Interim Economic Outlook

21 September 2016

Global growth warning: Weak trade, financial distortions

Global GDP growth is projected to remain flat around 3% in 2016 with only a modest improvement projected in 2017. This forecast is largely unchanged since June 2016 with weaker conditions in advanced economies, including the effects of Brexit, offset by a gradual improvement in major emerging market commodity producers. Overall, the world economy remains in a low-growth trap with persistent growth disappointments weighing on growth expectations and feeding back into weak trade, investment, productivity and wages.

OECD Interim Economic Outlook Forecasts

Real GDP growth (%)[1]

	2015	2016		2017	
		September 2016 Projections	difference from June EO[2]	September 2016 Projections	difference from June EO[2]
World	3.1	2.9	-0.1	3.2	-0.1
United States	2.6	1.4	-0.4	2.1	-0.1
Euro area	1.9	1.5	-0.1	1.4	-0.3
Germany	1.5	1.8	0.2	1.5	-0.2
France	1.2	1.3	-0.1	1.3	-0.2
Italy	0.6	0.8	-0.2	0.8	-0.6
Japan	0.5	0.6	-0.1	0.7	0.3
Canada	1.1	1.2	-0.5	2.1	-0.1
United Kingdom	2.2	1.8	0.1	1.0	-1.0
China	6.9	6.5	0.0	6.2	0.0
India[3]	7.6	7.4	0.0	7.5	0.0
Brazil	-3.9	-3.3	1.0	-0.3	1.4
Rest of the World	2.0	2.3	-0.1	2.8	-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 June 2016 Economic Outlook forecasts.
3. Fiscal years starting in April.

Continued weak trade growth, and the sharp slowdown in 2015 and 2016, underlines concerns about the robustness of global growth. While demand factors play a role, weak trade also reflects structural factors and a lack of progress – together with some backtracking – on the opening of global markets to trade in goods and services. Slowing trade growth will depress productivity growth in future years.

Long-term interest rates have fallen further in recent months, reaching exceptionally low levels in many countries, with more than 35% of OECD sovereign debt trading at negative yields. At the same *time, equity valuations remain high and have continued to increase in some economies despite weak profit developments and reduced long-term growth expectations. Real estate prices are rising rapidly in many economies, while credit quality and credit spreads are declining in some markets.*

Monetary policy has become overburdened and is creating distortions in financial markets. Effective monetary policy support requires more and collective fiscal policy, as well as implementing structural reforms to boost growth and inclusiveness. Monetary policy has created a window of low interest rates. Fiscal policy should take advantage of the increase in fiscal space to increase growth-enhancing spending. Structural reform momentum needs to be intensified, rather than continue to slow as in recent years. Trade policies are a key lever to boost growth and should be supported by measures that ensure the gains from globalisation are widely shared. A more balanced policy mix would put the global economy on a higher growth path and reduce financial risks.

Global growth is set to remain in a low-growth trap

Global GDP growth is projected to slow marginally to 2.9% in 2016, lower than in 2015 remaining around the same 3% of recent years. For 2017, global GDP growth is expected to improve only modestly to 3.2%, all well-below historical norms. Overall, the global GDP projection is largely unchanged since the Economic Outlook of June 2016, with weaker conditions in advanced economies, including the effects of Brexit, offset by a less negative performance of major commodity producers.

The world economy remains in a low-growth trap, with poor growth expectations depressing trade, investment, productivity, and wages. This in turn leads to a further downward revision in growth expectations and subdued demand. Poor growth outcomes combined with high inequality and stagnant incomes are further complicating the political environment, making it more difficult to pursue policies that would support growth and promote inclusiveness.

Among the major advanced economies, growth remains subdued. US GDP growth has slowed in 2016, despite solid consumption and job growth, due to weak investment, partly reflecting developments in the energy sector, and a prolonged inventory correction. US demand growth is likely to improve into 2017, but remain below historical standards. In the euro area, GDP growth slowed in the second quarter, driven by weak domestic demand, including the stalling of the short-lived recovery in investment. Although credit growth has improved in the euro area, high non-performing loans in some euro area countries continue to hold back growth prospects. While employment continues to expand slowly, there is still significant slack in the labour market and there are few signs of inflation and wage pressures. In Japan, growth remains sluggish and uneven, with the appreciation of the yen and weak Asian trade weighing on exports, although increased government spending in the 2016 Supplementary Budgets and the postponement of the consumption tax hike will support demand this year and next.

