



Interim Economic Outlook

7 March 2017

Will risks derail the modest recovery? Financial vulnerabilities and policy risks

Global GDP growth is projected to pick up modestly to around 3½ per cent in 2018, from just under 3% in 2016, boosted by fiscal initiatives in the major economies. The forecast is broadly unchanged since November 2016. Confidence has improved, but consumption, investment, trade and productivity are far from strong, with growth slow by past norms and higher inequality.

Disconnect between financial markets and fundamentals, potential market volatility, financial vulnerabilities and policy uncertainties could, however, derail the modest recovery. The positive assessment reflected in market valuations appears disconnected from real economy prospects. The interest-rate cycle turned in mid-2016 and rising divergence in interest rates between major economies heightens risks of exchange rate volatility. Vulnerabilities remain in some advanced economies from rapid house price increases. Risks to emerging market economies are high, including from higher corporate debt, rising non-performing loans and vulnerability to external shocks.

OECD Interim Economic Outlook real GDP growth projections

	2016	Year-on-year, %		2018	
		Interim EO projections	Difference from November EO	Interim EO projections	Difference from November EO
World	3.0	3.3	0.0	3.6	0.0
United States	1.6	2.4	0.1	2.8	-0.2
Euro area	1.7	1.6	0.0	1.6	-0.1
Germany	1.8	1.8	0.1	1.7	0.0
France	1.1	1.4	0.1	1.4	-0.2
Italy	1.0	1.0	0.1	1.0	0.0
Japan	1.0	1.2	0.2	0.8	0.0
Canada	1.4	2.4	0.3	2.2	-0.1
United Kingdom	1.8	1.6	0.4	1.0	0.0
China	6.7	6.5	0.1	6.3	0.2
India¹	7.0	7.3	-0.3	7.7	0.0
Brazil	-3.5	0.0	0.0	1.5	0.3
G20	3.1	3.5	-0.1	3.8	0.0
Rest of the World	2.3	2.7	-0.1	3.2	0.0

Note: Difference in percentage points based on rounded figures.

1. Fiscal years starting in April.

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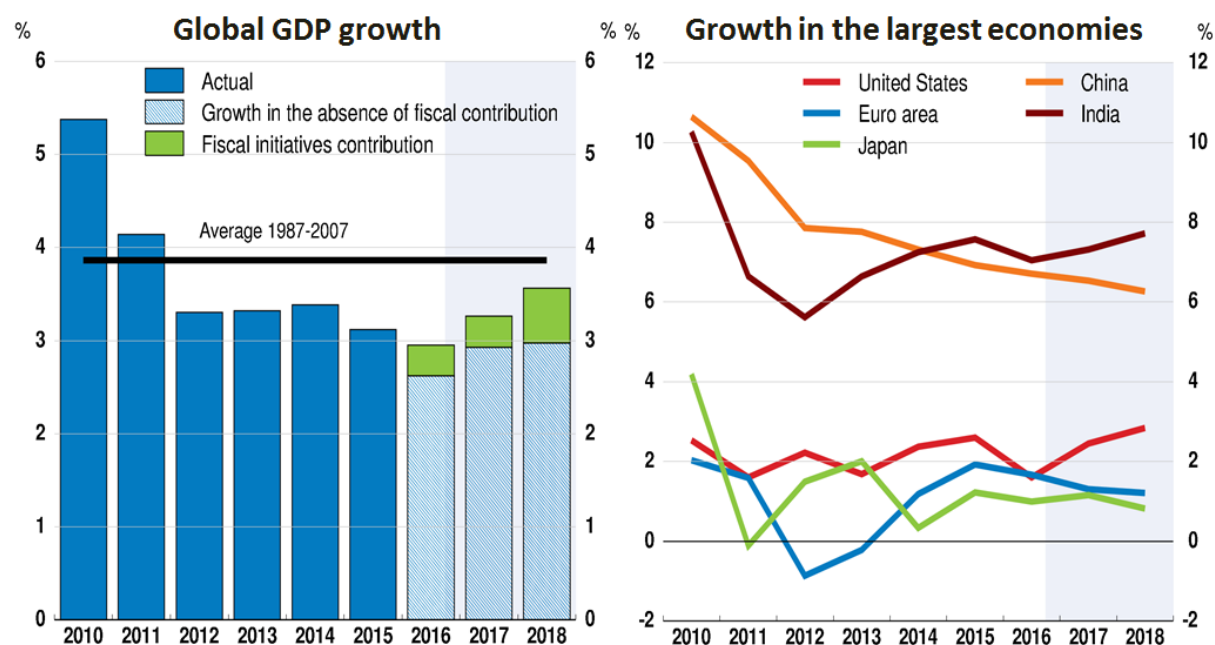
Policy needs to manage risks, strengthen growth and ensure it is more inclusive. Countries should use increased fiscal space to implement effective fiscal initiatives that boost demand and make government taxes and spending more supportive of long-term growth and equity. A durable exit from the low-growth trap also requires greater political commitment to implement structural reform packages to boost inclusive growth. These should combine policies to develop skills, remove barriers to competition and trade, and improve labour market policies in a way that raises overall incomes and shares the gains widely.

A stronger growth environment would enhance resilience. Countries should have robust early warning systems and supervision, use macroprudential instruments appropriately and promote effective approaches to managing and resolving non-performing loans. It is important to maintain open and transparent global markets for capital, goods and services.

Global growth is set to pick-up modestly, but remains too slow

Global GDP growth is projected to increase, rising from just under 3% in 2016 – the slowest pace since 2009 – to 3.3% in 2017 and around 3½ percent in 2018. While the modest pick-up is welcome, it would still leave global GDP growth below the historical average of around 4% in the two decades prior to the crisis.

The global GDP projection is broadly unchanged since the OECD *Economic Outlook* of November 2016. There have been some positive signs of accelerating activity and rising consumer and business confidence in recent months in advanced economies and a number of emerging market economies, including improved momentum around the turn of the year. However, interest rates and oil prices have risen which will offset this somewhat, although higher commodity prices will benefit some emerging market economies. Overall, the recent improvement in activity is in line with the modest pick-up in global growth projected in November.



Note: Estimated fiscal initiatives contribution based on fiscal stimulus in China and the euro area for 2016-18 and in the United States for 2017-18. Fiscal years starting in April for India.

Source: OECD March 2017 Interim Economic Outlook; OECD November 2016 Economic Outlook database; and OECD calculations.

