

18 February 2016

## ***Stronger growth remains elusive: Urgent policy response is needed***

*Global GDP growth in 2016 is projected to be no higher than in 2015, itself the slowest pace in the past five years. Forecasts have again been revised down in light of disappointing recent data. Growth is slowing in many emerging economies with a very modest recovery in advanced economies and low prices depressing commodity exporters. Trade and investment remain weak. Sluggish demand is leading to low inflation and inadequate wage and employment growth.*

*Financial instability risks are substantial. Financial markets globally have been reassessing growth prospects, leading to falls in equity prices and higher market volatility. Some emerging markets are particularly vulnerable to sharp exchange rate movements and the effects of high domestic debt.*

*A stronger collective policy response is needed to strengthen demand. Monetary policy cannot work alone. Fiscal policy is now contractionary in many major economies. Structural reform momentum has slowed. All three levers of policy must be deployed more actively to create stronger and sustained growth. The recipe varies by country, especially with regard to needed structural reforms.*

### OECD Interim Economic Outlook Forecasts

Real GDP growth (%)<sup>1</sup>

	2015	2016		2017	
		February 2016 Interim Projections	difference from November Economic Outlook <sup>2</sup>	February 2016 Interim Projections	difference from November Economic Outlook <sup>2</sup>
World	3.0	3.0	-0.3	3.3	-0.3
United States	2.4	2.0	-0.5	2.2	-0.2
Euro area	1.5	1.4	-0.4	1.7	-0.2
Germany	1.4	1.3	-0.5	1.7	-0.3
France	1.1	1.2	-0.1	1.5	-0.1
Italy	0.6	1.0	-0.4	1.4	0.0
Japan	0.4	0.8	-0.2	0.6	0.1
Canada	1.2	1.4	-0.6	2.2	-0.1
United Kingdom	2.2	2.1	-0.3	2.0	-0.3
China	6.9	6.5	0.0	6.2	0.0
India <sup>3</sup>	7.4	7.4	0.1	7.3	-0.1
Brazil	-3.8	-4.0	-2.8	0.0	-1.8
Rest of the World	2.1	2.5	-0.3	3.1	-0.2

1. Year-on-year. GDP at market prices adjusted for working days.

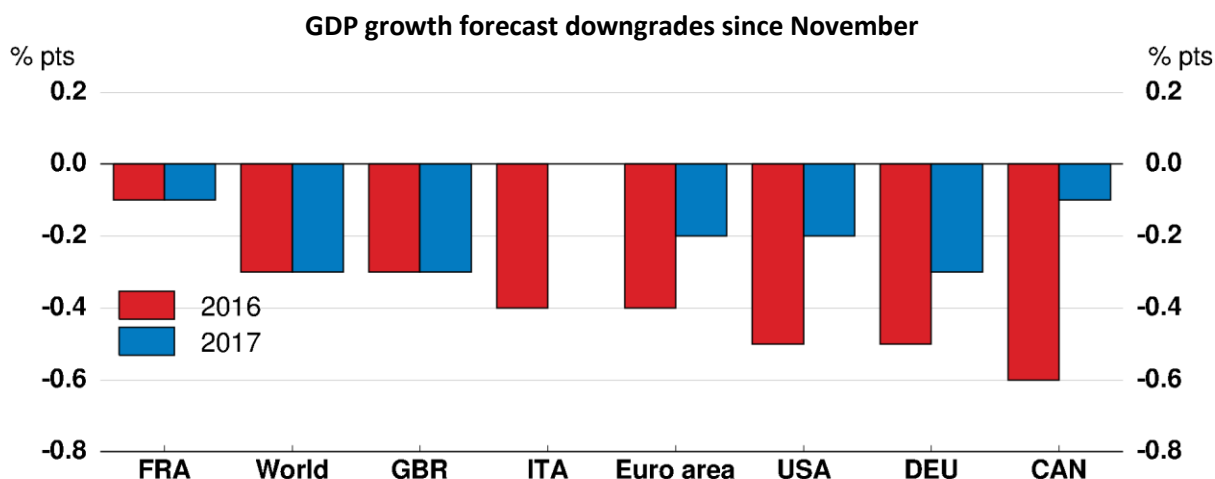
2. Difference in percentage points based on rounded figures for both the current and November 2015 Economic Outlook forecasts.

3. Fiscal years starting in April.

## A pick-up in global growth remains elusive

Global GDP growth in 2016 is now projected to be about the same as 2015, a further downgrading since the November 2015 OECD *Economic Outlook*. These rates are the lowest in the past five years and well below long-run averages. They are also lower than would be expected during a recovery phase for advanced economies and given the pace of growth that catching-up emerging economies could achieve.