The United Kingdom vote to leave the European Union on 23 June led to high volatility in financial markets and a marked rise in news-based measures of uncertainty. While markets have since stabilised, sterling has depreciated by around 10% in trade-weighted terms since the referendum. For 2016, GDP growth has been supported by a strong performance prior to the referendum, even though business investment contracted. Developments to date are broadly consistent with the more moderate scenarios set out prior to the referendum and reflect prompt action by the Bank of England in August. However, GDP is projected to slow to 1% in 2017, well below the pace in recent years and forecasts prior to the referendum. Uncertainty about the future path of policy and the reaction of the economy remains very high and risks remain to the downside. In the longer term, the UK's future trading arrangement with the EU and other partners will be critical to its economic prospects.[1] Spillovers to the global economy, notably the euro area, have been modest so far, including through confidence and financial markets weighing on investment; more negative effects on the euro area are likely to become apparent in 2017.

Growth in the major emerging market economies (EMEs) has slowed compared with recent years and will pick up only slowly in 2017, driven by an easing of the recessions in Brazil, Russia and other commodity producers. In China, fiscal and monetary stimulus is continuing to support demand as policy seeks to rebalance the economy from investment- and manufacturing-led demand towards consumption and services. Managing this rebalancing and risks in the financial system will be challenging. China's slowing growth has led to notably weak trade growth in Asia. For other Asian economies, these weak trade developments have been often offset by strong domestic demand growth supported by credit expansion. Solid growth should also continue in India, boosted by the large increase in public sector wages. Growth may surprise on the upside in 2017 due to the recent passing of key structural reforms, particularly the goods and services tax.

The prolonged period of weak global demand is increasingly causing adverse supply-side developments and contributes to the self-fulfilling low-growth trap. Investment, trade and productivity are weak, while employment growth has not been accompanied by significant wage gains. For the OECD as a whole, potential GDP-per-capita growth is estimated at 1% in 2016, which is half the average in the two decades preceding the crisis. Potential per capita output growth in China has also fallen by 1¾ percentage points since 2011 and by 1 percentage point in the remaining BRIICS economies. The decline in potential output growth reflects both weak investment and slower growth of total factor productivity, itself the result of a slowing of diffusion of innovations across firms and – more recently – slowing innovation at the technological frontier.[2] These developments exacerbate the challenges to improving well-being of people in both advanced and emerging economies.

The outlook is subject to significant risks. Financial instability risks are rising, including from exceptionally low interest rates and their effects on financial assets and real estate prices. Many EMEs face high private debt burdens and currency mismatches, and remain vulnerable to capital outflows as well as weaker-than-expected growth. On the upside, the economic recovery could gain more traction, especially if a stronger policy response takes place, for example via a collective fiscal stimulus in advanced economies. However, the difficulties of agreeing on effective responses to policy challenges and growing political tensions in many countries are significant downside tail risks for the global economy.

Global trade growth is exceptionally weak

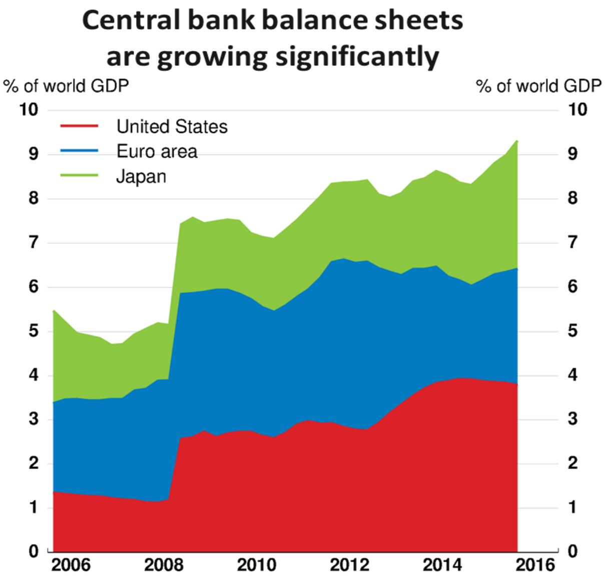
The volume of world trade fell in the first quarter of 2016 and, despite some recovery in the second quarter, global trade growth is set to fall short of GDP growth for the year as a whole. This is well below past norms and implies that globalisation as measured by trade intensity may have stalled. Structural factors, such as a slowdown and reversal of trade liberalisation and the weakening of global value chains (particularly in China and East Asia) appear to play a significant role in the deceleration in trade growth between 2011 and 2015. Cyclical factors, including the deep recessions in some commodity producing economies and the widespread weakness of fixed investment have compounded structural problems. If sustained, the trade slowdown will undermine already weak productivity growth and in turn hurt prospects for living standards.