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This comes against the background of a five-year period where the global economy has been in a low-growth trap. Growth has been disappointingly low and persistent growth shortfalls have weighed on future output expectations, thereby holding back current spending and potential output growth. This has given rise to weak global trade and investment. At the same time, productivity gaps between firms have widened as frontier firms have continued to make gains but laggard firms have under-performed, contributing to a widening gap in real incomes and rising inequality. These trends have led to low income growth for many households, particularly at the bottom of the distribution, and have in turn held back aggregate consumption growth.

The modest pick-up in global growth in 2017-18 reflects the effect of ongoing and projected fiscal initiatives, notably in China and the United States, together with an easier stance in the euro area and initiatives in other economies such as Canada. These are expected to catalyse private economic activity and push up global demand. Exiting the low-growth trap depends on the joint impact of macroeconomic, structural and trade policy choices, as well as on concerted and effective implementation of existing initiatives.

While global trade growth was exceptionally weak in 2016 at around 2%, recent data suggest some improvement, particularly in Asia. However, trade growth is likely to remain below pre-crisis growth rates, in part reflecting a slowdown or reversal of the expansion of global value chains. Indeed, equity prices for large internationally-exposed firms have under-performed relative to smaller, domestically-focused firms in many countries.

Headline inflation is rising in most countries as the result of higher energy prices, following the OPEC agreement in November to cut oil production. However, underlying inflation in advanced economies is still subdued and will pick up only slowly as the expansion gains traction, including to support more robust wage growth across the income distribution. Inflation is easing in a number of emerging market economies as the effect of past exchange rate depreciations fades and the effect of monetary policy actions works through, but commodity importers are exposed to rising commodity prices.

Domestic demand in the United States is set to strengthen over the next two years and expand at a solid pace, helped by gains in household wealth and a gradual upturn in energy production. Employment is rising steadily, although the pace is expected to ease somewhat, and wages should continue to pick up as the labour market tightens. GDP growth is projected to pick up to 2.4% in 2017 and 2.8% in 2018, supported by an anticipated fiscal expansion, especially in 2018, despite higher long-term interest rates and continued headwinds from the stronger US dollar. Policy choices, including on the composition of fiscal spending, taxation, regulation and trade, are likely to have a significant impact on growth outcomes.

In the euro area, GDP growth is projected to continue at the current moderate pace, supported by accommodative monetary policy and a modest fiscal easing over the coming years. There is fiscal space for more ambitious and effective fiscal initiatives in Europe. There are encouraging signs that business investment may be strengthening, but high non-performing loans and labour market slack in some euro area countries continue to hold back growth prospects. Growth is set to remain solid in Germany, but will continue at a slower pace in France and Italy. Although euro area-wide unemployment is falling steadily, the rate remains above 9%. Not only does unemployment overall remain high in some countries, youth unemployment is a particular drag on current demand and future potential growth. Headline inflation has been pushed up by higher energy prices, but the recovery is not yet sufficiently advanced to durably raise core inflation.

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Growth in China is expected to edge down further to 6¼ per cent by 2018 as the economy manages a number of necessary transitions, including shifting towards consumption and services, adjustment in several heavy industries, working off excess housing supply and ensuring credit developments are sustainable. Demand is being supported by very expansionary fiscal policy, including via policy banks, which in turn is boosting private investment and trade. Producer price inflation has picked up strongly, but consumer price inflation remains low.

Higher commodity prices and easing inflation are supporting a recovery from deep recessions in Brazil, Russia and some other commodity producers, although short-term supply restrictions will limit the positive impact of higher oil prices on production in some countries. Strong growth should continue in India over the next two years, helped by the implementation of key structural reforms and strong public sector wage growth.

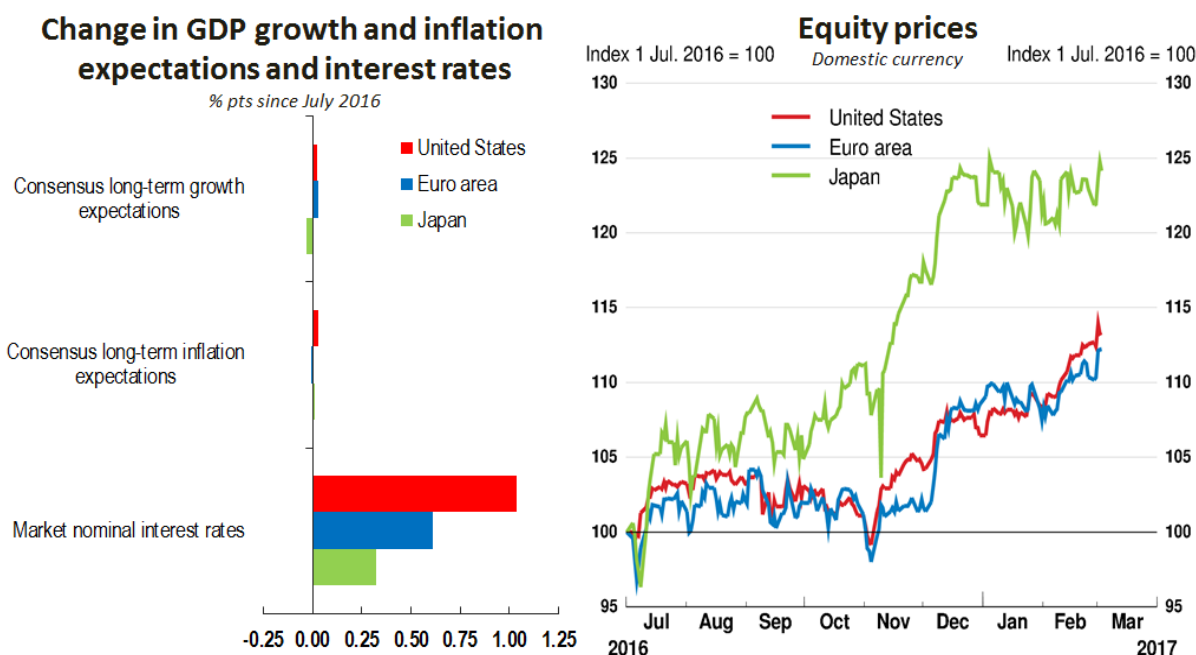
In most other major advanced economies, growth is projected to continue around the current modest path. In the United Kingdom, the pace of expansion in 2016 was lower than in previous years, despite support from resilient household spending, actions by the Bank of England and adjustment to the fiscal stance following the Brexit vote. UK growth is expected to ease further as rising inflation weighs on real incomes and consumption, and business investment weakens amidst uncertainty about the United Kingdom's future trading relations with its partners. In Japan, data revisions show a somewhat more positive picture of recent growth outcomes. Industrial production and exports have strengthened, helped by the depreciation of the yen, but consumption spending remains subdued. The fiscal easing will help GDP growth pick up to 1.2% this year but, with consolidation set to resume in 2018, growth prospects will depend on the extent to which wage growth picks up from its current low rate. Growth in Canada is expected to increase, supported by fiscal initiatives, export-market growth and the slowdown in commodity-related investment bottoming out.

