OECD ECONOMIC OUTLOOK

Preliminary Edition

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Summary of projections

	2007	2008	2009	2007	2008				2009				Fourth quarter		
				Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2007	2008	2009
								Per cent							
Real GDP growth															
United States	2.2	1.2	1.1	0.6	1.0	-0.5	0.7	0.2	1.0	1.4	2.2	3.0	2.5	0.3	1.9
Japan	2.1	1.7	1.5	2.6	3.3	1.1	1.0	1.3	1.6	1.6	1.7	1.7	1.5	1.7	1.6
Euro area	2.6	1.7	1.4	1.2	3.1	0.2	1.1	1.2	1.4	1.7	1.8	1.9	2.1	1.4	1.7
Total OECD	2.7	1.8	1.7	1.7	2.1	0.5	1.2	1.2	1.7	2.0	2.4	2.7	2.6	1.3	2.2
Inflation[1]															
United States	2.5	3.2	2.0	3.9	3.5	3.6	2.4	2.0	1.8	1.7	1.6	1.6	3.4	2.9	1.6
Japan	0.1	0.9	0.4	1.6	1.2	0.6	0.3	0.3	0.3	0.4	0.5	0.6	0.5	0.6	0.5
Euro area	2.1	3.4	2.4	4.8	4.2	3.3	2.6	2.4	2.3	2.2	2.1	2.0	2.9	3.1	2.1
Total OECD	2.2	3.0	2.1	3.5	3.4	3.2	2.5	2.3	2.0	1.9	1.8	1.8	2.8	2.8	1.9
Unemployment rate[2]															
United States	4.6	5.4	6.1	4.8	4.9	5.2	5.5	5.8	6.0	6.2	6.2	6.1	4.8	5.8	6.1
Japan	3.9	3.8	3.8	3.9	3.8	3.8	3.8	3.9	3.9	3.8	3.7	3.7	3.9	3.9	3.7
Euro area	7.4	7.2	7.4	7.1	7.1	7.2	7.2	7.3	7.4	7.4	7.5	7.5	7.1	7.3	7.5
Total OECD	5.6	5.7	6.0	5.5	5.6	5.7	5.7	5.9	6.0	6.0	6.0	6.0	5.5	5.9	6.0
World trade growth	7.1	6.3	6.6	4.8	6.5	6.1	6.1	6.3	6.6	6.9	7.0	7.1	7.2	6.2	6.9
Current account balance[3]															
United States	-5.3	-5.0	-4.4												
Japan	4.8	4.4	4.4												
Euro area	0.2	0.1	0.0												
Total OECD	-1.4	-1.3	-1.1												
Cyclically-adjusted fiscal balance[4]															
United States	-3.2	-5.2	-4.4												
Japan	-2.6	-1.6	-2.5												
Euro area	-0.7	-1.0	-0.8												
Total OECD	-2.0	-2.8	-2.5												
Short-term interest rate															
United States	5.3	2.7	3.1	5.0	3.2	2.6	2.6	2.5	2.3	2.6	3.4	4.0			
Japan	0.7	0.8	0.7	0.8	0.8	0.9	0.9	0.8	0.7	0.7	0.8	0.8			
Euro area	4.3	4.5	4.1	4.7	4.5	4.5	4.5	4.4	4.2	4.1	4.1	4.1			

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

Assumptions underlying the projections include:

- no change in actual and announced fiscal policies;
- unchanged exchange rates as from 13 May 2008; in particular 1$ = 104.44 yen and 0.64 €;

The cut-off date for other information used in the compilation of the projections is 23 May 2008.

1. USA; price index for personal consumption expenditure, Japan; consumer price index and the euro area; harmonised index of consumer prices.
2. Per cent of the labour force.
3. Per cent of GDP.
4. Per cent of potential GDP.

Source: OECD Economic Outlook 83 database.

EDITORIAL

AFTER THE STORM?

Several quarters of weak growth lie ahead for most OECD economies. At the same time, headline inflation could remain high for some time to come. This scenario is the combined outcome of financial market turmoil, cooling housing markets and sharply higher commodity prices. The projections in this *OECD Economic Outlook* carry both upside and downside risks and embody the following main features:

- US activity is essentially flat through 2008 and then picks up thereafter as housing adjustment ends, credit conditions normalise and the effects of past monetary ease are felt. With substantial capacity slack and under the assumption of unchanged commodity prices, inflation moderates significantly. Robust export growth, on the back of recent dollar depreciation, helps to narrow the external deficit to around 4½ per cent of GDP next year.

- Euro area activity is restrained through the current year by tighter credit, squeezed real incomes, lower export market growth and market share losses. Growth gradually recovers as these factors fade, though falling housing investment remains a drag throughout. Despite currency appreciation inflationary pressures are strong and, with capacity use moving just slightly below its normal level, it is only towards the end of the projection period that inflation reverts to 2%.

- Japan has been less directly affected by financial turmoil but growth is held back in the near term by slower export growth, weak household incomes and some hesitancy on the part of firms to invest. As growth regains momentum, inflation also gradually moves up to reach a rate around ½ per cent.