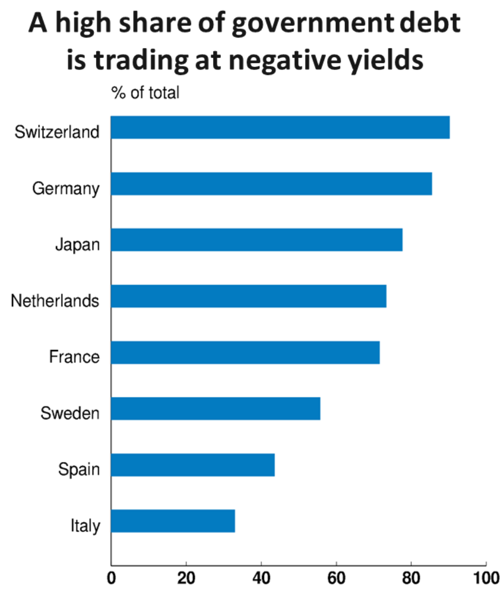
[1] Kierzenkowski et al (2016), "The Economic Consequences of Brexit: A Taxing Decision" OECD Economic Policy Paper No. 16, April, OECD Publishing, Paris.
[2] For more analysis on productivity see http://www.oecd.org/global-forum-productivity/.

Note: World trade is goods plus services trade volumes measured at market exchange rates in US dollars. World GDP volumes measured at market exchange rates in US dollars. The right-hand-side structural real-time global value chain indicator is adjusted for the economic cycle and changes in commodity prices. For further detail see OECD Economic Policy Paper "Cardiac Arrest or Dizzy Spell: Why is World Trade So Weak and What Can Policy Do About It?".
Source: OECD Economic Outlook databases, OECD STAN Bilateral Trade database; and OECD calculations.

Exceptionally low and negative interest rates distort financial markets and raise risks

Short- and long-term interest rates have fallen further in recent months, advancing more into exceptionally low and – in many cases – negative rates. This reflects a number of factors, notably the interaction of expectations of persistently low growth and the anticipated monetary policy response. Bond valuations are particularly high in Europe and Japan, where the share of sovereign bonds trading at negative yields is estimated above 70% in several countries. Consequently, around USD 14 trillion of government bonds, more than 35% of OECD government debt, is currently trading at negative yields. This unprecedented situation creates a number of distortions and risks.



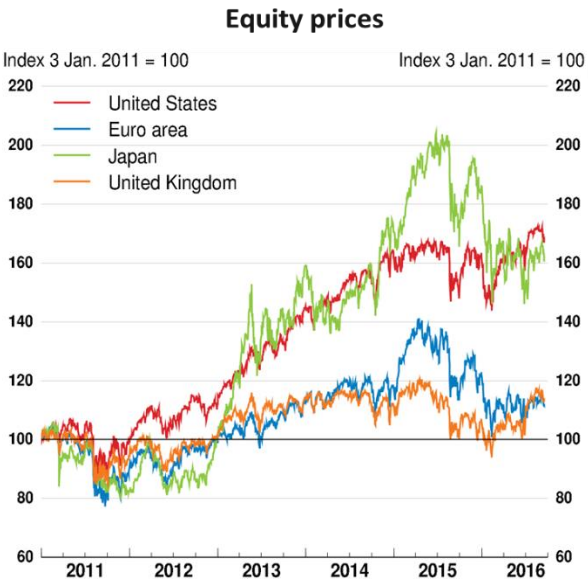


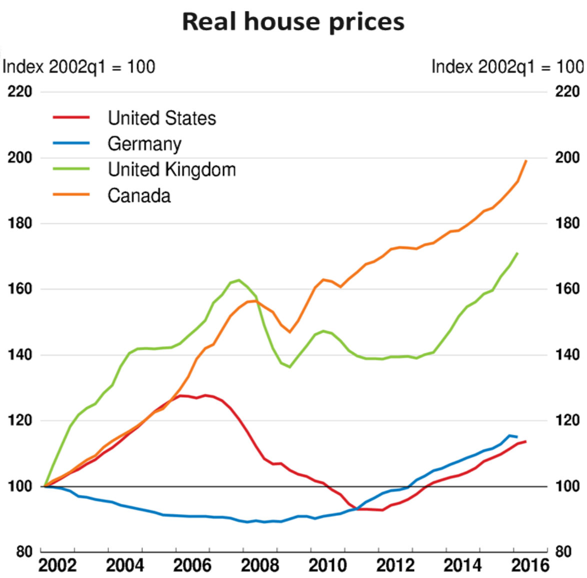
Source: OECD Business and Finance Outlook 2016; Thomson Reuters; Bloomberg; US Federal Reserve; Bank of Japan; UK Debt Management Office; ECB; and OECD calculations.

