BETTER POLICIES FOR BETTER LIVES

Interim Economic Outlook

20 September 2017

Short-term momentum: Will it be sustained?

Global GDP growth is projected to increase to around 3.5% in 2017 and 3.7% in 2018 from 3% in 2016, slightly improved since the OECD's June Economic Outlook. The upturn has become more synchronised across countries. Investment, employment and trade are expanding.

However, strong and sustained medium-term global growth is not yet secured. The recovery of business investment and trade remains weaker than needed to sustain healthy productivity growth. Wage growth has been disappointing, keeping inflation at low levels. Strong future growth in emerging market economies will depend on deeper reform.

OECD Interim Economic Outlook real GDP growth projections

Year-on-year (%)

	2016	2017		2018	
		Interim projections	Difference from June Economic Outlook	Interim projections	Difference from June Economic Outlook
World	3.1	3.5	0.0	3.7	0.1
United States	1.5	2.1	0.0	2.4	0.0
Euro area	1.8	2.1	0.3	1.9	0.1
Germany	1.9	2.2	0.2	2.1	0.1
France	1.1	1.7	0.4	1.6	0.1
Italy	1.0	1.4	0.4	1.2	0.4
Japan	1.0	1.6	0.2	1.2	0.2
Canada	1.5	3.2	0.4	2.3	0.0
United Kingdom	1.8	1.6	0.0	1.0	0.0
China	6.7	6.8	0.2	6.6	0.2
India[1]	7.1	6.7	-0.6	7.2	-0.5
Brazil	-3.6	0.6	-0.1	1.6	0.0
Russia	-0.2	2.0	0.6	2.1	0.5
G20	3.2	3.7	0.1	3.8	0.0

Note: Difference in percentage points based on rounded figures.
1. Fiscal years starting in April.

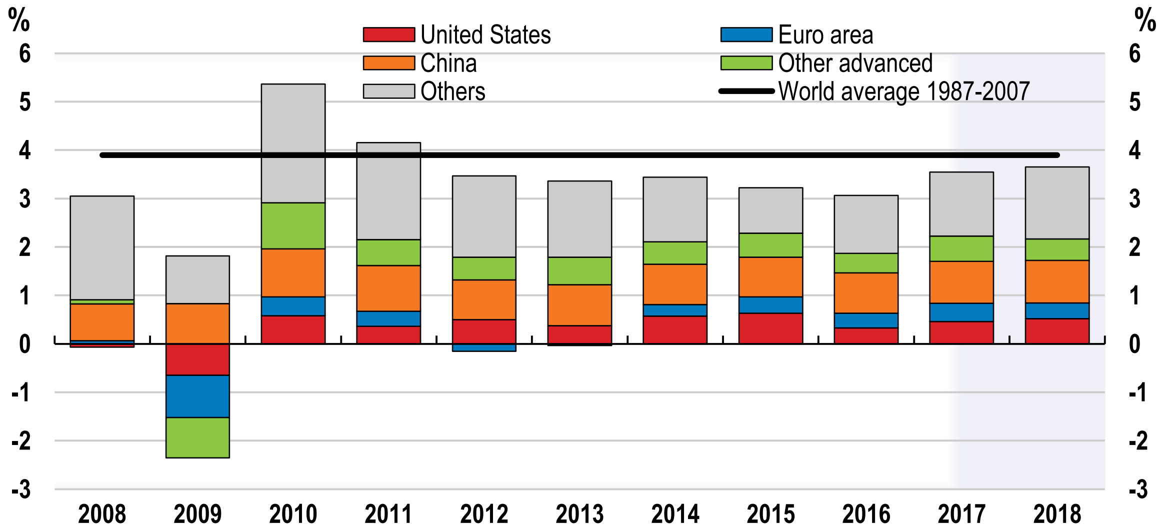
Policy must not be complacent in the face of stronger short-term momentum. To secure robust medium-term growth, monetary policy should remain accommodative in some economies but with an eye on financial stability, so as to continue to provide support while a further rebalancing is done towards fiscal and structural initiatives. Structural efforts need to be intensified to bolster the nascent investment recovery, to address slow productivity growth and to ensure the recovery yields benefits for all. As fiscal policy has eased in many economies, it is crucial to ensure that the fiscal room be used to deliver on supply-enhancing and equity-friendly fiscal measures.

Short-term growth momentum has become more synchronised

Global GDP growth in 2017 is projected to pick up to around 3.5% in 2017 and 3.7% 2018, higher than in 2016 but still below historical norms. Overall, the global GDP projection has slightly improved since the OECD June 2017 *Economic Outlook*, with the near-term momentum becoming more synchronised across the world. Forecasts for the euro area, Japan and Canada have been revised upwards, reflecting stronger performance than expected in the first half of 2017. Developments in emerging market economies have been more diverse with positive surprises in China and Russia, and a downward revision in India in part due to transitory factors.