The downgrade in forecasts is widespread, reflecting a broad range of disappointing incoming data for the fourth quarter of 2015 and the recent weakness and volatility in global financial markets. These trends have been apparent in both advanced and emerging economies.



Source: OECD Economic Outlook databases; and OECD calculations.

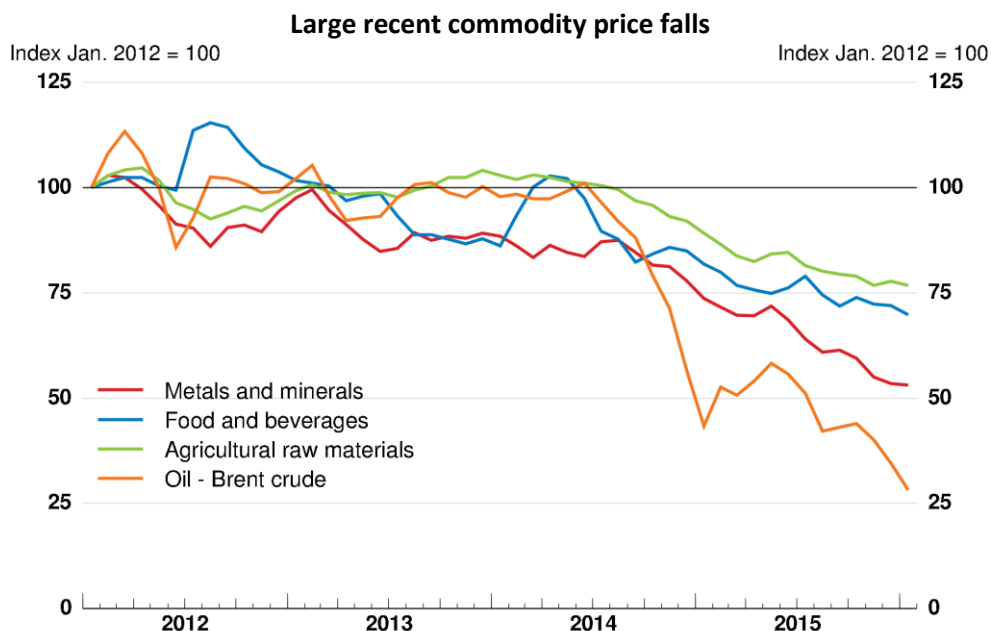
Sluggish growth is reflected in weak trade and has contributed to recent falls in commodity prices. While global trade flows have recovered somewhat from the sharp decline in the first half of last year, they nevertheless remain subdued. World trade volumes grew by only around 2% in 2015, a pace which in the past has been associated with very low outcomes for global GDP growth. Although some of the weakness of trade growth can be explained by GDP developments, low investment, and commodity price falls, the recent bout of weakness centred on Asia remains partly unexplained. The contraction of imports by China and other major EMEs has contributed to weaker export demand for advanced economies with an estimated drag on OECD GDP growth of around ½ percentage point in 2015.



Note: World trade is goods plus services trade volumes. World GDP growth is measured at purchasing power parities.

Source: OECD Economic Outlook database.

Commodity prices have fallen significantly since the OECD's *Economic Outlook* in early November, with the oil price declining by more than one-third and reaching its lowest level in dollar terms since 2003. The broadly-based price decline across commodities in recent months and the sharp decrease in China's commodity imports in January 2016 after solid growth in 2015 suggest that weak demand has contributed to lower commodity prices. For oil, positive supply shocks and the coming on stream of new capacity are also key factors. These price developments should support consumption in commodity importing economies, but will restrain investment and add to financial pressures on commodity-producing firms and commodity-exporting countries.



Source: OECD Economic Outlook database.

Overall, monetary policy stimulus and lower commodity prices are expected to support recovery in advanced economies, while emerging economies experience mixed fortunes. However, current policies will yield a low-growth equilibrium characterised by low demand, low investment, low inflation, unsatisfactory labour market outcomes, and weak productivity growth. In this context, desired improvements in living standards and in distribution of income are unlikely. A recovery in private sector investment and wage growth is needed for global economic activity to accelerate.