Low interest rates underpin widespread and substantial increases in asset prices, both internationally and across asset classes, which increases the likelihood and vulnerability of a sharp correction in asset prices. A reassessment in financial markets of interest rates could result in substantial re-pricing of assets and heighten financial volatility even if interest rates were to remain below long-term averages. This effect is reinforced by the exceptionally low level of interest rates and rising average duration of outstanding government and corporate bonds.

Share prices have risen significantly in recent years in advanced economies, notably in the United States. By contrast, the growth of profits for non-financial companies has recently slowed to a modest pace, following a post-crisis recovery, and long-term growth expectations for future GDP growth have fallen for most countries. This suggests that equity prices may largely be supported by falling long-term interest rates that have boosted the present value of discounted future profits, as well as cost reduction measures, share buybacks and dividend pay-outs, rather than as the result of additional productive investment by firms.[3]

The prolonged period of low interest rates has also contributed to rising real estate prices. Over recent years, real house prices have been growing at a similar or higher pace than prior to the crisis in a number of countries, including Canada, the United Kingdom and the United States. The rise in real estate prices has pushed up price-to-rent ratios to record highs in several advanced economies. Commercial real estate prices have also increased rapidly in a number of markets, including exceeding the pre-crisis highs in the United States. With rising property prices not accompanied by a rapid increase in household debt, risks to domestic financial stability may be less severe than prior to the crisis, but a price correction would nevertheless have significant effects on demand. Some countries should more actively use macro-prudential regulation to mitigate potential risks.





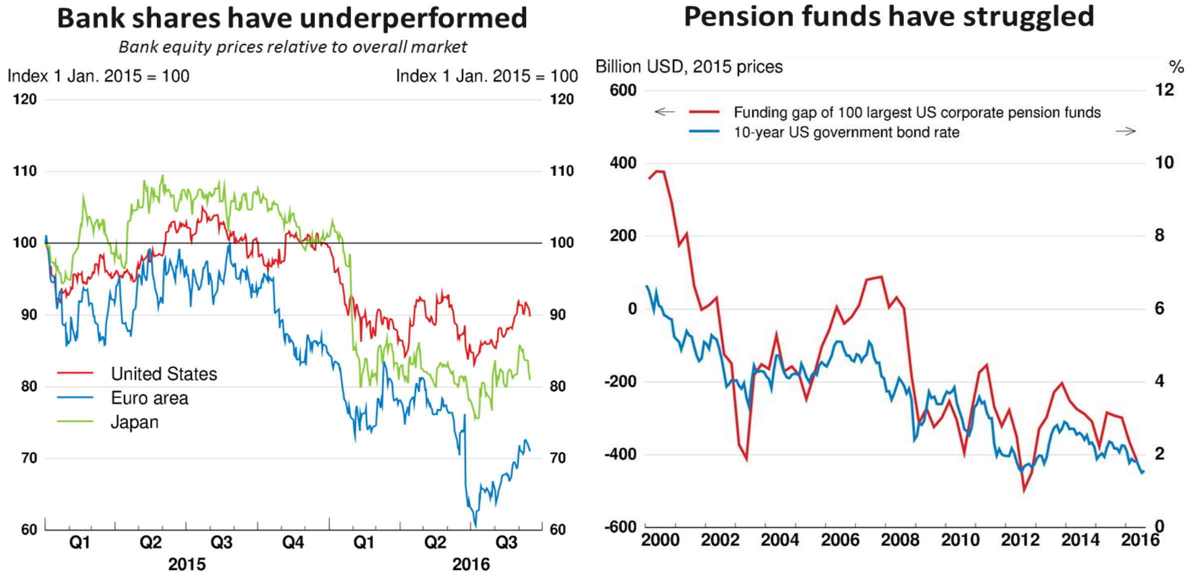
Source: Thomson Reuters and OECD Analytical House Price database.

If sustained over the next couple of years, negative and low interest rates will challenge financial institutions' business models and sustainability. For the banking sector, flat yield curves undermine the profitability of the traditional model of borrowing short and lending long. At the same time, negative deposit rates, low lending volumes and banking overcapacity imply lower profits. These developments are reflected in the underperformance of bank shares relative to other sectors, which may in turn slow credit availability.