Global growth contributions by regions

Contributions to year-on-year real GDP growth rate

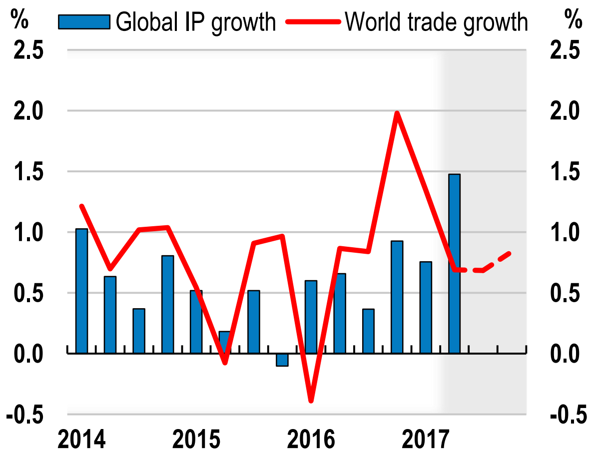


Source: OECD Economic Outlook database.

Short-term momentum is reflected in a rebound in industrial production, consumer spending and investment since the second half of 2016, while trade growth has recovered from the slump in late 2015 and early 2016. Business and consumer confidence have strengthened. The momentum in the global tech cycle has increased, as firms upgrade their capital stock and switch to new technologies that could support future productivity growth. In most major economies, growth is projected to improve in 2017 from sub-par performance in 2016.

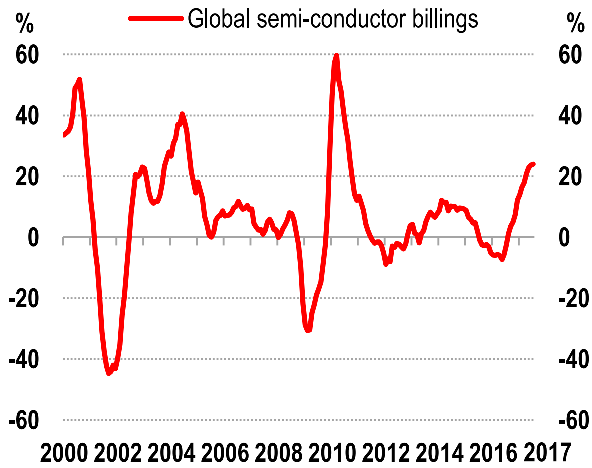
Industrial production and trade growth

Quarterly growth, volumes



IT cycle

Year-on-year changes, 3-month moving average



Notes: Trade growth based on goods and services trade volumes. The dotted line shows June 2017 forecasts. Semi-conductor billings in nominal USD.
Source: OECD Economic Outlook database; World Semi-Conductor Statistics; and OECD calculations.

In the euro area, GDP growth outpaced expectations in the first half of 2017 and has become more broad-based across countries, in a context of rising employment rates, accommodative monetary policy and reduced political uncertainty. The unemployment rate fell to 9.1% in July 2017, the lowest rate since 2009. The upswing is driven by stronger consumption growth and investment firming up, as well as healthy export growth. Headwinds from the recent euro appreciation on activity are expected to be modest. In Germany, the growth outturn in the first half of 2017 was stronger than anticipated, business confidence is strong, and investment in machinery and equipment has gathered pace. In France, growth is strengthening, supported by consumption and investment, and unemployment is edging down, albeit from high levels. The planned implementation of labour market and tax reforms can contribute to securing stronger, more inclusive growth and job creation. In Italy, the improved performance is driven by domestic demand with employment gains supporting private consumption. While fixed investment has increased following the new tax incentives, bank credit to non-financial corporations has not picked up yet. Medium-term risks in the banking sector are being gradually addressed through private sector recapitalisation, state-led precautionary recapitalisation and resolution.

In the United Kingdom, GDP growth has continued to slow with an easing of consumption and investment growth. A further slowing is expected in 2018, while uncertainty remains over the outcome of negotiations around Brexit. The unemployment rate has fallen to below 4.5%, but weak productivity and real wage growth persist. The depreciation of the sterling has modestly improved export prospects but also pushed up inflation, dampening purchasing power and private consumption.

In the United States, the pick-up in growth in 2017 and 2018 is supported by stronger consumer spending and business investment. Job creation has remained strong, but without triggering upward pressure on wage growth, in part due to the scope to bring people back into the labour force and involuntary part-time working. The extent to which fiscal easing and regulatory reform may provide an additional boost in 2018 remains uncertain.