The recovery in the advanced economies is set to remain modest. In the euro area, GDP growth is expected to pick up only slowly with investment remaining weak and unemployment remaining high. While some economies that undertook reforms following the crisis are expanding at a relatively fast pace, growth in the core euro area economies remains slow and GDP in the area has only just returned to its pre-crisis peak of early 2008. The positive effect of lower oil prices on activity has been less than expected, while very low interest rates and a weaker euro have yet to lead to sustained stronger investment. In several euro area countries, high private sector leverage and high levels of non-performing loans hamper the credit channel of monetary policy transmission. In Japan, while the quarter-to-quarter profile is volatile, both private consumption and exports have been weak in recent months, reflecting on the trade side weaker activity in key trading partners and more recently the strengthening of the yen.

In the United States, the domestic private-sector led recovery continues to have momentum, with ongoing gains in employment bolstering household demand. GDP growth slowed in the second of 2015 due to an intensification of various headwinds, including the drag on exports from the stronger dollar and energy sector investment from low oil prices. While these headwinds should ease, the self-reinforcing impetus to domestic demand from employment gains will inevitably fade as the labour market approaches full employment, unless wage gains are more pronounced. With

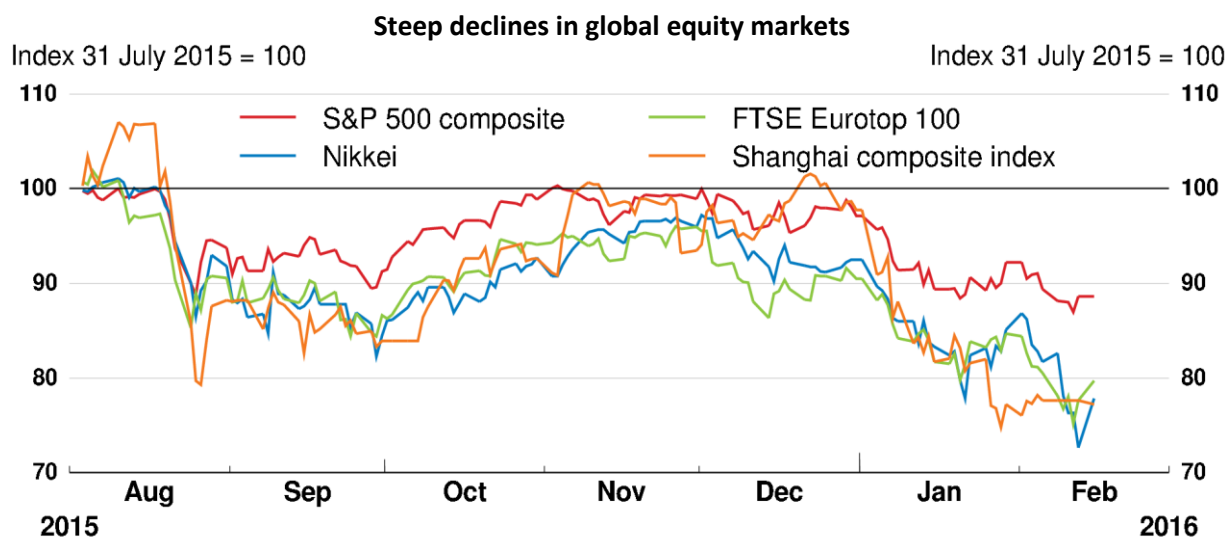
export markets on course for sluggish growth, business investment remaining mediocre, and few signs of upward pressure on real wages, there is little sign that other sources of demand will reinforce GDP growth as employment gains normalise.

Growth in key emerging economies continues to slow, following the pattern of recent years. In some countries, weak commodity prices have led to a sharp correction in demand. A tightening of financial conditions and capital outflows, accompanied in some cases by more restrictive monetary and fiscal policy, is depressing demand. The recession in Brazil will likely be deeper than previously anticipated with on-going political uncertainty and rising inflation. The contraction in Russia appeared to bottom out until the most recent fall in oil prices. Growth in India is projected to remain robust, although floods have had a negative impact in the short term and further progress is needed in implementing structural reforms to ensure that positive developments are sustained.

In China, growth has slowed as the economy rebalances from manufacturing to services. This has had substantial implications for global commodity prices and trade. Managing the rebalancing process together with financial risks will prove challenging. This may be compounded by equity and exchange rate volatility, as well as uncertainty about how authorities will react to further developments. Activity is being supported by fiscal and monetary stimulus. However, underlying financial and economic developments remain hard to assess and the impact of the return to a standard menu of investment and financial support to growth may prove to have less traction to sustain the current rate of growth.