Prolonged low interest rates also pose major challenges for other financial institutions, notably asset managers and pension funds. A lower discount rate increases the present value of liabilities of

[3] See also OECD (2016), *OECD Business and Finance Outlook 2016*, OECD Publishing, Paris.

defined-benefit pension funds and life insurance companies, which undermines their solvency. Conversely, low interest rates reduce future returns on assets given the larger share of fixed income securities in total investment portfolios of pension funds and insurers. This could have significant implications for financial institutions, but also savers and retirement incomes and businesses that face higher contribution rates or higher obligations from company-sponsored pension funds.



Note: The funding gap on the RHS is the difference between the end of the month assets of the 100 largest US corporate defined benefit pension plans and their projected pension obligations.
Source: Milliman; OECD Main Statistical database; and Thomson Reuters.

Stronger collective fiscal and structural policy action is needed

A stronger collective fiscal and structural policy response is needed to break out of the low-growth trap. This policy mix should reflect country and region-specific conditions, and account for international spillovers. If policy remains on the current path, low growth will continue with negative consequences for productivity, trade, jobs and inclusiveness, as well as rising risk.

Monetary policy has become overburdened and creates risks

Monetary policy is overburdened and, in the absence of strong fiscal and structural policy action, will not suffice to break out of the low-growth trap, while leading to growing financial distortions and risks. Current market-based expectations suggest that policy interest rates will remain zero or negative at least until end-2018 in the euro area and Japan and in the United States only slightly higher than at present. With past and current purchases of government bonds, central banks have become major holders and buyers of sovereign debt and are intervening in a wide range of other markets, including for corporate bonds and equities. The uneven policy response across countries and over-reliance on monetary policy adds to global imbalances and creates spillovers that can have disruptive effects on other countries through capital flows and build-up of financial risks.

Improved expectations of future growth as a result of fiscal or structural policy action would help to reduce the burden on monetary policy and facilitate an eventual normalisation of interest rates, thereby reducing risks. The US Federal Reserve should continue a gradual raising of rates provided that its full employment and inflation objectives look set to be attained as projected. In the euro area and Japan, an accommodative monetary policy stance remains appropriate, but any decision to increase the size or expand the scope of unconventional policies should weigh the benefits, costs and risks very carefully.

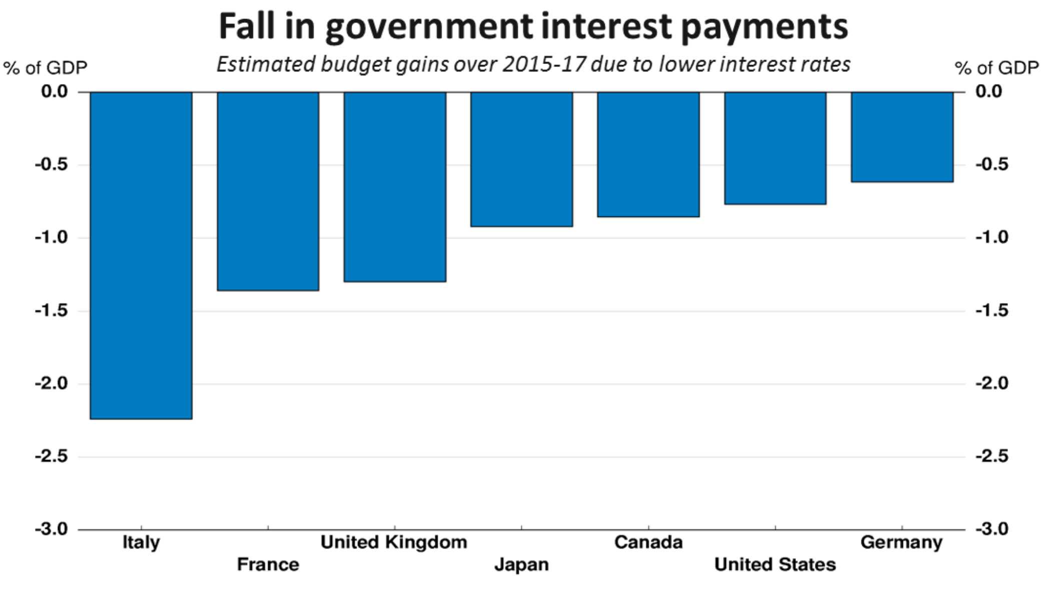
Emerging economies are facing a range of challenges with weak inflation in some related to slowing demand, while others are struggling with above-target inflation in recent years, in part the result of past exchange rate depreciations. The current range of monetary policy settings is broadly appropriate. At the same time, continued fast credit growth in several EMEs, notably China, requires a better use of financial regulation and macroprudential instruments to curb financial risks. Efforts to resolve high and increasing non-performing loans should continue in India.