In Japan, growth increased in the first half of the year, supported by an upturn in public investment and stronger export growth to Asian markets. Rising corporate profits should help strengthen business investment through 2018. However, wage growth remains weak despite the tight labour market. Fiscal consolidation is likely to weigh on activity in 2018.

Growth in the major emerging market economies has improved overall, helped by a rebound in some commodity producers and public infrastructure investment in China, although growth remains subdued in a number of oil-exporting economies. Strong import demand from China in the early part of 2017 has been a key driver of the higher than anticipated growth in the region. Growth in China is likely to moderate in 2018, as stimulus measures ease and efforts continue to stabilise corporate debt and rebalance the economy. In India, the transitory effects of demonetisation and of the implementation of the Goods and Services Tax (GST) have led to a downward revision in 2017 growth projections, while business investment has remained weak. In the longer run, the GST is expected to boost investment, productivity and growth.

Russia is rebounding from a recession with higher oil prices and lower interest rates providing a near-term boost to growth, while wages have risen. In Brazil, monetary easing is helping the gradual recovery and the strong decline in inflation is supporting consumer confidence. Medium-term growth prospects for Brazil hinge on delivering reforms, including on pensions, to ensure fiscal sustainability and enhance productivity growth.

Strong and sustained medium-term growth is not yet secured

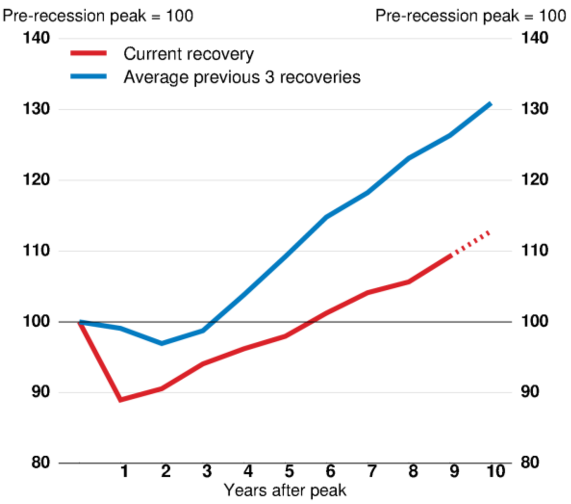
Short-term momentum is no guarantee of medium-term sustainable growth. The medium-term recovery of global growth is not yet secure with the risk that growth will moderate in the coming years, or remain sub-par and insufficient to sustain widespread improvements in living standards.

Stronger investment and wage growth are needed for a self-sustained recovery

Although business investment has increased for the OECD economies, it still remains weaker than the average of past recoveries, implying slow growth of productive capital. Productivity growth continues to be weak in advanced economies and has slowed in many emerging market economies. On the upside, the synchronised uptick in short-term growth could help to stimulate capital spending in advanced economies, given indications that global demand, as well as domestic demand, is an important ingredient for many investment decisions. However, lower expected long-term growth of global demand than in the pre-crisis period, the decline in business dynamism, and medium-term policy uncertainty are reasons to qualify expectations for a rebound in investment.