**Financial instability risks are substantial, particularly from emerging markets**

Financial markets are reassessing prospects, leading to lower equity prices and volatile markets and capital flows. This underlines the downside risks to economic activity from financial developments. The first six weeks of 2016 were an exceptionally bad period for global equities with the MSCI World Index falling by more than 9%. Globally, financial market volatility and uncertainty have increased. Concerns about global growth prospects and uncertainties regarding the renminbi exchange rate appeared to be factors behind global equity market developments. European financial firms have been hit particularly hard with bond spreads rising significantly and equity prices of banks falling by more than 20% since the beginning of 2016.

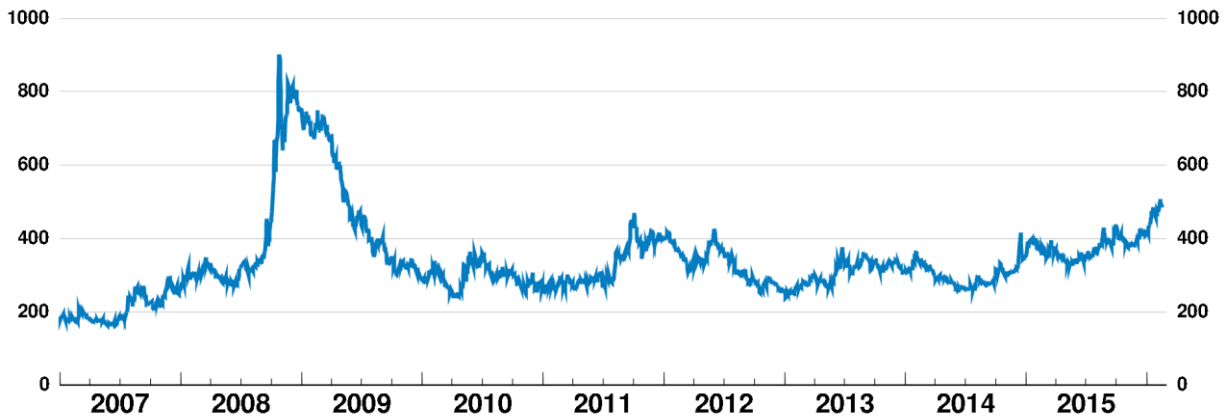


Source: Thomson Reuters.

Financial conditions have also deteriorated in many emerging economies over the past 18 months with renewed pressures in recent weeks. Capital inflows have weakened or reversed and a number of countries have experienced sharp depreciations or pressures on their currencies, despite a tightening of countries' policy settings. Emerging market sovereign risk premia have again risen since the start of 2016. Countries with large current account deficits, with the exception of India, or with heavy reliance on commodity exports have been most severely affected.

## EMEs sovereign bond spreads have increased

*EMBI Composite, basis points*



Source: Thomson Reuters.

Some emerging market economies are vulnerable to exchange rate shocks through a large share of foreign-currency denominated debt, including Brazil, Russia and Turkey. While the overall scale of risks through these channels appears lower than prior to past crises, with higher reserves and more macro-prudential buffers in place, there could nevertheless be serious financial and economic consequences if these risks were to materialise. These risks are compounded where current account deficits remain large and countries are also exposed to commodity prices that may weaken at the same time, in part reducing the value of natural hedges that some corporate borrowers have.

The rapid growth of private sector debt in emerging countries and the relatively high level of indebtedness by historic norms is a key risk in many emerging economies, notably China. This increases the exposure to a worsening in financial conditions, as well as exposing the risk that capital has been misallocated during the upswing.

Other prominent risks that could unfold through both real and financial channels include further disappointments to growth, a worsening of geopolitical tensions, and financial mispricing in the current exceptionally low interest rate environment.

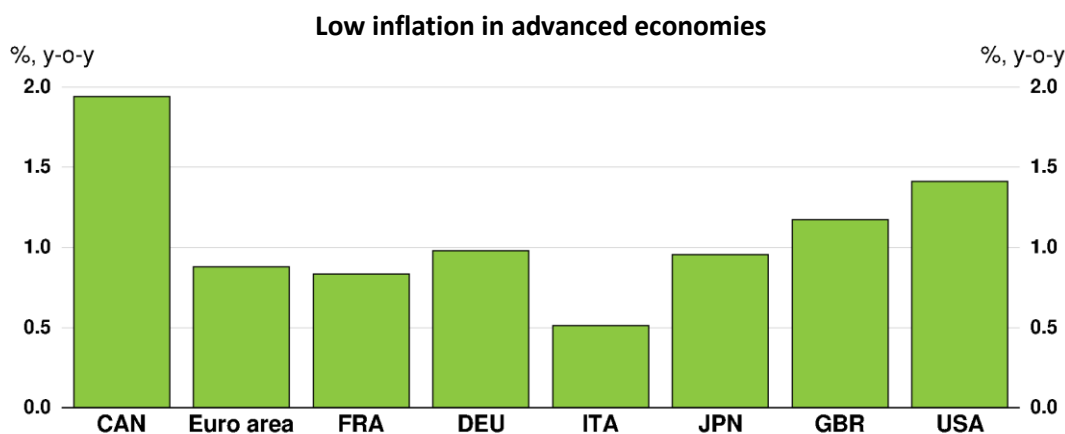
### ***A stronger collective policy response is urgent***