Use fiscal space provided by low interest rates to boost growth and equity

Fiscal space has increased in many advanced economies, as interest rates have declined by more than GDP growth and the decline more than offsets the increase in the debt-to-GDP ratio, raising the amount of debt that can be sustained. At the same time, a continuation of the low growth of recent years would undermine fiscal sustainability and the capacity to address future fiscal challenges. This calls for fiscal and structural measures to raise the productive capacity of the economy.

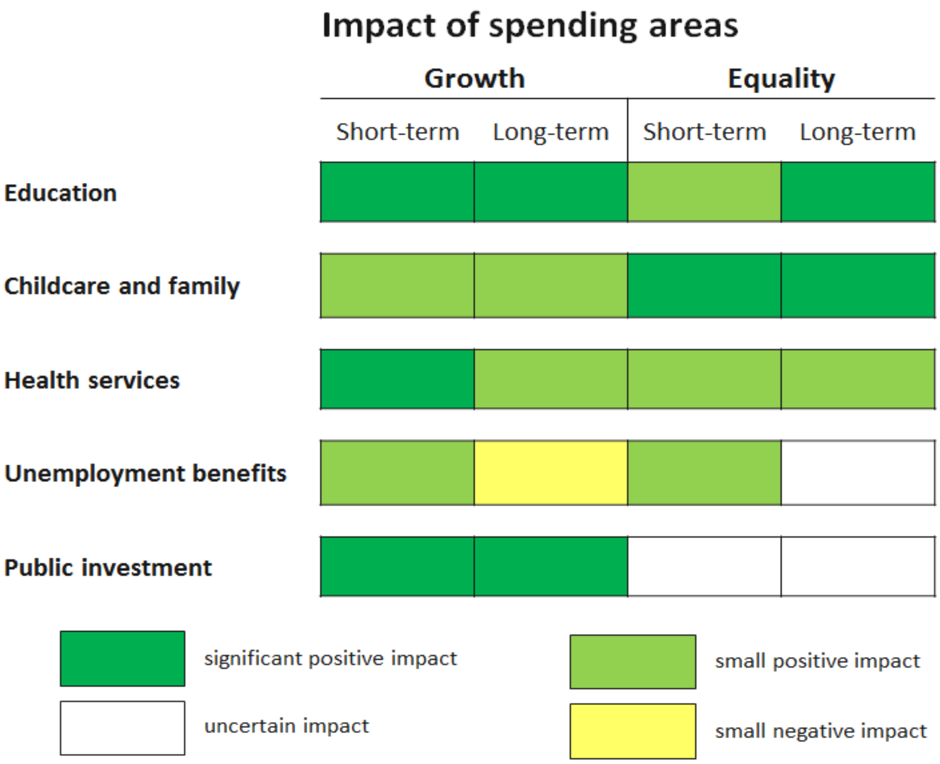
Canada, Japan and the United States have recently announced fiscal expansion measures, including raising spending on investment. The United Kingdom has also signalled an easing in the budgetary stance. While the consolidation phase in the euro area economies has ended, fiscal policy looks set to be only slightly easier in 2016 than 2015, to a certain extent reflecting a looser interpretation of the EU fiscal rules and unilateral measures by some countries. However, more could be done to make use of exceptionally low borrowing costs. The application of the EU Stability and Growth Pact should be modified to allow for a more supportive fiscal stance, for example by excluding net investment spending from fiscal rules and more generally developing a coherent approach for using discretion in applying fiscal rules.

All countries have room to restructure their spending and tax policies towards a more growth-friendly mix by increasing hard and soft infrastructure spending, and using fiscal measures to support structural reforms. Concrete instruments include greater spending on well-targeted active labour market programmes and basic research, which should benefit both short-term demand, longer-term supply, and help to make growth more inclusive. Supportive macroeconomic policies would create a more favourable environment for the short-term effects of structural reforms in the current weak demand environment.



Note: Based on general government debt at the end of 2014, assuming that 15% of this initial debt stock matures each year, comparing the interest rate on 10-year government bonds in 2014 with the interest rate for 2015 and the 2016 average until August for 2016 and 2017.
Source: OECD June 2016 Economic Outlook database and OECD Analytical Database.