The current economic situation is particularly unsettled and the distribution of risk around the projections is wide. In this environment, economic policy in OECD countries needs to take into account the growing importance of developments in non-OECD economies; the influences of higher energy and credit costs on the supply side of OECD economies; the possibility of upward drift in inflation expectations; and the uncertainty as to the effects of financial market developments on growth and inflation.

Globalisation was an important driver of the economic cycle on the way up as non-OECD economies exported both cheap manufactured products and surplus saving, helping to keep OECD interest rates low and thereby boosting asset demand and prices. Currently, robust non-OECD growth is an important factor behind high commodity prices. And, going forward, continued rapid import growth in non-OECD countries will help to cushion activity in the OECD area. At the same time, buoyant non-OECD demand is leading to inflationary pressure in these countries and sustains tensions in commodity markets.

Macroeconomic policy setting, and in particular monetary policy, in OECD countries needs to take into account that non-OECD countries are likely to be an important source of demand at the same time as they are likely to be a less important source of disinflation than previously.

Macroeconomic policy is also faced with a more hazy picture of OECD economies' supply capacity than previously. Both globalisation and structural reform have boosted potential growth rates in the past and will hopefully continue to do so. But sharply higher energy prices and higher costs of capital as a result of financial market developments could sap potential growth. The chapter on supply side uncertainties in this *Economic Outlook* provides some illustrative calculations of these effects. While such quantifications are inherently uncertain, macroeconomic policy needs to be alert to the possibility that capacity limits could be tighter than posited.

Signs that inflation expectations could be drifting up also call for caution. Well-anchored inflation expectations are a crucial policy asset earned, in many cases, through painful disinflation in past decades. Confidence in price stability can be enhanced through various institutional arrangements coupled with careful communication but the ultimate confidence-enhancing measure is to actually deliver.

Financial market influences on growth remain hard to gauge. The odds have improved that financial market dislocation has passed its peak, but this is far from a foregone conclusion. And even if true, the effects on growth are likely to linger. Uncertainty is compounded by the likely feed-back from a weaker growth environment on financial markets and by the fact that problems at financial institutions can be resolved in different ways. In this regard, it is desirable for capital deficiency to be addressed through the injection of new capital and asset disposal rather than through credit compression. While a slower than projected normalisation of financial markets cannot be excluded, nor can a more rapid restoration, especially if improved confidence were to create a positive feed-back between financial asset prices and institutions' balance sheets. Central banks need to stand ready to deal with both eventualities.

Apart from dealing with the fall-out on demand from current financial market distress, it will be necessary to re-visit the prudential and supervisory framework for financial markets. The Financial Stability Forum has recently provided directions for change in these areas and efforts towards implementation are in some cases already underway. It will be important to carry through with the required reforms, also when the memory of recent turmoil becomes more distant and those subject to tighter regulation more likely to resist. At the same time, regulatory overkill needs to be avoided. Many recent innovations in financial markets have the capacity to improve welfare, when appropriately harnessed.

It also needs to be considered whether and how the tendency for financial markets to generate cycles can best be addressed. This may involve both regulatory initiatives to attempt to damp inherent cyclicality as well as a reconsideration of monetary policy conduct. Dynamic provisioning and reserve requirements are some of the instruments that may help smooth credit cycles and increase resilience of the financial sector but they are not without drawbacks. Concerning monetary policy, it may not be desirable nor feasible to prick bubbles, but greater symmetry in the response to credit booms and busts may be useful.

As regards fiscal policy, the United States has introduced temporary tax rebates that seem to be appropriately timed and targeted and therefore stand a good chance of providing needed support to activity. The issue of fiscal stimulus has also been broached for other OECD regions but, in general, the case for such initiatives is weak. Inflation pressures in the euro area are such that any stimulus might have to be offset by monetary policy and, in any case, automatic fiscal stabilisers are much stronger than in the United States. In Japan, the fiscal situation does not allow fiscal expansion and the economy is anyway less directly affected by financial turmoil than other OECD countries.

Much higher food and energy prices are leading to demands for offsetting policy action. Such demands ought to be resisted. Only by allowing the right price signals to affect demand and supply can better balance be established in these markets. Concerns for living standards among those on low incomes are better addressed through an appropriately designed tax and social transfer system.

Overall, OECD economies have been hit by strong gales over the recent past and it will take time and well-judged policies to get back on course. Nonetheless, it is a tribute to the effects of past structural reform and well-honed macro-policy frameworks that the effects of this near-perfect storm have not been worse. This underlines the need to persevere with such policies.

28 May 2008

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CHAPTER 1

GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

Overview

Growth is slowing in response to strong headwinds

The odds are improving that financial market turmoil has passed its peak. Still, its fallout will continue to act as a brake on growth for considerable time to come. Other headwinds causing the on-going slowdown in activity in the OECD area are likely to continue, including cooling housing markets and high commodity prices. Weakness has been most marked in the United States. However, despite buoyancy during the first quarter of 2008 in Japan and Germany, the slowdown is set to generalise across virtually all OECD economies (Table 1.1). There is also some slowdown outside the OECD area, albeit partly induced by policies aimed at restraining inflation.