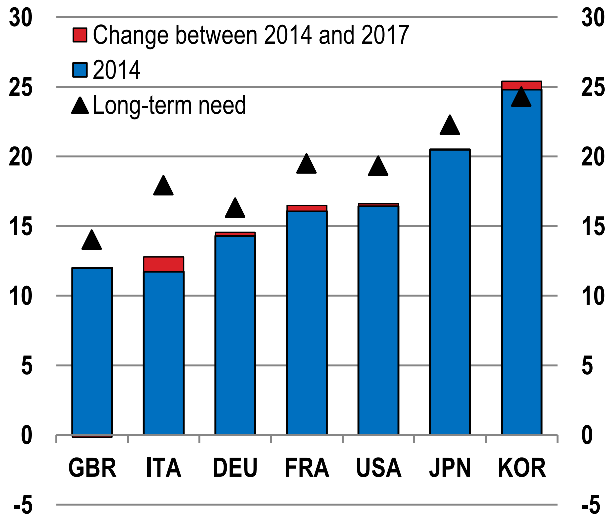
A weak investment recovery

OECD economies



Investment shortfalls by country

Non-residential investment, % of potential GDP

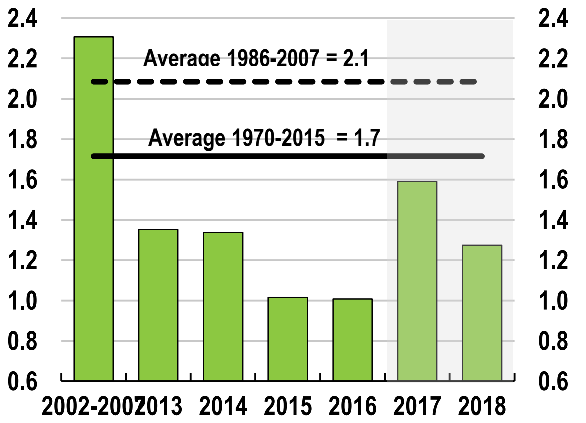


Notes: Current recovery: since 2008Q1 including forecasts in the dotted line. Previous 3 recoveries: pre-recession peaks in 1973Q4, 1980Q1 and 1990Q3. Investment is real total gross fixed capital formation. Long-term needs are estimated with the methodology of Lewis et al. (2014), "Investment Gaps after the Crisis", OECD Economics Department Working Paper.
Source: OECD Economic Outlook database; and OECD calculations.

Alongside stronger investment, faster trade expansion and deepening of global value chains would help to boost productivity growth. While trade growth was particularly strong around the start of 2017, driven in part by developments in China, it slowed again in the second quarter and remains below its long-term pace relative to GDP growth. This reflects a combination of cyclical factors, including weak demand for trade-intensive investment activities, but also structural developments, including an apparent slowing or reversal in the deepening of global value chains. Restoring trade intensity to its pre-crisis path, including through easing trade restrictions, would help close the shortfall of productivity growth compared with pre-crisis trends.

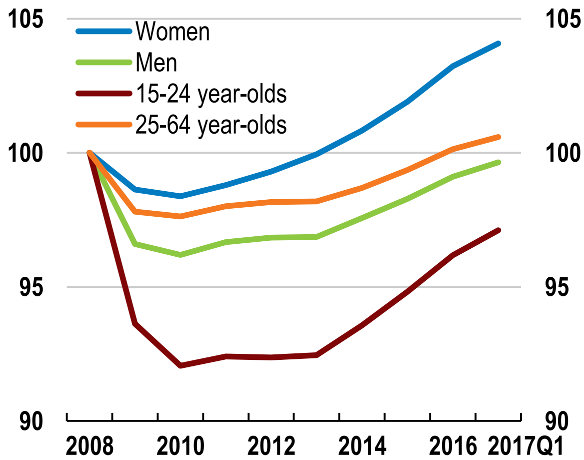
Global trade intensity

Ratio of global trade growth to global GDP growth



Employment rate

OECD average, index 2008=100



Notes: Trade intensity in 2017 and 2018 are projections from the OECD June 2017 Economic Outlook database.
Source: OECD Economic Outlook database; OECD Employment database; and OECD calculations.

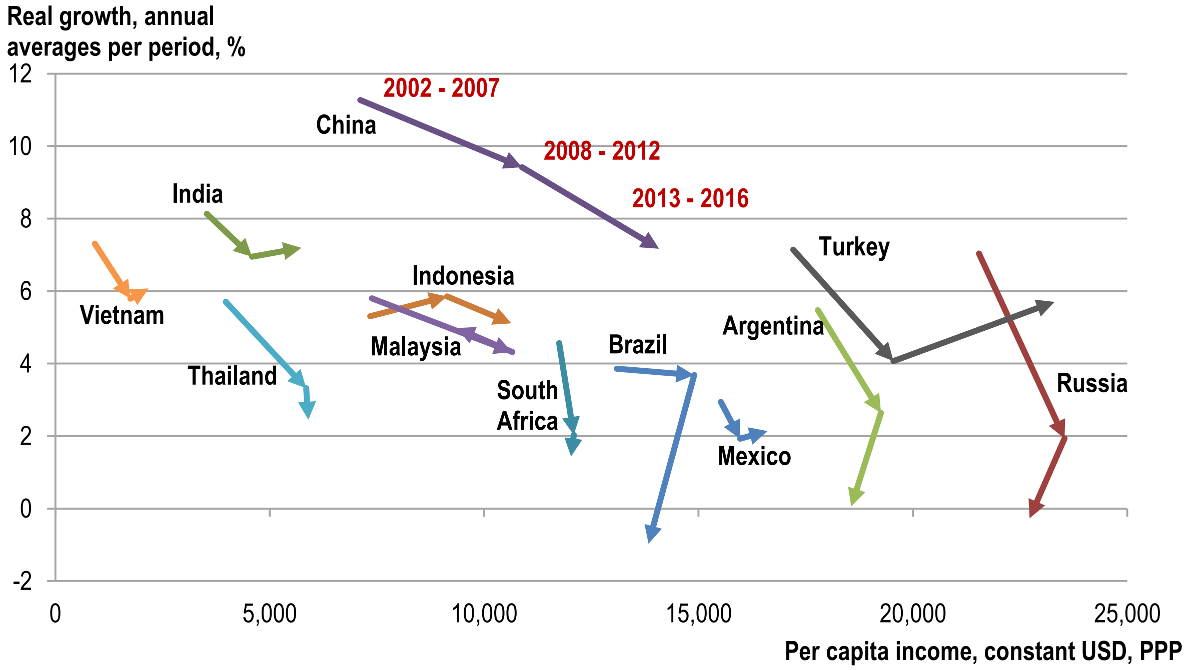
Despite declines in unemployment in most advanced economies, the employment recovery remains uneven. While employment rates for prime-age workers have now recovered to their pre-crisis levels in the OECD area, the employment rates of male workers and youth have still not caught up with 2008 levels. Furthermore, wages have largely failed to pick up despite rising employment: real wages have only grown by 0.2% per year since 2008 on average in the OECD countries, limiting gains in household disposable incomes. Real income growth has been particularly weak at the bottom of the distribution, where the ground lost since the crisis by the bottom 10% has still not been fully recovered.