Financial vulnerabilities and policy risks could derail the modest recovery

Disconnects, volatility, financial vulnerabilities and policy uncertainty could derail the projected modest pick-up in growth. While immediate indicators of financial market stress have generally moderated compared with a year ago, underlying tensions have continued to rise. Although risks may not materialise immediately, they remain a real possibility and a set of large shocks, possibly interacting with each other, would disrupt the recovery.

In financial markets, there are apparent disconnects between the positive assessment of economic prospects reflected in market valuations and forecasts for the real economy. Equity valuations have increased significantly further in many major markets over the past six months, despite the large rise in nominal interest rates and with long-term nominal and real GDP growth expectations based on consensus forecasts barely changed. Expectations for corporate earnings growth in the euro area and the United States have also not been revised up over this period. The improvement in market sentiment also contrasts with continued low growth of consumption and investment, which still lag well-behind previous recoveries, and the slowdown in productivity growth with persistent inequality.

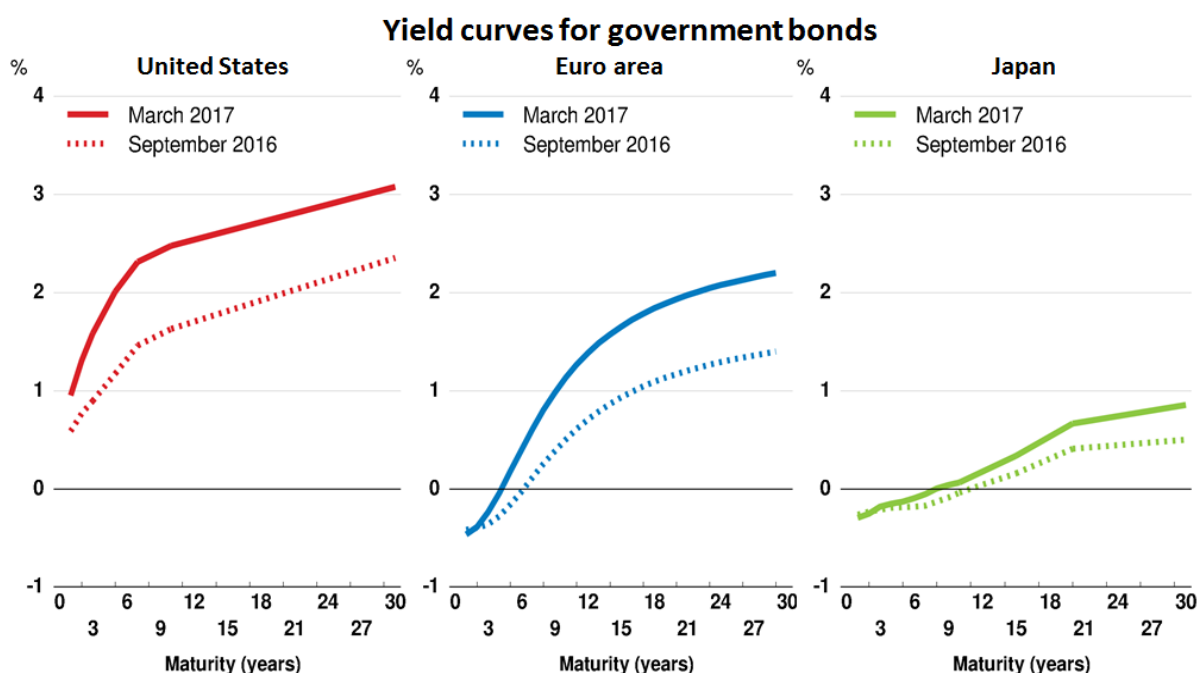
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Note: Change in long-term growth and inflation expectations are the change in Consensus Economics forecasts for 2017-26 for average annual real GDP growth and CPI inflation respectively. Nominal interest rates based on 10-year government bond yields.

Source: Consensus Economics; OECD Main Economic Indicators database; and Thomson Reuters.

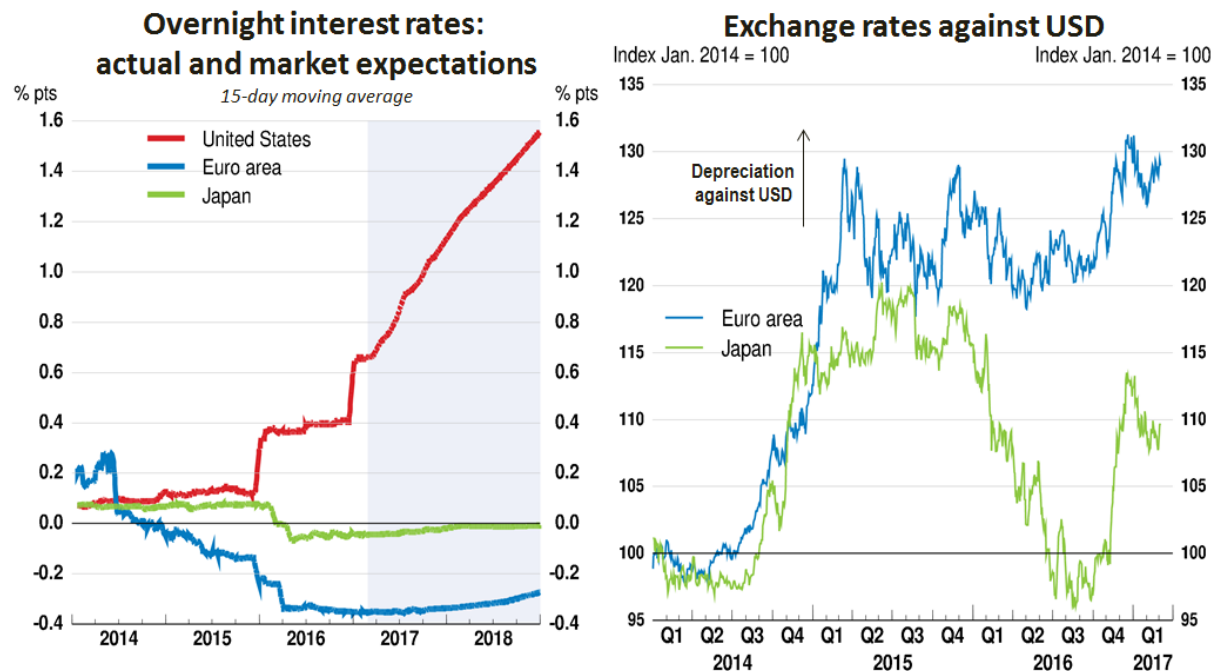
The turning of the interest rate cycle in mid-2016 heightens risks of financial market volatility. Long-term interest rates have risen globally in recent months, although they remain low by historical standards. Some normalisation of rates as the result of a rebalancing of demand support from monetary to fiscal policy is welcome. However, the financial market response to the increase in rates, following a prolonged period of exceptional monetary stimulus and unprecedentedly low yields, may not be smooth. A sharp reassessment by markets of the future path of interest rates could result in substantial and widespread re-pricing of assets that have been supported by low bond yields.



