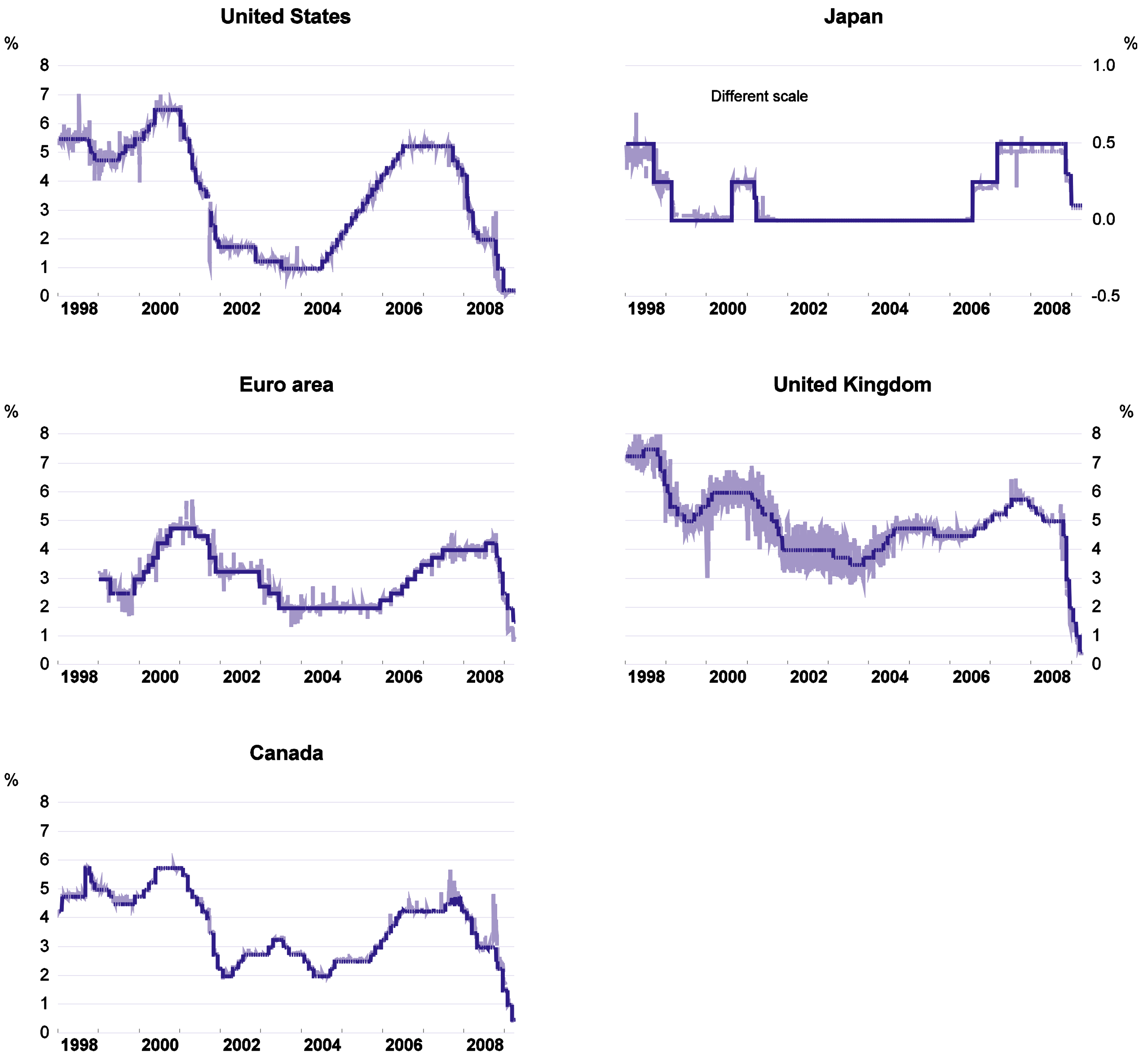


Note: Personal consumption expenditures deflator for the United States; Harmonised index of consumer prices for euro area; Consumer price index for Japan.

Source: OECD.