Deeper reforms in the emerging economies will be required to sustain higher global growth

A durable strengthening of growth in emerging market economies is central if global growth is to return to higher long-term norms. However, GDP has slowed overall in these countries since the 2000s. While emerging markets with potential to “catch up” are expected to grow at faster rates than advanced economies, their ability to generate enough investment and productivity growth to do so in the past two decades has been mixed.

Despite recent rises, most commodity prices remain well below their peaks in 2008 and 2011-14, depressing capital spending in commodity exporting economies. In other countries, including China, investment remains a key factor underpinning growth, but its pace has moderated, partly reflecting necessary adjustments to reduce over-capacity in some sectors. Enhanced capital deepening and productivity gains are required to overcome the headwinds of rapid demographic developments in some countries and a further moderation of growth in China. Moreover, financial vulnerabilities, such as high debt, currency mismatch between debts and revenues and rising non-performing loans, could derail the medium-term growth outlook.

Robust global growth requires a turnaround in emerging market economies



Source: OECD Economic Outlook database; and IMF.

Stepping up the pace of structural reforms to boost productivity growth, including through more competition-friendly regulations and efforts to raise labour utilisation rates, is essential if medium-term growth prospects in catching-up economies are to strengthen. In recent years, progress in enacting structural reforms has slowed in many emerging market economies. Lowering barriers to foreign trade, easing regulatory restrictions on investment and firm entry, strengthening competition while ensuring a level playing field between public and private businesses, and deepening capital markets would improve the efficiency of capital allocation and boost job growth.

Rebalancing the policy mix should support inclusive growth and manage risks

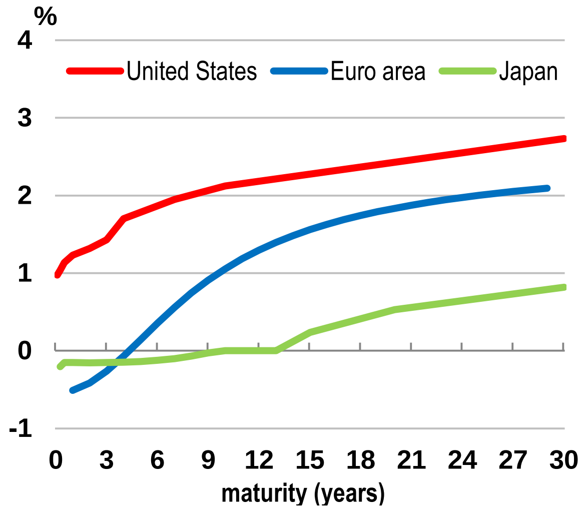
Policy must not be complacent in the face of improved short-term momentum. Strong political commitment is needed to secure robust medium-term growth and ensure its benefits are widely shared. Despite the broadening recovery in advanced economies, sub-par investment, trade and wage growth – as well as significant financial stability risks related to exceptionally low interest rates – call for further rebalancing of policy support for inclusive growth from monetary policy towards fiscal and structural action. Geopolitical and domestic policy risks that could harm confidence and growth need to be avoided.

Monetary policymakers face a balancing challenge

Monetary support remains necessary to ensure that the recovery is sustained and that inflation increases towards its target levels, but financial stability vulnerabilities persist. In the major advanced economies, some central banks have begun gradually to tighten monetary policy, notably through the four policy-rate increases in the United States since December 2015 and discussions about reducing the Federal Reserve's balance sheet. However, interest rates remain at exceptionally low levels at all maturities. Core inflation has remained subdued across advanced economies, with the lack of wage growth keeping services inflation low. In the euro area, the appreciation of the euro could have a further dampening effect on inflation if it persists.