Table 1.1. **Growth is slowing sharply**

OECD area, unless noted otherwise

	Average 1995-2004	2005	2006	2007	2008	2009	2007 q4	2008 q4	2009 q4
	Per cent								
Real GDP growth[1]	2.7	2.7	3.1	2.7	1.8	1.7	2.6	1.3	2.2
United States	3.1	3.1	2.9	2.2	1.2	1.1	2.5	0.3	1.9
Euro area	2.2	1.7	2.9	2.6	1.7	1.4	2.1	1.4	1.7
Japan	1.1	1.9	2.4	2.1	1.7	1.5	1.5	1.7	1.6
Output gap[2]	-0.3	-0.3	0.2	0.4	-0.3	-1.1			
Unemployment rate[3]	6.6	6.5	6.0	5.6	5.7	6.0	5.5	5.9	6.0
Inflation[4]	3.5	2.2	2.3	2.2	3.0	2.1	2.8	2.8	1.9
Fiscal balance[5]	-2.3	-3.0	-1.5	-1.5	-2.5	-2.6			

1. Year-on-year increase; last three columns show the increase over a year earlier.
2. Per cent of potential GDP.
3. Per cent of labour force.
4. Private consumption deflator. Year-on-year increase; last 3 columns show the increase over a year earlier.
5. Per cent of GDP.

Source: OECD Economic Outlook 83 database.

A generalised but not uniform slowdown

Area-wide growth, after reaching a trough of ½ per cent (annualised) in the second quarter, the lowest since the slump following the high-tech bubble, is projected to remain weak through the rest of this year. This aggregate picture masks considerable divergence in growth across countries. Indicative of such divergences, at the end of 2007 the United States, the euro area and Japan were all estimated to be running at capacity, but by the end of 2009, output will have fallen more than 2% below potential in the United States, ¾ per cent below in the euro area and remain slightly above potential in Japan. Other economies which will be among the hardest hit, judged by how far activity is below potential output, include: those most directly affected by financial turmoil, notably Iceland; those where housing downturns are most pronounced, especially Ireland and Spain; the United Kingdom which may be more vulnerable because of the importance of financial markets and links between financial turmoil, the mortgage market and spending by households; those with closest ties to the United States, in particular Canada and Mexico; and those starting from a weak position, notably Italy. Growth in the emerging markets, while moderating, remains strong, especially in China.

Financial turmoil implies risks on both sides

Continued turbulence in financial markets has spread to new markets and institutions, reaching beyond the origin of the problems with the US subprime mortgages and derived products and leading to a generalised wariness and re-pricing of risk. Recent signs suggest that conditions in some financial markets are improving, but further financial disruption cannot be excluded, with causality likely to flow in both directions between weak activity and financial pressures. While the resulting activity risks imply a fat downside tail to the probability distribution around the projection, there are also upside risks associated with a faster dissipation of financial turmoil. Overall, the projection is best characterised as a most likely outcome.

A pick-up in inflation expectations may inhibit policy stimulus

The case for macroeconomic policy stimulus has been stronger in the United States than in Europe or Japan and both US monetary and fiscal policy have already acted forcefully. Going forward, the scope for policy support to decelerating activity depends on inflation developments. Soaring oil, food and other commodity prices have led to a sustained pickup in headline inflation rates and increases in producer price inflation suggest further impending cost pressures. In these circumstances, a ratcheting up of inflation expectations remains a potent threat.

Policy rates should remain on hold in the major regions this year

Against this background, in the United States the current accommodative monetary policy stance should be maintained until the recovery takes hold, with the policy easing being reversed promptly once financial headwinds abate. By contrast, policy rates in the euro area are currently close to neutral, and the outlook for activity and inflation, together with the presence of strong automatic fiscal stabilisers and the disappearance of past exceptional budget revenue, do not point to a need for stimulus. In Japan, output is projected to remain above potential but, even so, underlying inflation is moving into positive territory at a very slow pace suggesting that policy rates should stay put for some time to come.