Policy rates have been slashed[1]

Last observation: 27 March 2009

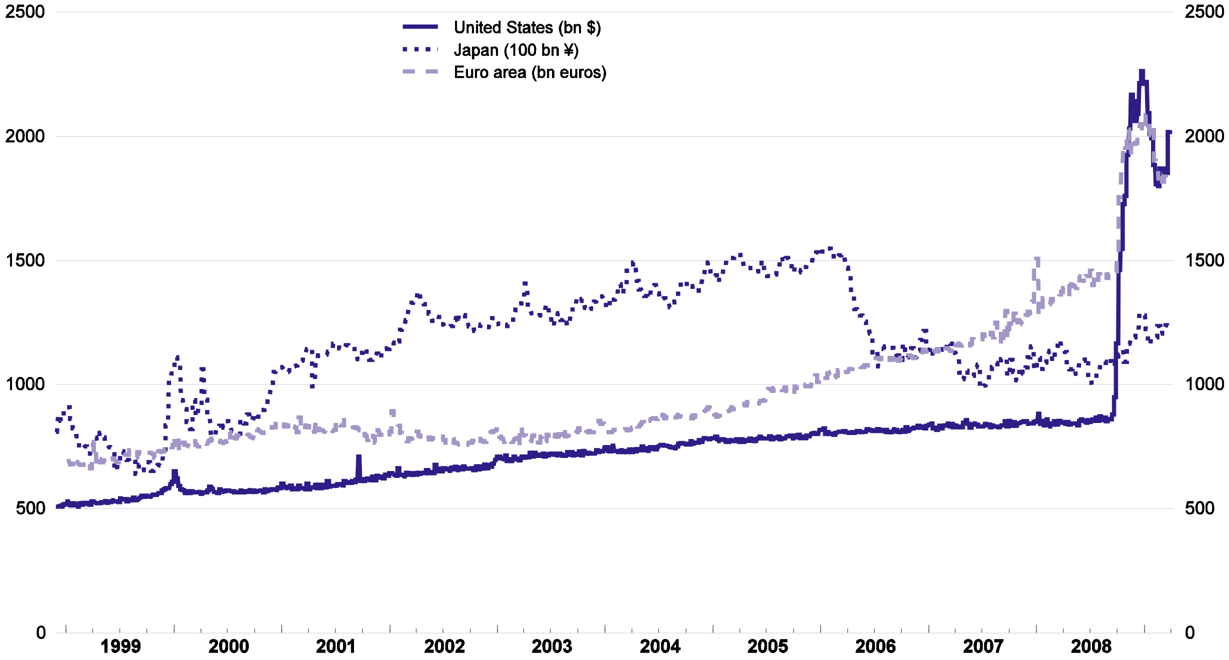


1. The dark line represents the main policy rate of the central banks. The light line plots the effective overnight rate.

Source: Bloomberg, Bank of Japan, Datastream, ECB.