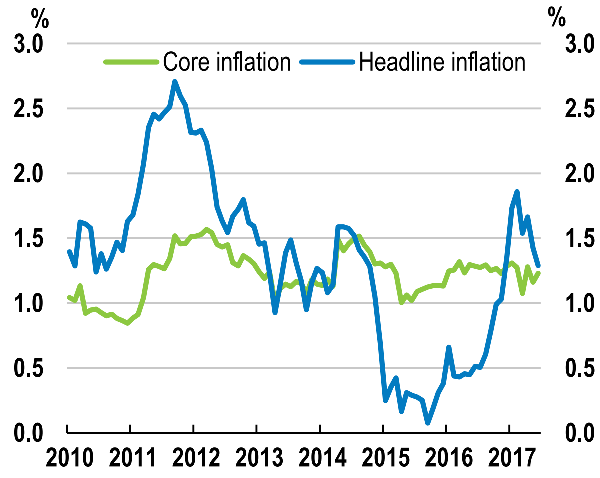
Yield curves on government debt

September 2017



Inflation in advanced economies

Year-on-year percentage changes

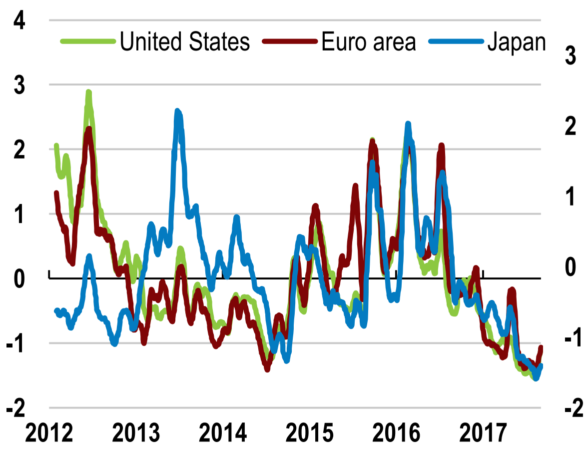


Note: Averages across advanced economies are constructed using PPP GDP weights. Advanced economies include Canada, Japan, Sweden, Switzerland, the United Kingdom, the United States and the aggregate euro area. Core inflation excludes food and energy prices.
Source: ECB; Thomson Reuters; and OECD Economic Outlook database.

Authorities face a difficult balancing act in continuing to provide support while managing financial stability risks, including through macroprudential tools. The long period of low interest rates has boosted asset price valuations and created financial distortions that will be testing to resolve. Equity prices have continued to rise in recent months, keeping price-earnings ratios well above their historical averages in a number of advanced economies. Corporate yield spreads have remained compressed and measures of stock market volatility have reached very low levels, encouraging riskier asset exposures. Such developments create significant risks of volatility if market sentiment were to reverse suddenly. In some advanced economies, including Australia, Canada, Sweden and the United Kingdom, house prices are elevated relative to rents, raising financial stability risks if rising interest rates were to trigger a housing market correction. Emerging market economies face challenges relating to their increased exposure to global financial cycles and to policy spillovers from developed economies. Their main vulnerabilities remain related to past rapid credit growth, foreign currency exposures and non-performing loans.

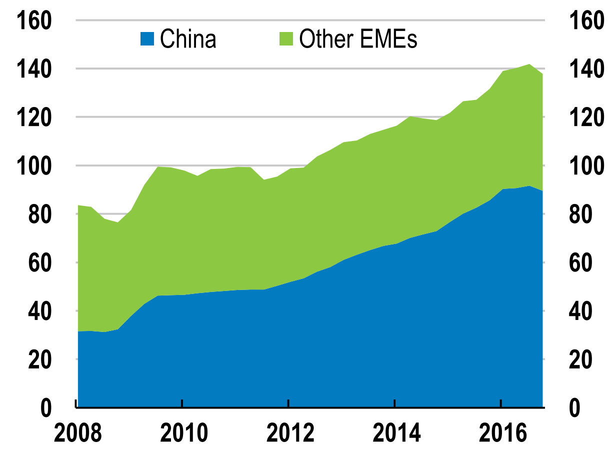
Low stock market volatility

30-day moving average, in standard deviations



High debt in emerging market economies

Credit to non-financial sector, % of total EME GDP



Source: Thomson Reuters; and Bank for International Settlements.

Continued use and exit from unconventional policies represent a significant challenge for monetary and financial stability, where authorities face important uncertainties. The large balance sheets of major central banks following years of quantitative easing raise questions about sequencing of decisions regarding central bank assets and policy interest rates. To minimise financial market volatility and global spillovers, central banks should at the appropriate time opt to reduce their assets gradually and in a predictable way.