Global macroeconomic policy, comprising monetary, fiscal and structural actions, must become more supportive of demand and resource reallocation. Experience to date suggests that reliance on monetary policy alone has been insufficient to deliver satisfactory growth, so that greater use of fiscal and structural levers is required.

Monetary policy has become more accommodative with the European Central Bank and, at a smaller scale, the Bank of Japan announcing new measures in recent months, including additional asset purchases and negative deposit rates. These actions have been prompted by slower-than-expected growth and weak inflation outcomes, which remain persistently below target.

Clear communication by the US Federal Reserve helped to avoid financial market volatility at the time of the first policy rate rise since 2008. Market expectations for future increases in the federal funds rate have since dampened substantially, in line with downward revisions to GDP growth prospects, with US monetary policy now expected to tighten at a slower pace.

Monetary policies should remain highly accommodative until inflation has shown clear signs of moving durably towards the official target. In emerging market economies, monetary support should be provided where possible given inflation developments and capital market responses.

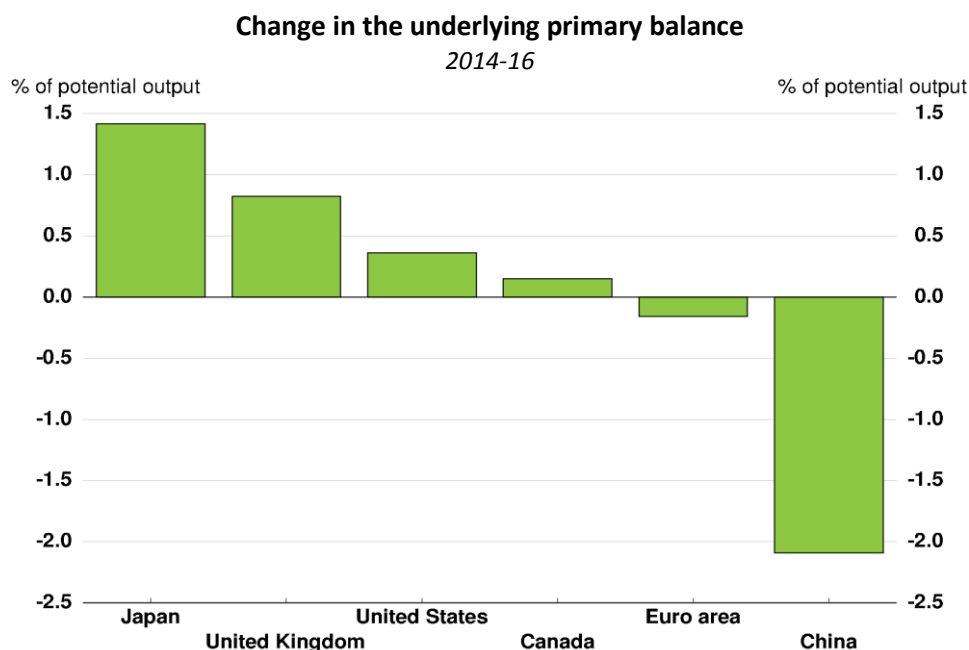


*Note:* Core inflation (consumer prices excluding food and energy) for latest month available. The private consumption deflator is used for the United States.

*Source:* OECD Economic Outlook database.

By contrast, fiscal policy is contractionary in many major economies. In advanced economies, the pace of fiscal consolidation has eased somewhat compared with earlier years but the policy stance remains fairly close to neutral in the United States and the euro area, while Japan is tightening policy in its efforts to reduce the high fiscal deficit and stabilise debt-to-GDP dynamics. Meeting fiscal plans will remain challenging while nominal growth outcomes disappoint, hence pointing to the need for a new strategy. A number of emerging economies have also undertaken discretionary actions to tighten the policy stance, as fiscal policy space is typically more constrained, but should be used where possible to support sustainable growth.