Central banks have expanded their balance sheets

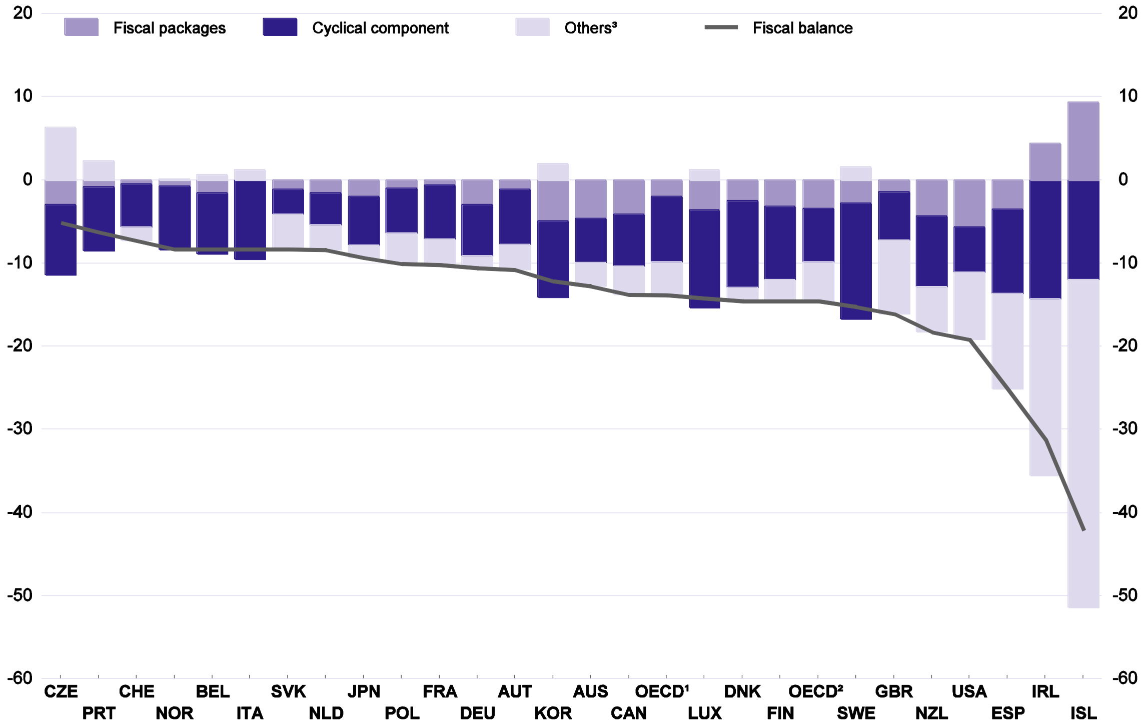
Latest available date: 27 March 2009



Source: Datastream.

Fiscal packages will impact public balances

Cumulative impact on net lending, % of GDP, 2008 to 2010



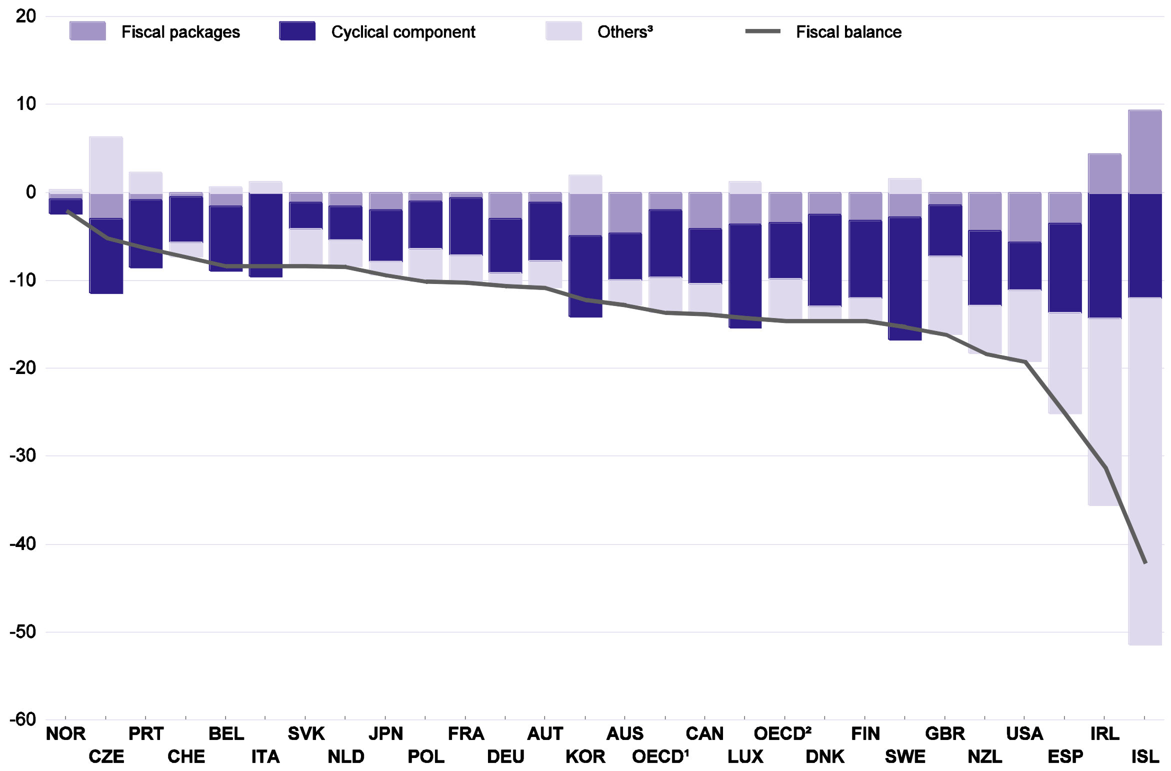
Note: Norway is mainland, excluding oil.