Source: ECB; and Thomson Reuters.

OECD Interim Economic Outlook, March 2017

The recent interest rate rises have been associated with sizeable exchange rate movements, with the US dollar appreciating rapidly against the euro and yen, and a number of emerging market currencies have faced market pressures. Financial market expectations imply that a large divergence in short-term interest rates between the major advanced economies will open up in the coming years. This raises the risk of financial market tensions and volatility, notably in exchange rates, which could lead to wider financial instability.



Note: Market expectations at 2 March 2017.

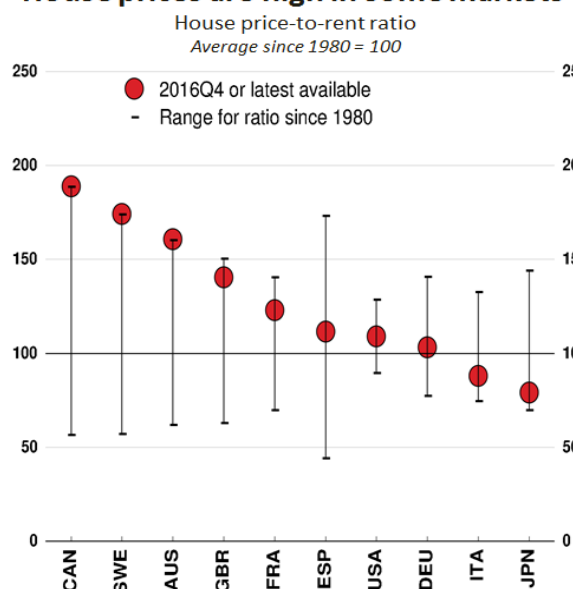
Source: OECD Exchange Rates database; OECD November 2016 Economic Outlook database; Thomson Reuters; and OECD calculations.

Significant financial vulnerabilities arise from the overreliance on monetary policy in recent years, which has led to an extended period of exceptionally low interest rates, rising debt levels in some countries, elevated asset prices and a search for yield. In advanced economies, some countries have experienced rapid house price increases in recent years, including Australia, Canada, Sweden and the United Kingdom. As past experience has shown, a rapid rise of house prices can be a precursor of an economic downturn. House price-to-rent ratios are at record highs in several countries and above long-term averages in many others. Although there has been a slower accumulation of household debt in recent years, mortgage-debt-to-income ratios remain high in many countries.

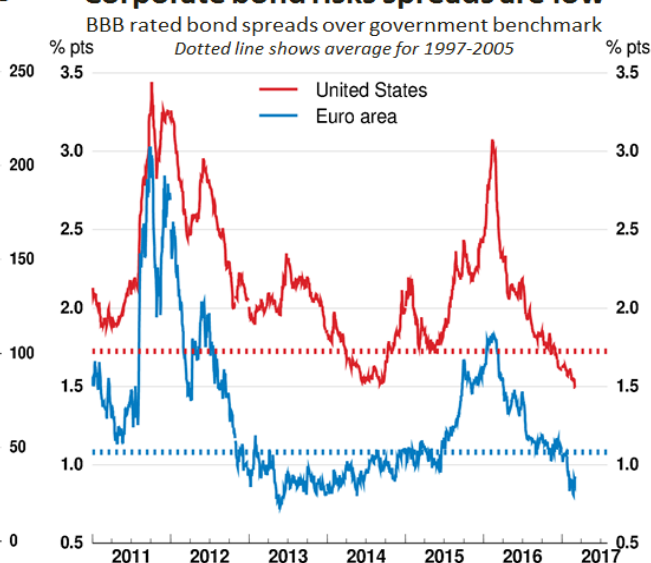
Bond issuance by non-financial corporates has been strong since the crisis. While this partly reflects low interest rates and a substitution away from bank finance, corporate bond spreads in the United States and the euro area have fallen to below their pre-crisis average, especially for sub-investment grade bonds. The average credit-rating of bond issuance by non-financial firms has also declined in recent years.

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House prices are high in some markets