The main exception is China, which has undertaken substantial additional fiscal stimulus to support growth. The general government deficit increased by 2.1 per cent of GDP in 2015 and is expected to widen further. While the support for demand is welcome, China will have to carefully calibrate fiscal and monetary easing to smooth the path towards a slower rate of growth as the economy rebalances. Specifically, stimulus spending should promote the transition to stable consumption-based growth, in part through a focus on policies to reduce precautionary household savings.



*Note:* For China, change in the general government balance as a per cent of GDP from 2014-15.

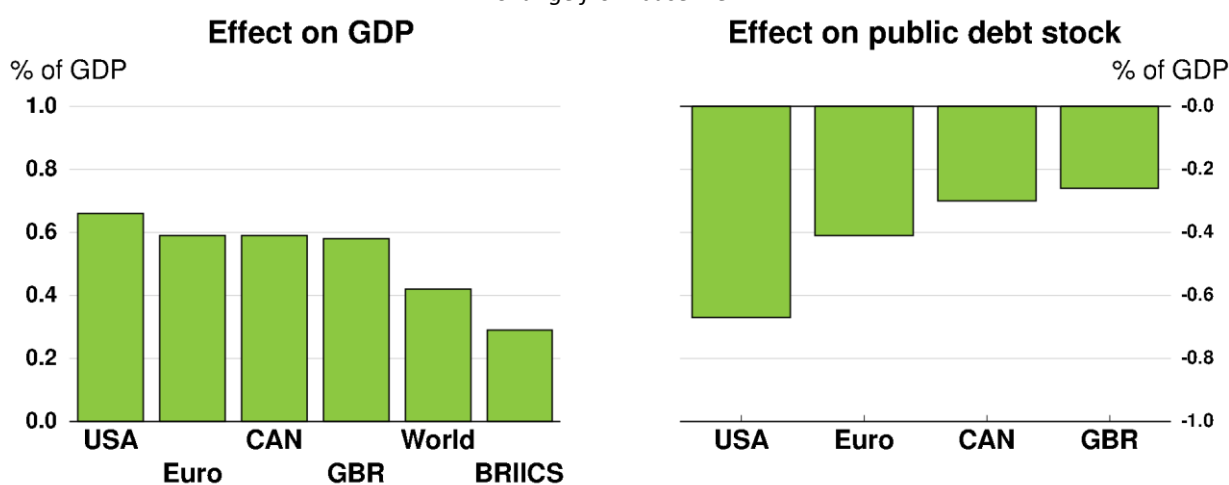
*Source:* OECD Economic Outlook databases.

A stronger collective fiscal policy response is needed to support growth and provide a more favourable environment for productivity-enhancing structural policies. Governments in many countries are currently able to borrow for long periods at very low interest rates, which in effect increases fiscal space. Many countries have room for fiscal expansion to strengthen demand. This should focus on policies with strong short-run benefits and that also contribute to long-term growth.

A commitment to raising public investment collectively would boost demand while remaining on a fiscally sustainable path. Investment spending has a high-multiplier, while quality infrastructure projects would help to support future growth, making up for the shortfall in investment following the cuts imposed across advanced countries in recent years. These effects would be enhanced by, indeed need to be undertaken in conjunction with, structural reforms that would allow the private sector to benefit from the additional infrastructure; notably in the Europe Union, cross-border regulatory barriers are a significant obstacle. Collective public investment action combined with structural reforms would lead to a stronger GDP gain, thereby reducing the debt-to-GDP ratio in the near term.

**First year effects of a ½ per cent of GDP public investment stimulus by all OECD economies**

*Change from baseline*



*Note:* Simulation using the NiGEM model, based on a two-year increase in the level of government investment equivalent to ½ per cent of GDP per annum in all OECD countries. The euro area figures are a weighted average of Germany, France and Italy.