Easing of the fiscal stance through well-targeted growth-friendly measures is likely to reduce the debt-to-GDP ratio in the short term. Furthermore, provided that fiscal measures raise potential output, a temporary debt-financed fiscal expansion need not increase debt ratios in the longer term. For countries with strong institutions and with clear investment needs, further capital spending is more likely to be growth-enhancing in conditions of weak demand.



Source: Cournède, Goujard and Pina (2014).

Additional output gains would ensue from cross-country spillovers if collective action is taken to use fiscal resources for projects and activities with a high-growth impact. Collective action among the major advanced economies to raise public investment is estimated on average to increase the first-year impact on GDP by one half compared with a scenario where each country acted individually. Spillovers through trade and financial integration amplify the effects of co-ordinated policy actions up to a point where stimulus is more likely to be self-financing.

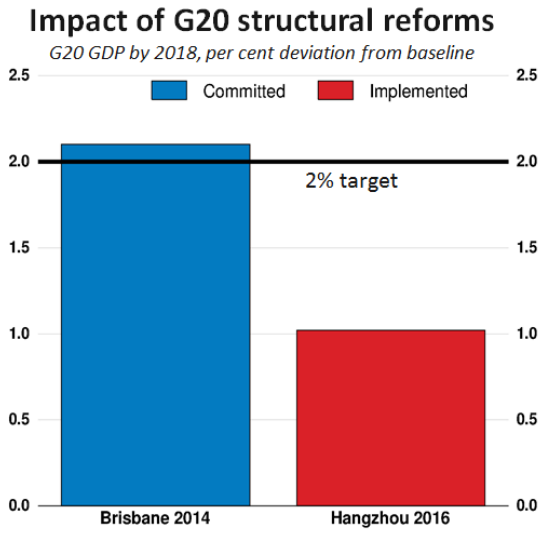
Implement structural reforms that strengthen globalisation to boost growth, while sharing the benefits

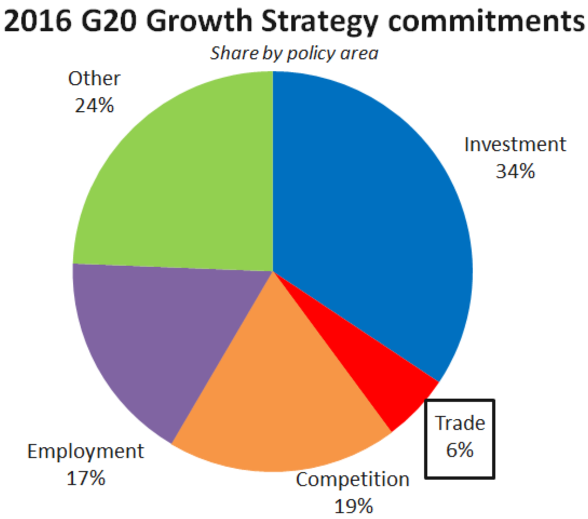
Improved structural policies are needed to strengthen the underlying growth of productivity through higher investment, stronger trade and new innovations, while improving the conditions for knowledge diffusion and the creation of more high-quality jobs.

While a faster pace of structural reforms is now needed to move to a higher growth path, the implementation of reforms in both advanced and emerging economies has slowed in the most recent years, particularly for productivity-enhancing policies.[4] In 2014, the G-20 committed in Brisbane to implement structural measures that would raise GDP by 2% by 2018. Only around half of these measures have been implemented to date, leading to an estimated gain of only 1% of GDP by

[4] OECD (2016), *Economic Policy Reforms 2016: Going for Growth Interim Report*, OECD Publishing, Paris.

2018.[5] Furthermore, more recent G-20 reform commitments have been less ambitious than those of 2014 and the share of commitments related to trade has fallen significantly.





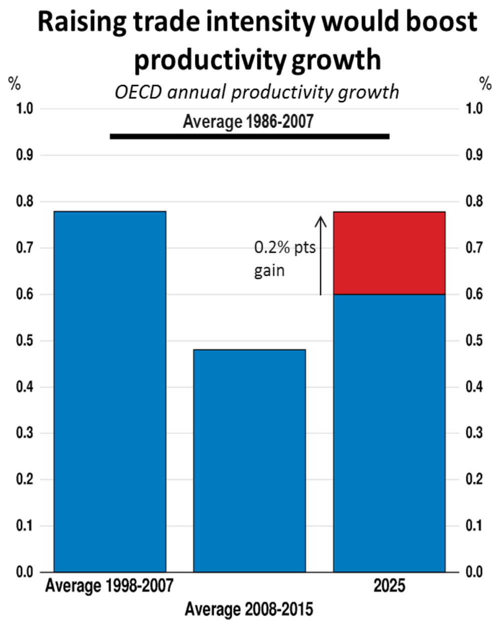
Source: OECD and IMF.