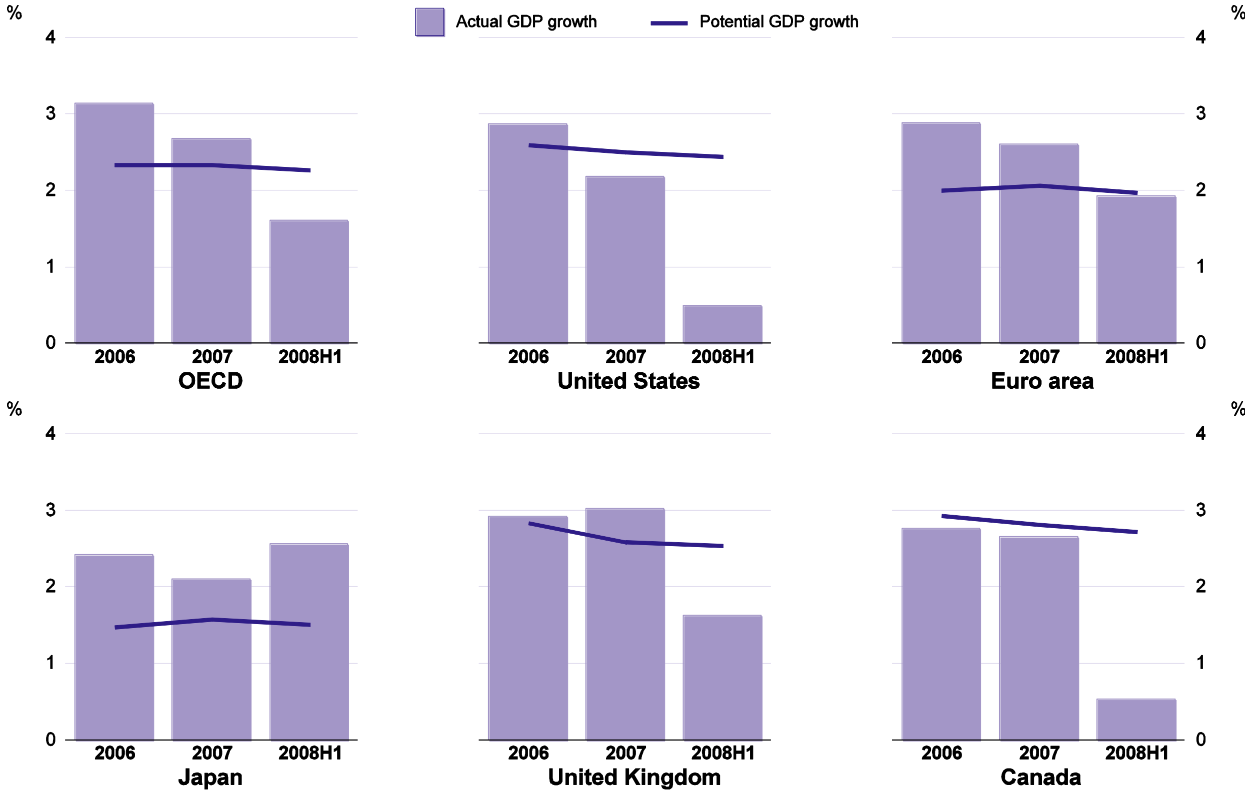
Recent developments

Growth is now slowing in the OECD area

The US slowdown has broadened

Activity has decelerated in a highly differentiated manner across most of the OECD area (Figure 1.1). The US economy has been very weak and growth might be negative in the second quarter of the year. The housing market remains massively oversupplied, with residential construction continuing to plunge at steep rates and house prices declining. Private consumption weakened significantly in the first part of 2008 as high inflation, driven by gasoline and food prices, reduces consumers' purchasing power, tighter credit begins to bite and falling house prices weighed on households' wealth and collateral. Business investment, which began decelerating last year, declined in the first quarter of 2008, reflecting the weakening of actual and prospective demand. By contrast, exports have remained relatively strong, benefitting from dollar depreciation and hitherto strong world trade growth. This, together with subdued imports, has led to a significant fall in the US current account deficit to just below 5% of GDP by the end of 2007, down from 6½ per cent in the middle of 2006.

Figure 1.1. A generalised, but differentiated, slowdown



Note: The value for 2008H1 is based on an annualised growth rate between 2007H2 and 2008H1 and is partly estimated.

Source: OECD Economic Outlook 83 database.

The euro area has been relatively resilient

Activity in the euro area has held up well to date, with growth in the first quarter picking up to an annualised rate of 3% due to surprising strength in Germany and, to a lesser extent, France. However, much of the positive surprise in Germany may reflect temporary factors,[1] implying a "pay-back" subtraction from growth in the second quarter. Private consumption in the euro area continues to be sluggish in the face of rising inflation, driven by strong increases in energy and food prices. Over the past year, robust business investment and exports -- which were particularly strong in Germany -- have partly compensated for this weakness. However, there are increasing signs that the appreciation of the euro -- up by some 10% in real effective terms since the beginning of 2006 -- is damping export growth. Residential construction investment is falling, reflecting large corrections in a few countries, notably in Spain and Ireland, together with a continued slowing in most others.

Growth in Japan has moderated

In Japan, GDP grew at an underlying rate of some 2% last year, about ½ percentage point above potential and advanced strongly in the first quarter of this year as well. Recent strength reflects a rebound in housing investment after the disruption caused by the regulatory change introduced in the middle of last year as well a continuation of rapid export growth. However, business investment, which has been the other engine of growth in recent years, fell in the first quarter and softening business confidence and survey evidence point to further near term weakness. At the same time, rising gasoline and food prices will moderate the growth of private consumption.

China has continued to grow strongly…

Growth in major emerging market economies has continued to be brisk. In China the economy slowed to a still robust year-on-year growth rate of 10½ per cent in the first quarter of 2008. The contribution of exports continues to diminish and that of domestic demand to increase. Headline consumer price inflation remains high at above 8% in the first quarter. While sharp increases in food prices continue to be the main driver of headline inflation, upstream pricing pressures remain elevated with producer prices having accelerated in aggregate and across a broad range of industry segments. In response, the central bank has continued policy tightening, lifting interest rates and sterilising foreign exchange inflows *via* increased reserve ratios for commercial banks and bond issuance. Since the second half of last year, there has been a more rapid appreciation of the renminbi *vis-à-vis* the dollar, although in effective terms the appreciation has been much more modest.