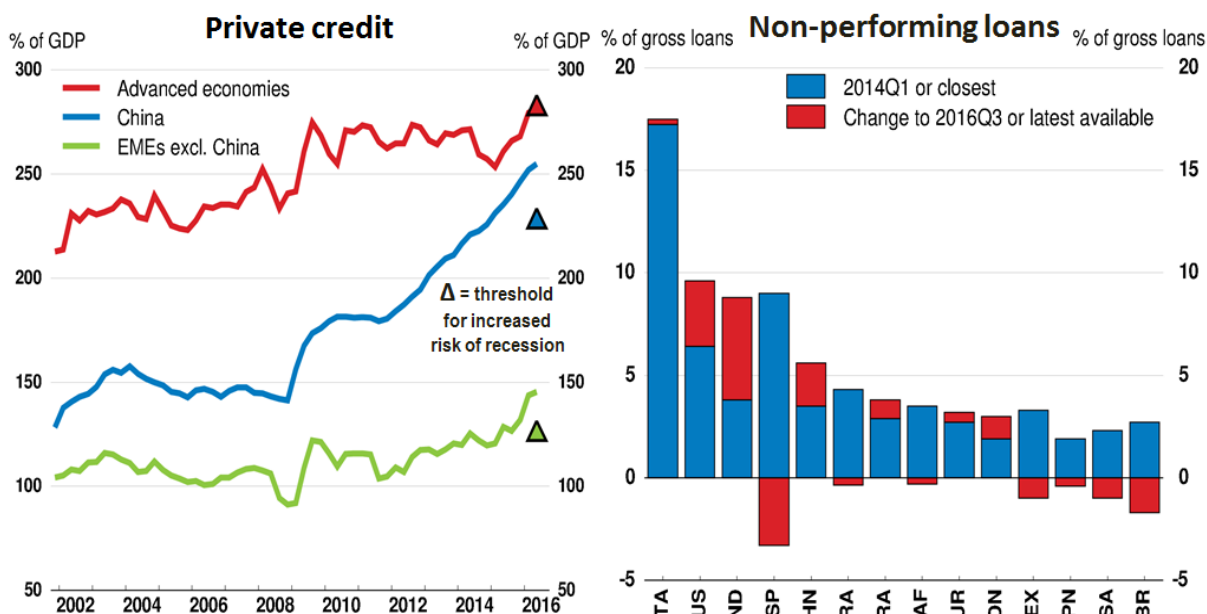
Corporate bond risks spreads are low



Note: Credit spreads between Merrill Lynch corporate BBB rated bonds and government benchmark bonds. Spreads based on average yields for 5-7 years and 7-10 years.

Source: OECD Analytical House Price database; and Thomson Reuters.

Significant global financial vulnerabilities stem from emerging market economies, although the sources of potential vulnerability differ across economies. The rapid growth of private sector credit and the relatively high level of indebtedness by historic norms is a key risk in some countries, notably China, fuelled by favourable financial conditions amid low global interest rates. These high debt burdens, particularly of non-financial companies, leave economies more exposed to a rapid rise in interest rates or unfavourable demand developments. At the same time, a turning of the credit cycle is leading to a rise in non-performing loans, particularly for India and Russia, potentially exposing a misallocation of capital during the upswing and creating pressures on the banking system. In China, the high share of non-performing and “special-mention” loans reflects to a large extent borrowing by state-owned enterprises.

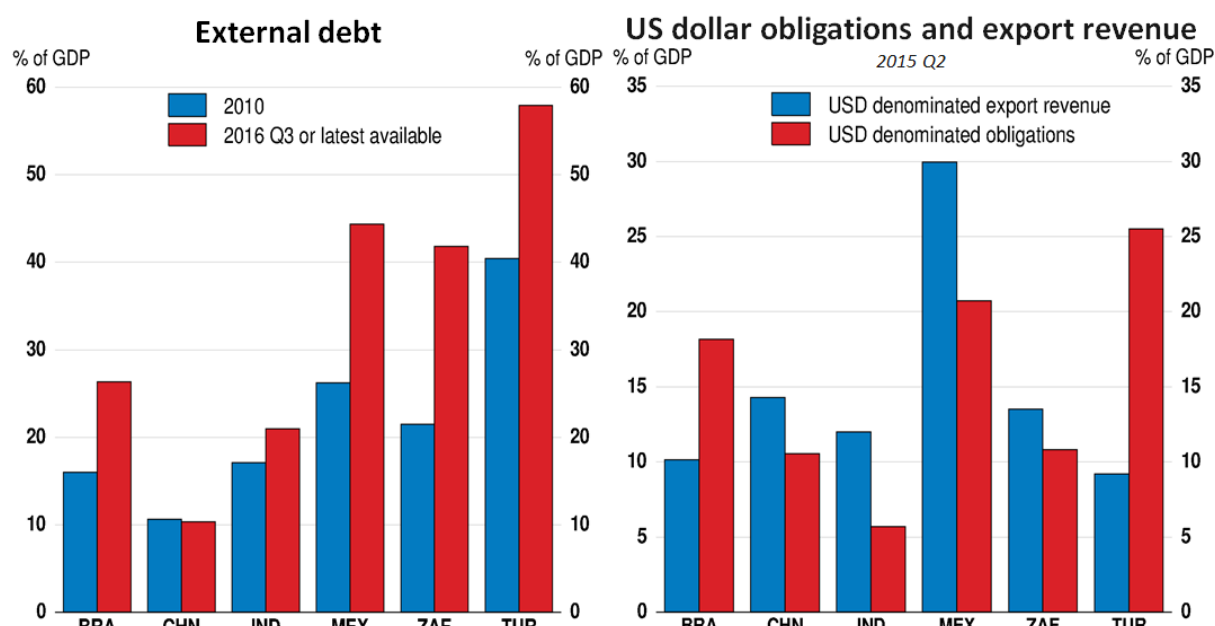


Note: Threshold estimates from OECD economic resilience framework. For RHS China includes “special-mention” loans.

Source: BIS; China Banking Regulatory Commission; Hermansen and Röhn (2017); IMF; OECD Resilience database; and OECD calculations. See: www.oecd.org/economy/growth/economic-resilience.htm for further detail.

OECD Interim Economic Outlook, March 2017

Many emerging market economies are also vulnerable to external shocks and currency mismatches. Sharp movements in foreign interest rates, rapid depreciations of the domestic currency, and or rising risk premia can induce financial stresses in countries with high levels of overseas borrowing or those with a mismatch between foreign currency denominated debts and export revenues. While exposure should take into account the position at the firm level and natural hedges and other factors, Brazil, Indonesia, Russia and Turkey have aggregate US dollar liabilities in excess of their estimated annual US dollar export revenues. While a number of factors make emerging market economies as a whole more resilient than during past episodes of rising interest rates in advanced economies, such as higher foreign exchange reserves and changes in the structure of foreign borrowing, exposures to global volatility are nevertheless high in many countries.