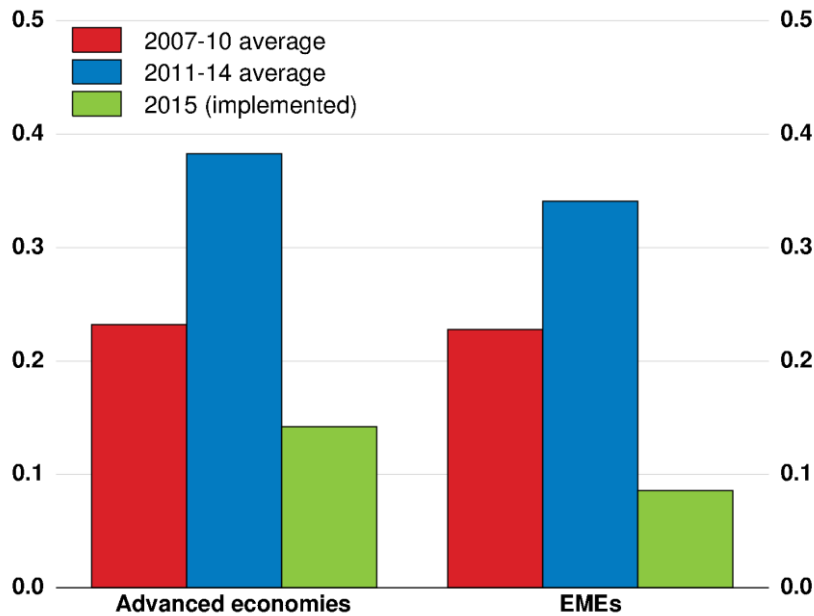
*Source:* OECD calculations.

In emerging markets, exchange rate adjustment should be allowed to take place, but the associated financial risks need to be managed. Regulatory and macro-prudential policy measures should be adapted to evolving risks.

Structural reform momentum needs to be revived as policies to support demand alone cannot restore sustainable growth. In recent years the pace of structural reforms in both advanced and EMEs appears to have slowed. The post-crisis period saw an increase in commitment and implementation of structural reforms, but this is fading away. Efforts by the G20 to raise the level of ambition on structural reforms have made some progress but many policy commitments have yet to be implemented. The slowing pace of reform is particularly troubling for long-term growth prospects, with signs of weaker productivity growth and slower diffusion of productivity gains from the most efficient firms.

## The pace of structural reforms shows insufficient ambition

*Share of OECD Going for Growth recommendations implemented*



*Note:* Calculated for all countries for which recommendations are available. Emerging market economies include Brazil, Chile, China, Columbia, India, Indonesia, Mexico, Russia, Turkey and South Africa; Mexico and Turkey only prior to 2011. Advanced includes the rest of the OECD.

*Source:* OECD *Going for Growth* 2016 (forthcoming).

The benefits of structural reforms would be enhanced by a more supportive demand environment, which increases the benefits to firms and workers of the new opportunities created and helps to support the necessary reallocation of resources. Hence there are synergies between macro demand management policies and structural policies. In the context of rising inequality, policy packages should also be designed to integrate the impact of developments on earnings across the income distribution.

### ***Europe needs to speed up progress on collective actions and speak with a single voice***

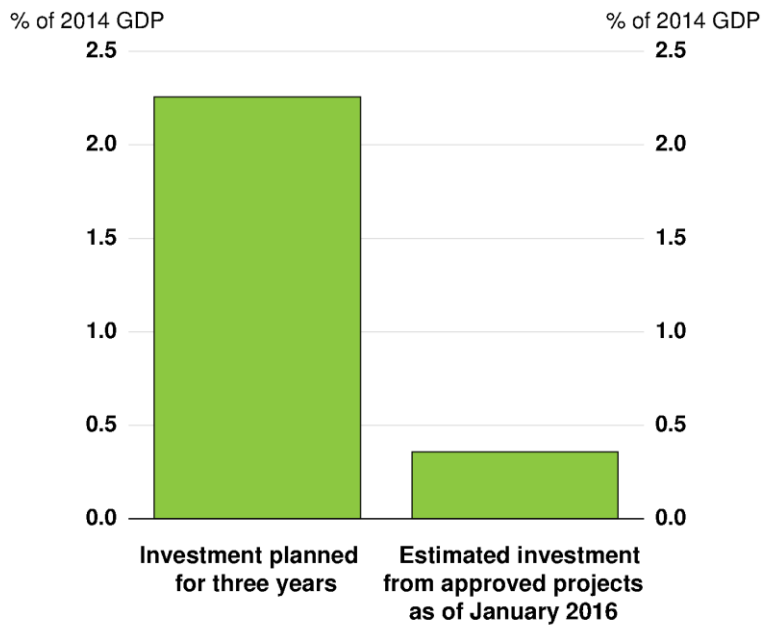
The slow recovery in the euro area is an important factor dragging on the global recovery and leaves Europe vulnerable to global shocks. This takes place against the background of exceptional monetary stimulus, favourable exchange rate and commodity developments.