… as have other emerging economies

Growth in India slackened by about 2 percentage points during 2007 to 8½ per cent year-on-year in the final quarter. At the same time, inflationary pressures have re-emerged. Growth in Russia accelerated in 2007 on the back of strong increases in investment and consumption, to slightly above 8% for the year. In Brazil, GDP growth firmed to 5½ per cent in 2007, the fastest pace of expansion since 2004, driven by continued strength in private consumption and a rebound in investment.

1 . The annualised growth rate in Germany in the first quarter was more than 6%, the highest in more than a decade, supported primarily by gross fixed capital formation and a significant contribution from stockbuilding. Part of this exceptional growth reflects temporary factors; in addition to the unusually large contribution from stockbuilding, construction activity was strong reflecting unusually mild weather conditions and the surge in business investment may be partly due to an overhang of orders placed last year to take advantage of generous depreciation allowances which have now expired.

Labour markets are softening

Employment has declined sharply in the United States

As activity has weakened, employment growth in the OECD area has slowed (Table 1.2). The slowdown has been most marked in the United States where private payroll employment has fallen since the end of last year at a pace which in the past has signalled the onset of a recession. As a consequence the unemployment rate has risen to around the estimated structural rate of 5%, while several indicators are pointing to easing wage pressure (Table 1.3).

Table 1.2. **Labour markets have begun to weaken**

	2005	2006	2007	2007 q3	2007 q4	2008 q1	2008 q2
	Percentage change from previous period, seasonally adjusted at annual rates						
Employment							
United States	1.8	1.9	1.1	0.3	0.7	-0.6	-0.2
Japan	0.4	0.4	0.5	-1.5	0.9	-0.3	-0.2
Euro area	1.1	1.6	1.8	1.8	1.2	1.3	0.2
Labour force							
United States	1.3	1.4	1.1	1.0	1.2	0.0	0.9
Japan	0.1	0.1	0.2	-1.7	1.3	-0.7	0.0
Euro area	1.1	0.9	0.9	1.2	0.6	0.9	0.7
Unemployment rate	Per cent of labour force						
United States	5.1	4.6	4.6	4.7	4.8	4.9	5.2
Japan	4.4	4.1	3.9	3.8	3.9	3.8	3.8
Euro area	8.8	8.2	7.4	7.3	7.1	7.1	7.2

Note: For 2008, estimates and projections.
Source: OECD Economic Outlook 83 database.

Labour markets remain tight in the euro area…

In the euro area the slowdown in employment growth is more recent and more moderate, so that the unemployment rate remains at its lowest level since at least the beginning of the 1990s, below the OECD's estimate of its structural level. Productivity growth has weakened further, leading to some pick-up in unit labour costs which going into 2008 were increasing at about 2% *per annum* (Table 1.3). While this pick-up is a feature of most euro area countries there are significant differences between them; in Germany the rate of increase is still well below the average, France is close to the average, while Italy and Spain are well above it. Moreover, weak productivity growth has allowed little room for increases in euro area real compensation per employee over the past five years, helping to explain both weak consumption and rising inflationary pressures.

... and in Japan where there are encouraging signs of wage growth

Employment creation has also continued in Japan, although on a slowing trajectory, with the unemployment rate stabilising close to the lowest level in a decade. In the past, falling hourly compensation and unit labour costs have been a feature of Japan's deflationary trap. However, wages for full-time workers increased in early 2008 as a consequence of a tight labour market and because the shift towards lower-paid non-regular employment, which reduces wage costs, appears to have slowed.

Table 1.3. **Wage developments remain moderate**

	2005	2006	2007	2007 q3	2007 q4	2008 q1	2008 q2
	Percentage change from previous year						
Labour productivity[1]							
United States	1.5	1.1	1.3	2.0	2.0	2.3	1.5
Japan	1.5	2.0	1.6	1.6	1.2	1.0	2.3
Euro area	0.6	1.3	0.8	0.7	0.3	0.5	0.6
Compensation per employee							
United States	3.5	4.0	4.4	5.0	3.8	3.3	3.8
Japan	0.1	0.2	-0.6	-0.8	-1.0	0.6	1.1
Euro area	1.5	2.2	2.3	2.2	2.3	2.2	2.8
Real compensation per employee[2]							
United States	0.3	0.8	1.7	2.5	1.2	1.2	2.1
Japan	1.4	1.1	0.1	-0.2	0.3	2.1	2.5
Euro area	-0.4	0.3	0.1	0.0	0.1	-0.1	0.5
Unit labour cost							
United States	2.2	3.0	3.3	3.0	2.2	1.3	2.6
Japan	-1.1	-0.8	-1.8	-1.9	-1.5	-0.5	-0.6
Euro area	1.1	1.1	1.7	1.6	2.3	2.0	2.4

Note: For the total economy, year-on-year increase; last 4 columns show the increase over a year earlier. For 2008, estimates and projections.

1. Productivity is measured on a per person basis.
2. Deflated by the GDP deflator.

Source: OECD Economic Outlook 83 database.