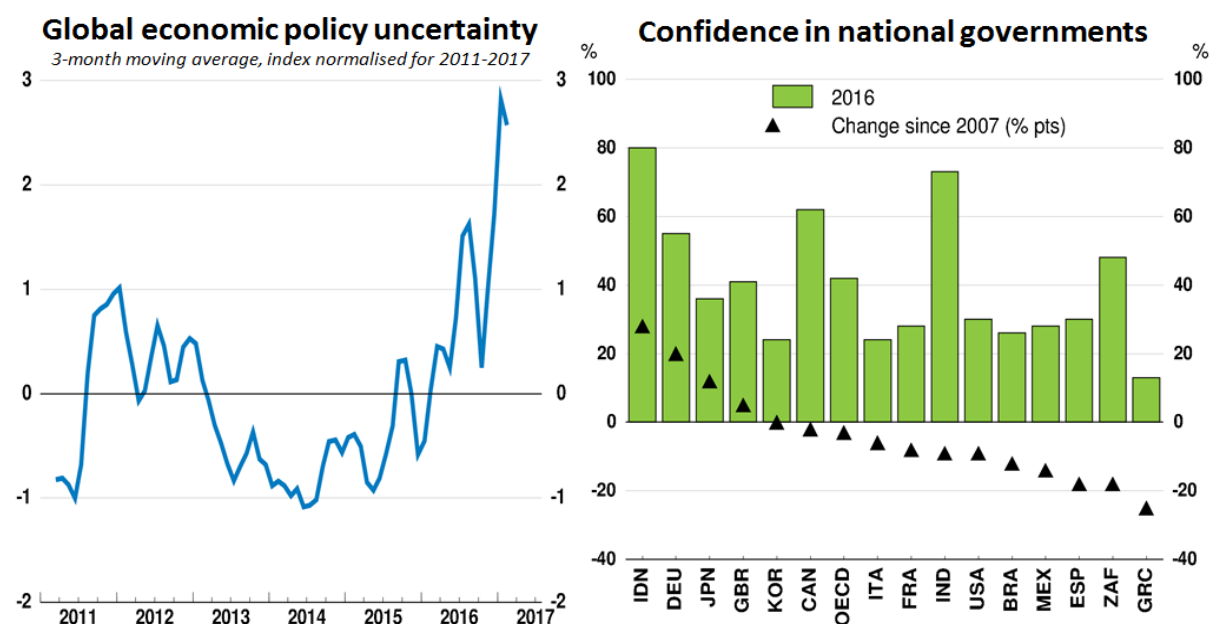


Note: External debt shows liabilities for portfolio investment, debt securities, other investment and other debt instruments. USD denominated obligations are for non-bank borrowers and include cross-border and locally-extended loans, and bonds issued by non-banks in the country and offshore affiliates of non-banks. USD denominated export revenue is given by the share of merchandise exports invoiced in US dollars in 2015.

Source: Gopinath (2016); IMF International Investment Position database; McCauley et al. (2015); and OECD calculations.

Uncertainties in many countries about future policy actions and the direction of politics are high. News-based measures indicate global policy uncertainty increased significantly in 2016, rising particularly sharply in some countries. Many countries have new governments, face elections this year, or rely on coalition or minority governments. More generally, falling trust in national governments and lower confidence by voters in the political systems of many countries can make it more difficult for governments to pursue and sustain the policy agenda required to achieve strong and inclusive growth. Rising inequality and growing concern about the fairness of society may also help to undermine trust and confidence in governments. These tensions lead to less predictable outcomes, including on progress in implementing policy reforms.

OECD Interim Economic Outlook, March 2017

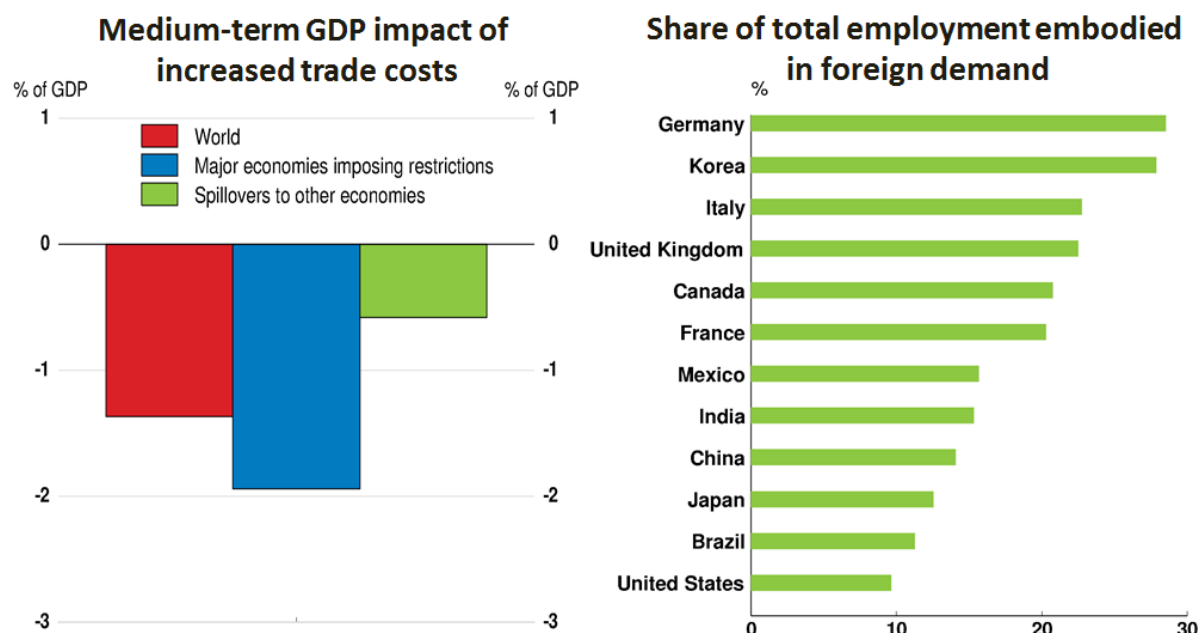


Note: Percentage who answered 'yes' to the question: "Do you have confidence in national government?".

Source: Gallup World Poll; OECD Trust and Public Policy (2017); PolicyUncertainty.com; and OECD calculations.

There is significant uncertainty about the future direction of trade policy globally, in part because of falling public support for trade in advanced countries connected to disparities in outcomes across industries, workers and regions. Efforts are needed to strengthen domestic policies that support trade openness, maximise the gains from trade and ensure that the benefits are fairly shared, with obstacles to the process of reallocation and transition for workers reduced. Internationally, progress is required in ensuring a level playing field. A roll-back of existing trade openness would be costly, with a significant share of jobs in many countries linked to participation in global value chains. An increase in trade barriers in the major global trading economies – Europe, the United States and China – roughly equivalent to an average increase of tariffs to the bound tariff rates in 2001, the year when the trade negotiations under the Doha Development Round started, would have a major adverse impact on trade and GDP, particularly for those economies that imposed new trade barriers.