1. Simple OECD average.
2. Weighted OECD average.
3. Includes other discretionary measures, not in response to the financial crisis, disappearance of exceptional revenues linked to the asset cycle, and other one-off measures.

Source: OECD.

Automatic stabilisers are large in many OECD countries

Cumulative impact on net lending, % of GDP, 2008 to 2010

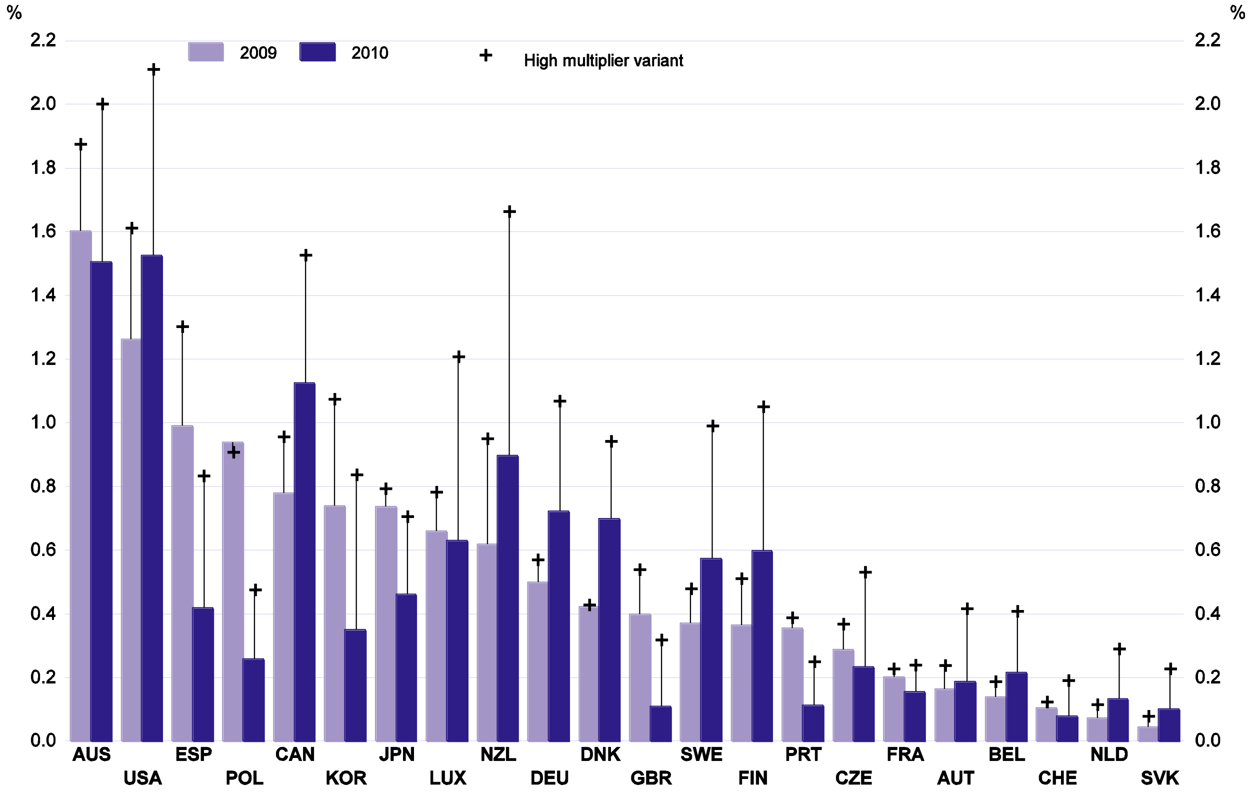


1. Simple OECD average.
2. Weighted OECD average.
3. Includes other discretionary measures, not in response to the financial crisis, disappearance of exceptional revenues linked to the asset cycle, and other one-off measures.

Source: OECD.

The effect of fiscal packages on GDP varies across countries

Effect on level of GDP (%), 2009-10



Note: Bars indicate values based on the reference multiplier case. Crosses show estimates based on a high multiplier alternative. See Box 3.1 (p.114-116 of OECD Economic Outlook interim report) for an explanation of the basis for the multiplier assumptions. Countries are arranged according to the size of effect in 2009.

Source: OECD.