Forces shaping the outlook and associated risks

OECD economies face a triple adverse shock as globalisation evolves

OECD economies are facing three adverse shocks which are reducing demand: financial turmoil, a downturn in the global housing cycle, and a squeeze on real incomes from soaring energy and food prices.[2] At the same time higher commodity prices are putting upward pressure on headline inflation, while higher oil prices and increases in the cost of capital resulting from the financial turmoil may be durably curtailing potential supply (Chapter 3). These three shocks are inextricably linked to the growing importance of emerging markets in the global economy. Most obviously, the increased demand for commodities from these countries has led to soaring prices. In addition, the credit, housing and asset price cycle which has now turned was fuelled by low interest rates on the back of both the so-called global savings glut, to which emerging economies contributed importantly, and imported disinflation, as a result of penetration by cheap manufactured products.

2. To provide some rough estimates of how the major OECD economies would respond to these and other shocks, Appendix 1.A1 presents some ready reckoners based on the OECD's new Global Model.

Financial turmoil has deepened

Banks have been hit hard by the crisis

The turmoil that hit financial markets in the summer of 2007 has many features similar to previous credit crises (Reinhart and Rogoff, 2008), with a distinguishing characteristic this time around being the complexity and opaqueness of the financial assets involved. As in several previous crises, the most visibly affected institutions have been banks and, in the United States and elsewhere, many have already reported sizeable write-downs and credit losses linked directly or indirectly to the troubled subprime mortgage market, amounting so far to about $380 billion.[3] Banks are also being affected by an involuntary expansion of their balance sheets,[4] while the share of risky assets they are holding has increased.

How balance sheets are repaired has growth implications

The problems that banks are encountering are playing a key role in the transmission of the crisis both to other financial institutions and to the real side of the economy. Going forward, much will depend on the manner in which bank balance sheets are restructured. In this respect, large-scale recapitalisation, or the transfer of assets to other agents, offers the best way to quickly restore the functioning of loan markets. Raising new capital has not been easy in a market where equity prices of financial institutions have been falling (Figure 1.2) and earlier high profile recapitalisations have entailed large losses for investors, including some sovereign wealth funds.[5] This could

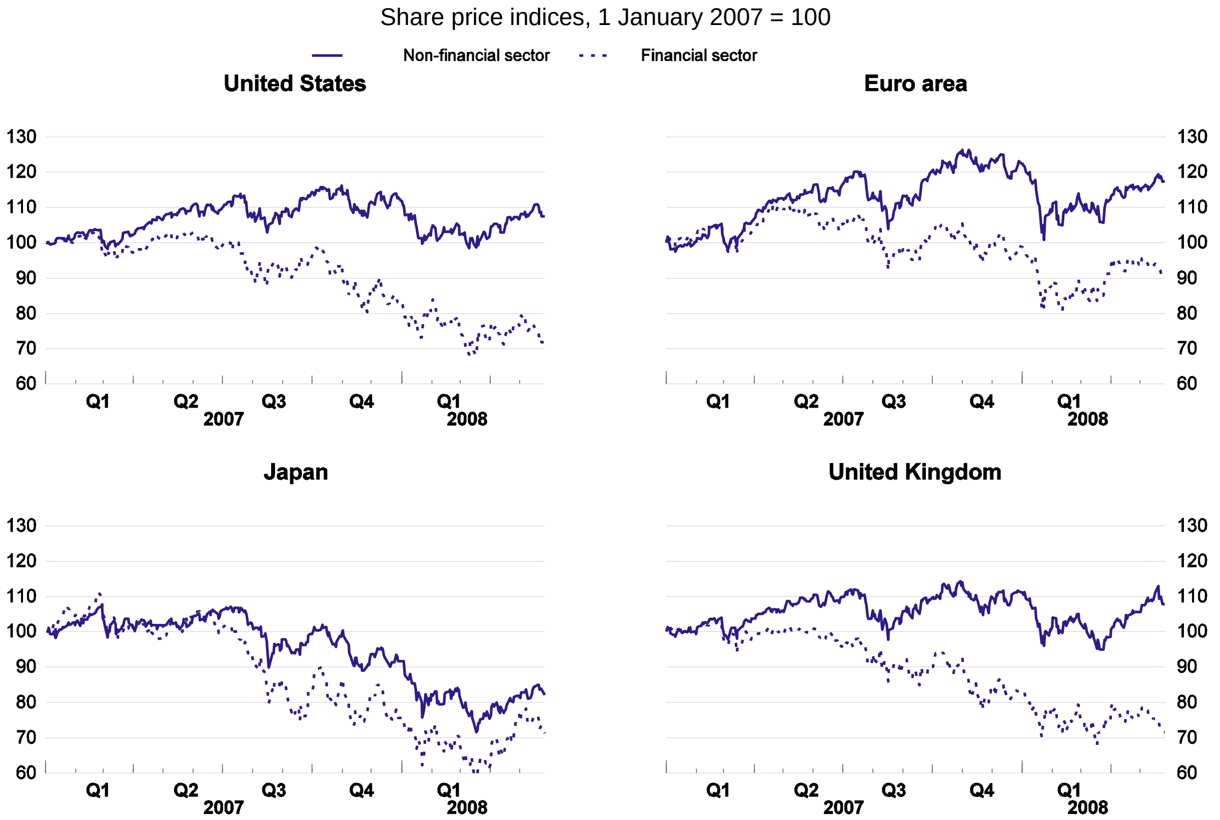
3 . The estimate of reported credit losses and write-downs is based on recent data (19 May) from Bloomberg for more than 100 of the world's largest banks and securities firms. Some of these write-downs are based on mark-to-market values that may overestimate the fall in asset prices. Indeed, as pointed out for instance by the Bank of England (2008a), because of illiquidity, thin markets and the confidence crisis, current market prices have become unreliable predictors of potential losses and are likely to lead to over-estimations. OECD estimates of the total credit losses associated with residential mortgage backed securities range from $350 to $420 billion, although not all of the losses are in banks and security firms (Blundell-Wignall, 2008). Instead of market prices, these estimates rely on a default model approach and assume a 40% to 50% recovery rate on defaulting loans and an economic and house price scenario benchmarked against previous episodes. This price scenario implies, however, a smaller fall in house prices than the one assumed in this *Economic Outlook*, suggesting that total losses could be possibly higher unless the recovery rate on defaulting loans turns out to be better than expected. This estimate is nevertheless close to that by Greenlaw *et al.* (2008). It is much lower than the estimates in IMF (2008) that not only partly relies on market prices, but also includes possible losses on a wide range of other assets.