OECD Interim Economic Outlook, March 2017



Note: LHS shows the impact of a goods trade cost increase of 10 percentage points for China, Europe and the United States against all trading partners, equivalent to an average increase in tariffs to 2001 levels, when trade negotiations under the Doha Development Round started. RHS for 2011, latest available.

Source: OECD METRO model; OECD TiVA database; and OECD calculations.

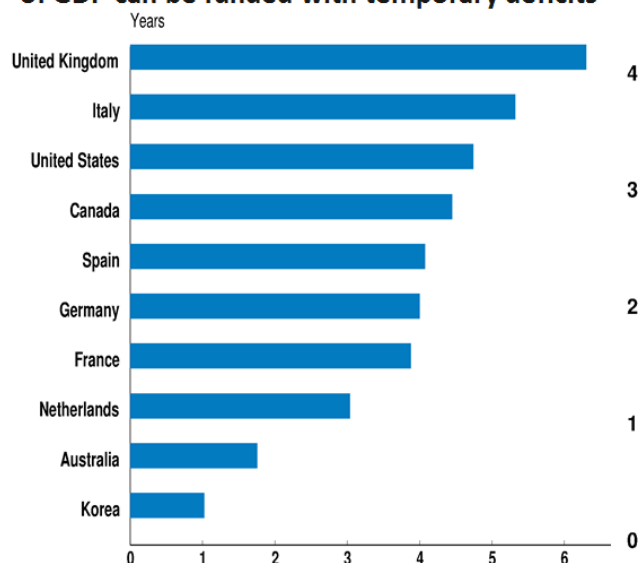
Policy needs to make growth stronger and more inclusive, and manage risks

Policy needs to manage risks, strengthen growth and ensure that it is more inclusive. A durable exit from the low-growth trap requires greater political commitment to implement structural reform packages to boost inclusive growth and the use of fiscal space through effective fiscal initiatives. This would help to reduce both near- and long-term risks.

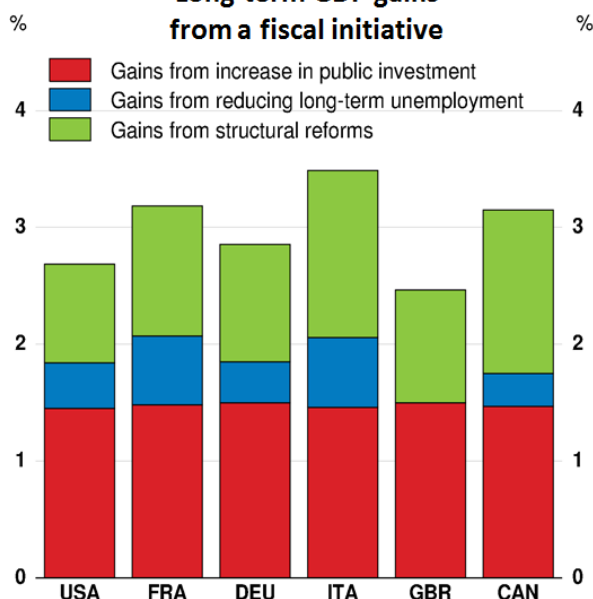
Fiscal space created by relatively low interest rates should be used more actively to catalyse private demand and raise incomes. Most countries have room for additional fiscal initiatives to boost growth and employment and enhance inclusiveness without compromising debt sustainability, especially if combined with structural reforms and even if temporarily financed through the issue of new debt. While many advanced economies have adopted a more supportive fiscal stance this year, collectively there remains too little support from fiscal policies and structural improvements for a durable increase in economic activity that catalyses a private response. An expansionary policy remains appropriate for the United States and would improve the policy mix. A number of other countries, notably in the euro area, should pursue a more expansionary stance. While situations vary across emerging market economies, a broadly neutral stance is appropriate in some countries, while others need to continue to pursue structural adjustment following the commodities boom. In China, spending needs to be directed at the health and education sectors and avoid adding to financial risks. In India, an increase in tax revenues and an improvement in spending efficiency would help regain fiscal room.

OECD Interim Economic Outlook, March 2017

Years a permanent investment increase of 0.5% of GDP can be funded with temporary deficits



Long-term GDP gains from a fiscal initiative

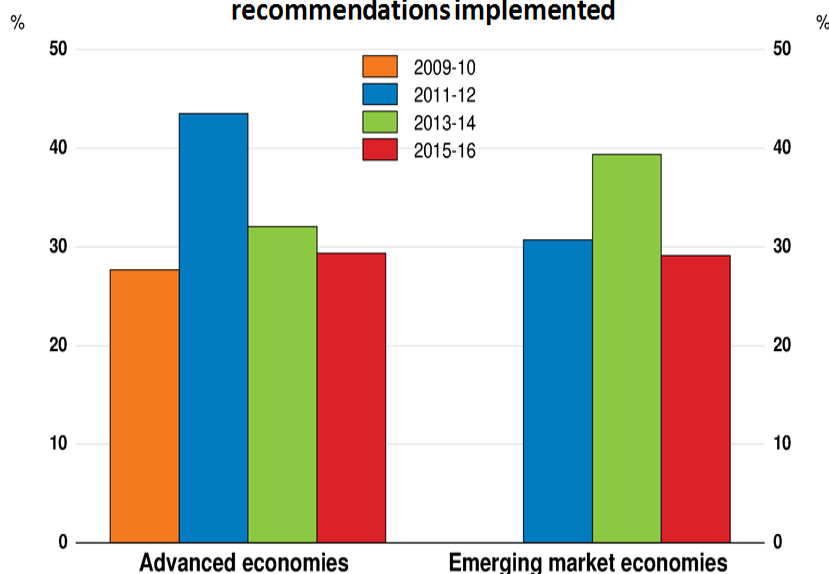


Note: RHS shows impact of a sustained public investment increase of 0.5% of GDP. Gains from structural reforms for a 10% reduction of product market regulations.

Source: OECD [“Using the fiscal levers to escape the low-growth trap”](#); Mourougane A. et al. (2016), “Can an increase in public investment sustainability lift economic growth?” OECD Economics Department Working Papers, No. 1351, OECD Publishing, Paris; and OECD calculations.