In the United States, the Federal Reserve should continue with a gradual increase in policy rates and soon start reducing its balance sheet, provided spare capacity in the labour market continues to shrink and inflation approaches the target. In the euro area, the ECB should follow through with its plan to gradually taper asset purchases before phasing out the negative interest rate policy. The Bank of Japan should continue its current stimulus in order to achieve the inflation target and minimise near-term fiscal risk from Japan's elevated and rising government debt, as well as associated financial stability risks. A rethinking of the monetary policy strategy would be needed if anomalies in financial markets proliferate and the inflation target is not met for a prolonged time.

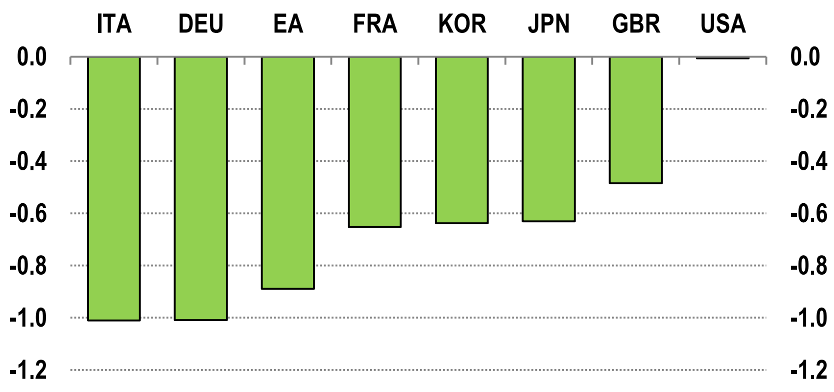
Short-term monetary policy requirements differ among the largest emerging market economies. Policy rates have recently been cut in Brazil, India, Indonesia and Russia in light of falling inflation and the continued need for monetary stimulus. Further easing is expected in Brazil by 2018 as headline inflation has fallen well below target. In Russia, a continuation of monetary policy easing is also warranted given declining inflation and still moderate recovery. In India, there could be room for further cuts in interest rates if inflation durably remains around or lower than 4%. In China, monetary policy should aim to reduce the heavy reliance of economic growth on credit, thus targeting actions toward reducing the risks stemming from the significant accumulation of corporate and local government debt.

Policymakers need to deliver on fiscal easing and focus policies on inclusive and sustainable growth

The fiscal stance in many OECD countries is expected to ease under current plans in 2017-18, as policy has moved in recent years from contractionary or a neutral stance towards providing more support. While headline balances have typically improved as tax receipts have grown, underlying primary balances have fallen, reflecting use of fiscal space, including through savings on government interest costs. Some governments have locked in low borrowing costs by extending the maturity of their debt, offering significant protection against higher rates. Governments should ensure that fiscal easing is delivered as planned to improve supply-side conditions.

Government gross interest payments have declined

Average annual difference between 2011-14 and 2017-18, % of GDP

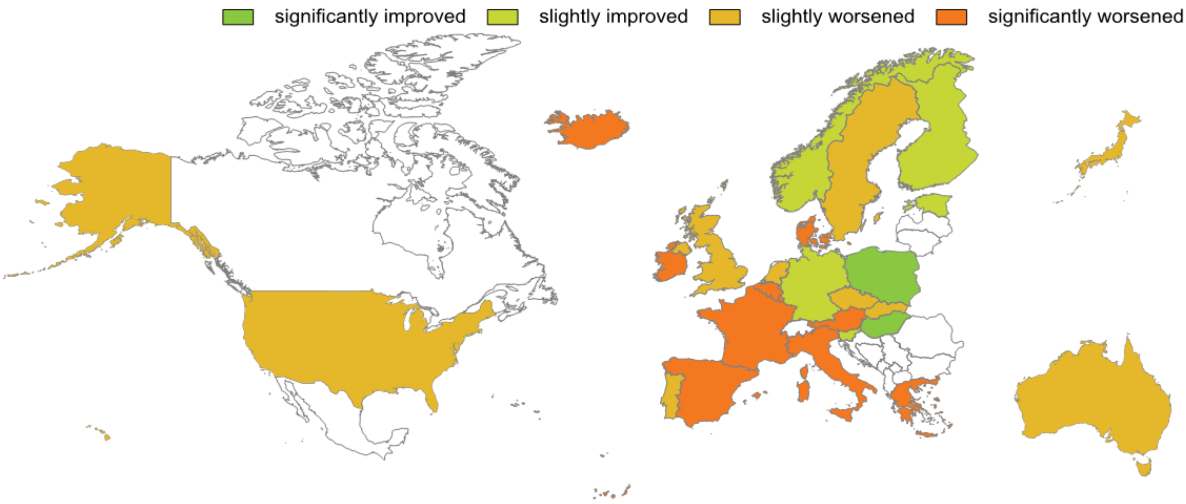


Note: Based on general government gross interest payments. Data for 2017-2018 are OECD projections. Source: OECD Economic Outlook database; and OECD calculations.