4 . This is being driven by: *(i)* the need to take back previously off-balance-sheet structured investment vehicles (SIVs); *(ii)* previous over optimism with respect to warehousing of assets for future securisation; and *(iii)* the requirement to honour credit lines. This has been less the case in the euro area where securitisation had not reached the same level as in the United States and where banks have been able to continue to securitize loans to households and non-financial corporations. On the other hand, bank balance sheets show a clear acceleration of loans to other financial institutions reflecting notably the drawing on credit lines by conduits and SIVs (ECB, 2008).

5 . Sovereign wealth funds (SWFs) have made an important contribution to the ongoing recapitalisation of banks, illustrating the important role they can play in economic development and stability in the host as well as home country. Nevertheless, more generally held perceptions that SWF investments might be motivated by political rather than commercial objectives may be a concern, which can most effectively be tackled by the home countries of SWFs taking steps to strengthen transparency and governance of the SWFs. At the same time, recipient countries should in turn avoid protectionist barriers to foreign investment and discrimination between investors (OECD, 2008b).

change, however, once perceptions are in place that share prices have hit bottom though existing shareholders may be reluctant to accept dilution of their stake at rock-bottom prices. As concerns the transfer of assets, a number of recent transactions have allowed banks to sell off some of their loan-book. But such transfers remain limited to a few institutions and proposals to create an *ad hoc* structure to park bad assets, financed either by private or public money, have not succeeded.

Figure 1.2. Share prices of financial institutions have fallen sharply



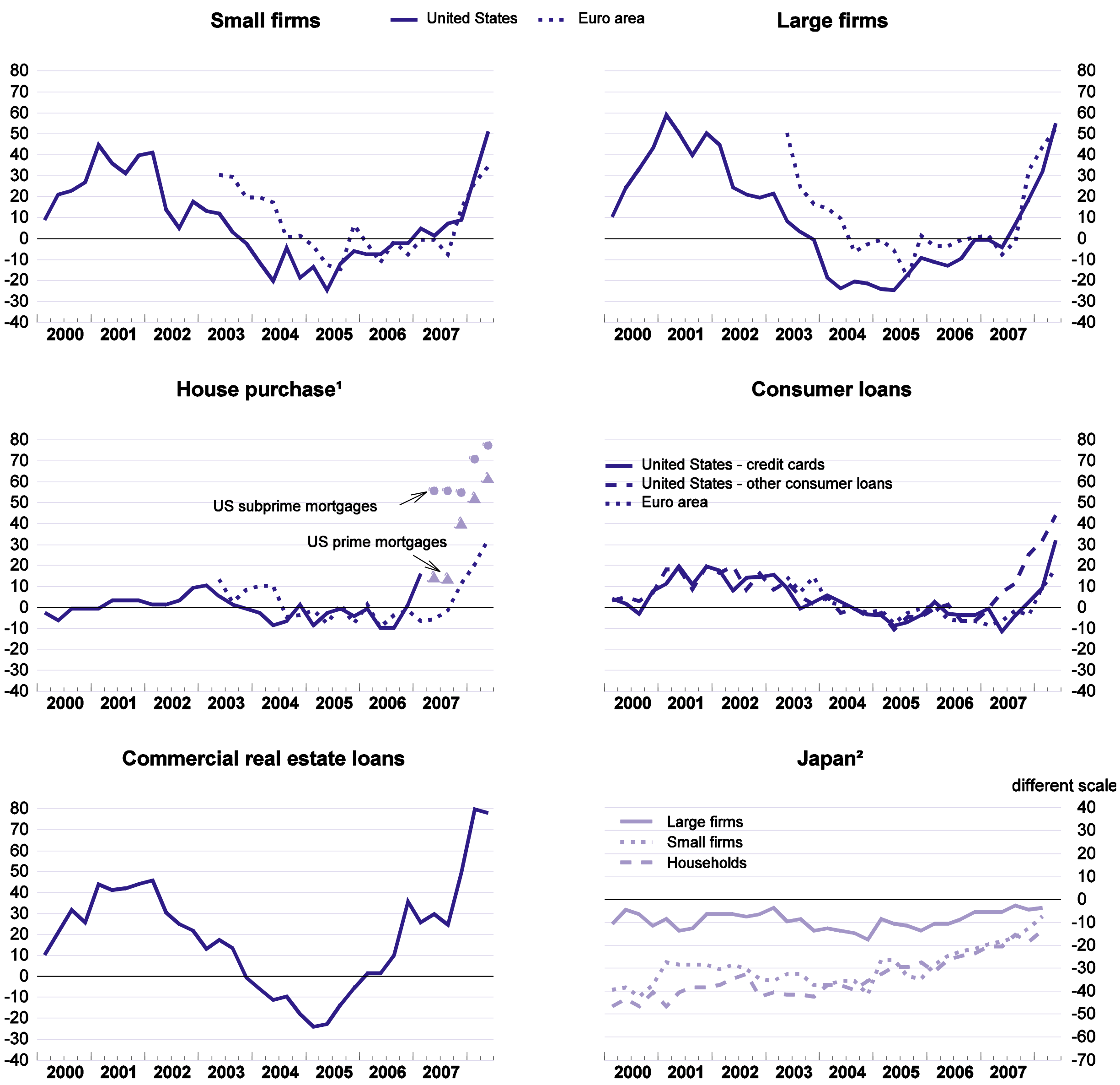
Source:Datastream.