Rebalancing the policy mix towards fiscal policy initiatives and structural reforms would reduce the burden on monetary policy in major advanced economies and pave the way for higher growth and normalised interest rates. In turn, this would help ease the pressures arising from financial vulnerabilities. Policy rates should continue to gradually increase in the United States provided the recovery continues as projected. Given modest demand and weak price pressures, existing exceptional monetary measures should continue in the euro area and Japan, but there is little room for further action given the risk of adding to financial vulnerabilities, particularly in the absence of supportive fiscal and structural measures. There is scope for some additional monetary easing in commodity-producing economies such as Brazil and Russia, where inflation has now peaked.

OECD Going for Growth recommendations implemented

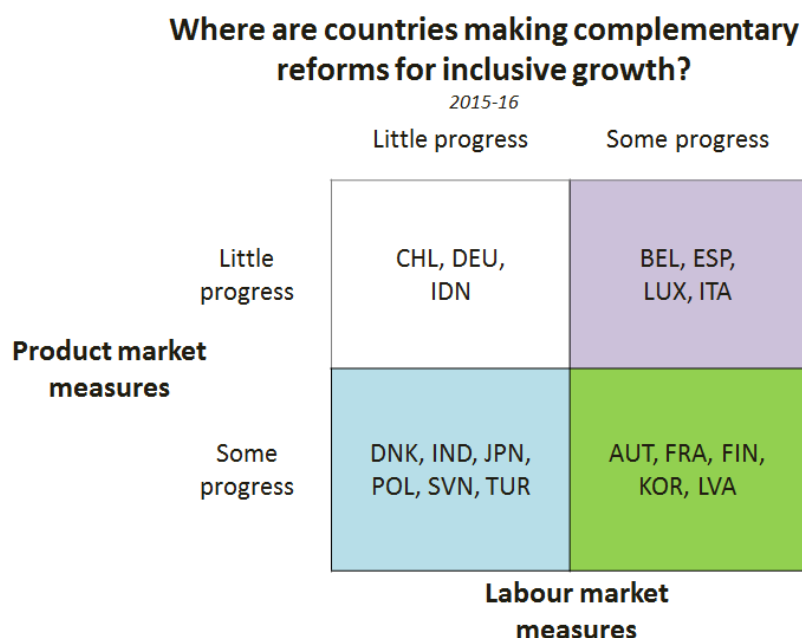


Source: OECD *Going for Growth* 2017, forthcoming on March 17: www.oecd.org/eco/growth/goingforgrowth.

OECD Interim Economic Outlook, March 2017

More ambitious structural reforms and implementation of announced measures are needed to ensure a durable strengthening in growth, together with more inclusive and resilient outcomes. However, as highlighted in the forthcoming OECD *Going for Growth* 2017, the pace of reform has again declined over the past two years and is now back to the pre-crisis level.¹

Reforms can be more effective if implemented in coherent policy packages. This can increase their economic impact and contribute to ensuring the benefits are widely shared, helping to build political support. For example, the gains from reducing barriers to competition will be greater with more favourable labour market regulations or social protection that support mobility of workers with adequate social protection, active job market assistance, policies to develop skills and the ease of transferring pensions between employers. Many countries have scope to build coherent packages combining measures that increase trade and competition with active labour market policies, investment in skills and changes to labour market regulations. However, very few countries have taken full advantage of the benefits of combining reform measures in these areas to achieve more inclusive growth.













Note: Reform progress based on responsiveness to OECD *Going for Growth* recommendations by policy area. Little progress is for a reform responsiveness rate of 0 to 20% and some progress is for a responsiveness rate of more than 20%. Source: OECD *Going for Growth* 2017, forthcoming on March 17: www.oecd.org/eco/growth/goingforgrowth.



Fiscal initiatives should redirect spending towards investments that help to tackle the barriers to achieving long-term inclusive growth, including investment in soft infrastructure like education and research together with investment in public infrastructures. All countries have room to restructure their spending and tax policies towards a more growth- and equity-friendly mix, including through the tax and transfer system. However, very few advanced economies presently plan to increase public investment as a share of GDP in the coming years and some continue to reduce capital spending.

¹ The OECD's *Growth for Growth* 2017 provides a comprehensive overview of structural reform priorities and progress for inclusive growth. It will be released on 17 March: www.oecd.org/eco/growth/goingforgrowth.

OECD Interim Economic Outlook, March 2017

Fiscal-structural initiatives to maximise impact on growth and inclusiveness

Impact of spending reform	Growth	Income of the poor	Countries with most room for gains
Improving education			CHL, GRC, MEX, PRT, TUR
Increasing public investment and R&D			DEU, GBR, ITA, MEX, TUR, USA
Increasing government effectiveness			FRA, GRC, HUN, ITA, SVN
Increasing family benefits			CHE, ESP, GRC, PRT, USA
Decreasing public subsidies			BEL, CHE

 positive impact
  uncertain or no impact

Source: Based on Fournier and Johansson (2016), "The Effect of the Size and the Mix of Public Spending on Growth and Inequality", OECD Economics Department Working Papers, No. 1344, OECD Publishing, Paris.

Supportive macroeconomic policies would create a more favourable environment to strengthen the impact of structural reforms and increase resilience. Additional output gains would arise from positive cross-country spillovers if collective action were taken to use fiscal resources for high-growth projects and activities. This is also the case for trade and investment policies, where collective efforts would have greater positive impact than individual efforts, and clear and longer-term commitments to policies and frameworks can help to underpin stronger and more sustainable growth.

A stronger growth environment would enhance resilience, but may not suffice to tackle all financial vulnerabilities. Countries also need to have robust early warning systems, engage in active supervision and use macroprudential instruments appropriately, including setting limits on mortgage loan-to-value and debt-service-to-income ratios. The resilience of housing markets can be improved by addressing tax biases in favour of debt-financed home ownership and unnecessary obstacles to housing supply. Faced with market volatility and mismatches, emerging market economies should ensure that they have a credible policy framework and maintain open and transparent capital markets.

In countries with existing or emergent credit problems, it is necessary to ensure effective approaches to managing and resolving non-performing loans. Ineffective bankruptcy mechanisms and insufficient capital buffers can discourage banks from recognising losses from non-performing loans, slowing down the necessary reallocation of resources trapped in "zombie" firms. Resolving non-performing loans swiftly and decisively, including in the euro area, would help to boost investment by more productive firms so they can grow and expand.

OECD Interim Economic Outlook, March 2017

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 the United States, Japan, the euro area, Germany, France, Italy, the United Kingdom, Canada, China, India and Brazil. Projections for world and G20 GDP growth are also updated, based on Interim projections for these countries and changes in external forecasts, applied to the most recent *Economic Outlook* projections, for the rest of the world.

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.