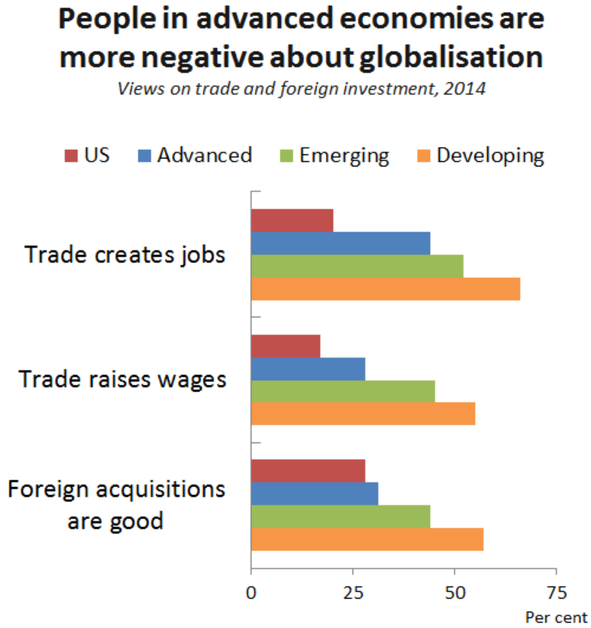
Countries should implement more ambitious reforms to strengthen inclusive growth. To complement and make more effective the significant labour market reforms undertaken to date, renewed steps are needed to ease competition-restraining product market regulations and barriers to foreign trade and FDI; strengthen skills acquisition and use; adjust the structure and efficiency of tax systems; and improve R&D and innovation policies. More could still be done to improve labour utilisation, notably through improving the design of unemployment and social benefits, lowering high social security contributions and implementing effective active labour market policies. In several euro area countries, action is required to improve the ability of the banking and financial sectors to support new and productive activities. While the reform priorities vary by country, there is significant room for raising performance in all major advanced and emerging economies.

Trade is an important driver of productivity growth, enhancing competitive pressures, enabling greater specialisation and improved resource allocation, and facilitating knowledge transfer. This underlines the importance of specific policy action to help trade growth recover from the anaemic rates experienced in recent years. Despite some mild recovery in world trade growth that could come from cyclical factors and income convergence in EMEs in the longer term, the gains in trade intensity are likely to be modest in the absence of specific policy action to boost trade.

A first set of trade policy priorities is related to avoiding new trade protectionist measures that are reducing market access alongside steps to roll back the protectionist measures introduced since the crisis. Second, all advanced and emerging economies could boost trade and productivity by reducing unnecessary trade costs by implementing policies to improve border and customs procedures, removing tariff and non-tariff barriers, removing regulatory restrictions on trade in services, particularly logistics, and harmonising costly regulations between countries. Removing impediments and distortions for cross border investment would also contribute to trade by encouraging FDI and a better integration into GVCs.

[5] IMF and OECD Paper for Hangzhou 2016 G20 Summit "*Quantifying the Implementation and Impact of G-20 Members' Growth Strategies*".





Note: The left-hand-side presents a scenario in which the world and OECD trade intensity (exports plus imports as a share of GDP) increases by 1.3 percentage points per annum (the average from 1986-2007) from 2017. The effect of this increase on OECD total factor productivity growth is shown. For further detail see OECD Economic Policy Paper "Cardiac Arrest or Dizzy Spell: Why is World Trade So Weak and What Can Policy Do About It?"
Source: OECD June 2016 Economic Outlook database; OECD STAN Bilateral Trade database; OECD calculations, and Pew Research Center.

Policy packages should make sure that the benefits of higher growth are shared broadly

Although most people in advanced economies still believe that trade and foreign investment are good for output growth, support for globalisation in advanced economies has weakened as median wages have stagnated in many countries in the past decade. Therefore, it is important to implement coherent and comprehensive policy packages that include measures to make sure that the benefits of trade and investment reforms are widely shared. In this sense, policy makers should improve and increase spending on active labour market policies to promote skill upgrading and matching, improve social safety nets to provide better support to workers during job transitions and avoid the risk of creating poverty traps, invest more in human capital and infrastructure, as well as promote competition among firms to underpin more robust competition for markets and workers.

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 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. Near-term developments are assessed using the OECD's short-term indicator models.