The mix of tax and spending policies in each economy should be improved to ensure that they are more supportive of inclusive and sustainable growth. While in the immediate aftermath of the crisis taxes and transfers played an important role in cushioning the rise in income inequality, in part through mechanical budget responses, their redistributive impact has declined in most countries after 2010. In some instances, this evolution stems from fiscal consolidation programmes and a phasing-out of benefits. Personal income taxes on low and middle income earners have been reduced in a number of countries in 2016, which can improve incentives to work for lower earners and improve redistribution, but the impact of recent tax cuts on redistribution and overall tax wedges is expected to be limited.

Priority should be given to public spending that yields the highest benefits for growth inclusiveness and long-run supply. In most countries, new analysis by the OECD suggests that public spending became less effective at promoting growth and reducing inequality during the crisis period (Bloch and Fournier, 2017). Some of the spending items most conducive to inclusive and sustainable growth, such as public investment expenditure, suffered drastic cuts in the face of short-term budget strains, undermining long-term goals. Education, hard and soft infrastructure, family benefits and health investments are the types of quality public spending that should be prioritised according to specific conditions in each country.

Change in the effectiveness of public spending to boost growth and reduce inequality since 2005



Note: The indicator combines information on the effect of the size and effectiveness of government and the public spending mix on growth and inequality. The categories refer to changes between 2005 and 2012. Significantly improved is a positive change of more than 0.3 standard deviations (sd); slightly improved is a positive change of less than 0.3 sd; slightly worsened is a negative change of less than 0.3 sd; and significantly worsened is a negative change of more than 0.3 sd.

Source: Bloch and Fournier (2017), “The Deterioration of Public Spending Quality during the Global Financial Crisis: Insights from New Indicators”, OECD Economics Department Working Paper, forthcoming; and OECD calculations.

Step up structural reforms to support productivity and wages

More ambitious structural reforms are needed to ensure that the global economy moves to a stronger and more sustainable growth path, and that increases in incomes and living standards are shared broadly. Reforms in advanced economies have mainly focused on raising employment in recent years, but need to be complemented with productivity-boosting reforms. The overall pace of structural reform in both advanced and emerging market economies remains well below what is needed to reverse the slowdown in productivity and wage growth.

Stronger structural reform ambition should aim to address the missing engines of the current global upturn – private investment, trade, and productivity gains. Efforts to promote business dynamism and to create favourable conditions for business investment should be stepped up. More could be done to ease barriers to product-market entry and competition, both domestically and through a renewed commitment to trade and foreign direct investment openness. More competitive product markets would provide a better environment to revive the stalled diffusion of innovation between frontier firms and the rest of the economy, and address the growing productivity and wage dispersion within economies. In many countries, there is significant scope to reform insolvency regimes to reduce barriers to corporate restructuring and the personal cost associated with entrepreneurial failure. Such reforms would yield productivity gains by redirecting resources trapped in "zombie" firms towards productive investment, as shown by recent OECD analysis (Adalet McGowan, Andrews and Millot, 2017).

Coherent packages of structural reforms can enhance their overall effectiveness by raising their combined economic impact and helping to ensure that their benefits are widely spread. In particular, reforms to reduce barriers to product market competition, trade and investment should be accompanied by labour-market measures to help vulnerable workers transition to new jobs. Carefully crafted integrated policy packages would help reap the benefits from innovation and globalisation while dealing with the job losses that are concentrated in specific industries or geographical locations. Yet, in recent years, there has been only a limited packaging of reforms. Policy efforts have been concentrated either in the labour market or product markets, but very rarely in both areas, despite the opportunities that exist to combine measures to boost competition with reforms promoting skills acquisition and more inclusive labour market participation.

This period of short-term momentum in the global economy, along with the fiscal room created by the current monetary environment, gives policymakers space to address the structural impediments that hold back productivity growth and leave citizens behind. Sustained and inclusive growth depends on policymakers following through to meet expectations of their citizens.

The OECD *Interim Economic Outlook*

The OECD *Interim Economic Outlook* is an update each March and September of the OECD's twice-yearly *Economic Outlook* published in November and June. Revised projections for annual real GDP growth are provided for Brazil, Canada, China, the euro area, France, Germany, India, Italy, Japan, the Russian Federation, the United Kingdom and the United States. Projections for world and G20 GDP growth are also updated, based on Interim projections for the countries identified above and changes in external forecasts applied to the most recent *Economic Outlook* projections for the rest of the world and the rest of the G20.

The *Interim Economic Outlook* projections are based on a simplified version of the process used to prepare the *Economic Outlook*, based on models and judgement.