A central concern is the risk of the euro area getting stuck on a low growth, low inflation path with confidence about medium-term growth being too weak to generate higher investment and the innovations and reallocation that would strengthen productivity and employment growth. Low growth would also create negative feedback loops with the banking sector, as has been highlighted by the recent sharp decline in equity and bond prices of European banks: in recent weeks, share prices of European banks have been trading at low levels close to those observed during the financial crisis in 2009.

While some countries have undertaken important structural measures, reforms have been too slow in the euro area as a whole. Progress has been notably slow in creating more favourable conditions for European integration through the EU Single Market. Implementation of the “Juncker” investment plan has yet to deliver the targeted boost to investment. The further harmonisation in regulation needed to make the plan work also lags. The European Investment Bank also needs to accept financing higher-risk projects than in the past. Deleveraging and completing Banking and Capital Market Union are complementary efforts. Greater ambition is now required to make Europe-wide institutions more favourable to growth and productivity.



### Implementation of the Juncker investment plan disappoints

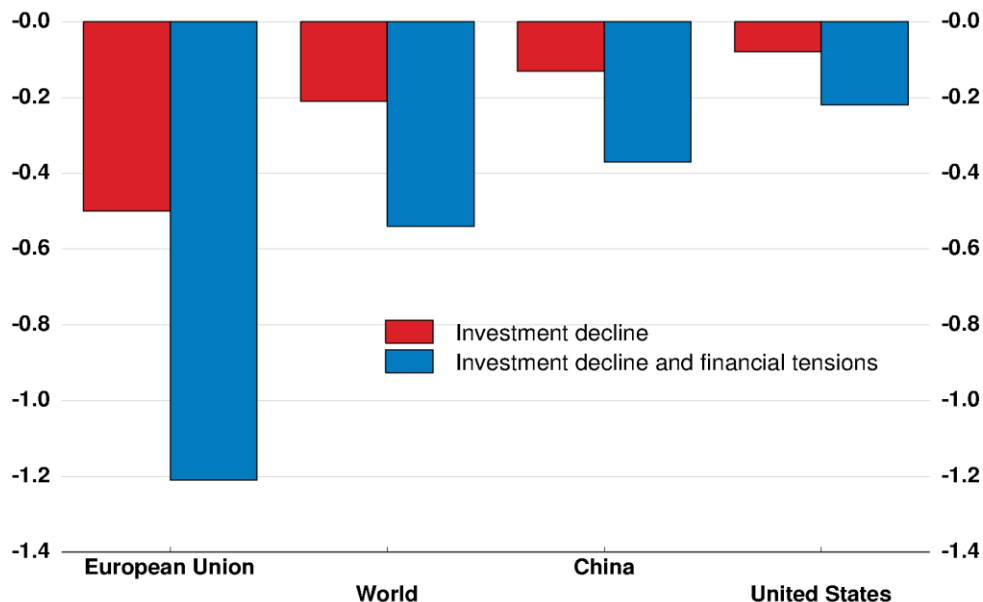


Source: European Commission; Eurostat.

At the same time, the European Union faces growing challenges to maintain political support for the European project from a number of developments including the European refugee surge, external security threats, the unpopularity of austerity measures and centrifugal forces in a number of countries. This uncertainty risks dampening investment further and could lead to more difficult financial conditions, which would depress already weak growth in Europe and elsewhere. Europe needs to regain its sense of self, and speak with a single voice to promote unity and growth.

### Impact of uncertainties in Europe

Change in GDP after two years, per cent



Note: The investment decline scenario reduces the growth rate of business investment in all European Economic Area countries by 2½ percentage points in both 2016 and 2017 due to higher policy uncertainty and expectations of weaker medium-term growth. The shock is equivalent to around one fifth of the policy uncertainty shock of 2011. The second scenario adds a 50 basis point increase in equity and investment risk premia in all EU countries, returning approximately one sixth of the financial conditions prevailing at the height of the euro area crisis.

Source: OECD calculations.

## **The OECD *Interim Economic Outlook***

The OECD *Interim Economic Outlook* is a partial update each February/March and September of the OECD's twice-yearly *Economic Outlook* published in November and May/June. Revised projections for annual GDP growth are provided for the United States, Japan, the euro area, Germany, France, Italy, the United Kingdom, Canada, China, India and Brazil. Projections for world GDP growth are also updated, based on Interim projections for these countries and changes in external forecasts, applied to the last *Economic Outlook* projections, for the rest of the world.

The revised projections are based on a simplified version of the process used to prepare the *Economic Outlook*, based on models and judgement. Near-term developments are assessed using the OECD's short-term indicator models.