Credit to other financial institutions is being cut

The other option is to shrink balance sheets by reducing lending, which can have negative spillover effects to other areas of the economy, and in turn may trigger additional losses in the financial sector. Indeed, commercial banks in the United States and Europe have been tightening lending standards to both households and businesses (Figure 1.3) and the effects are evident in a number of market segments, including loans to other financial institutions, like hedge funds. These institutions, which are often highly leveraged, have been forced to sell assets into illiquid markets to either meet margin calls or restore targeted leverage ratios, further weakening prices and amplifying the deleveraging process (Greenlaw *et al.*, 2008).

Figure 1.3. Banks are tightening lending standards

Net percentage of banks tightening credit



1. In the United States, starting in 2007q2 changes in standards for prime, non conventional (not displayed on this figure) and subprime mortgage loans are reported separately.

2. The Bank of Japan publishes a diffusion index of 'accommodative' minus 'severe'. The data have then been transformed to show the net percentage of banks tightening credit, as for the United States and the euro area.

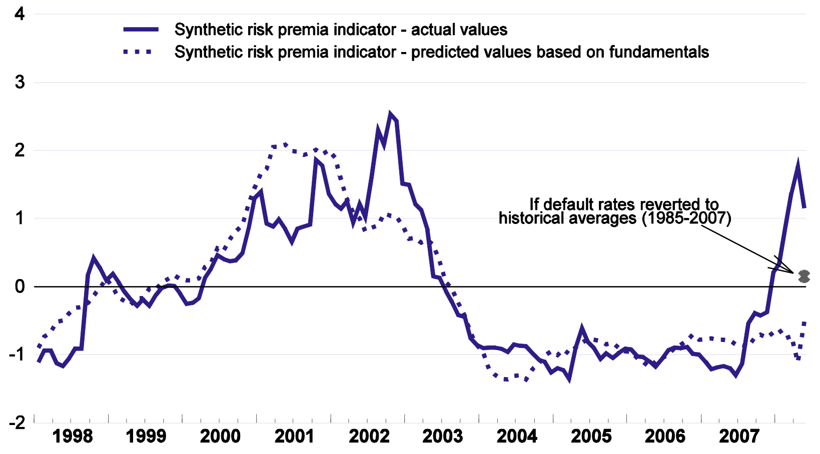
Source: US Federal Reserve, Senior Loan Officer Survey; ECB, The euro area bank lending survey; and Bank of Japan, Senior Loan Officer Opinion Survey.

As growth weakens financial tensions are spreading

The re-pricing of risks has spread from opaque securitised products to other assets classes, including traditional bonds and equities. At the same time, government bonds in the major OECD countries have benefitted from a flight to quality, though this effect has diminished more recently in line with greater optimism that turmoil is being contained. The OECD synthetic indicator of corporate and emerging market bond risk premia has increased sharply since the autumn of 2007, to a level that cannot be accounted for by actual default rates, nor by a return of these rates to their historical norms (Figure 1.4). Hence, current prices seem not only to reflect the unwinding of the under-pricing of risk that prevailed before the turmoil but also the anticipation of much weaker growth and a corresponding surge in defaults as well as some possible overshooting. This reflects an on-going shift in the causal links between financial markets and the economy at large. Until recently, the causality has been mainly from financial strains to activity; it has now started to operate in both directions, at least in the United States, creating negative feedback effects and possibly prolonging the headwinds from financial dislocation.

Figure 1.4. Risk premia have risen sharply

Deviation from average (in standard deviations of synthetic risk premia indicator[1])



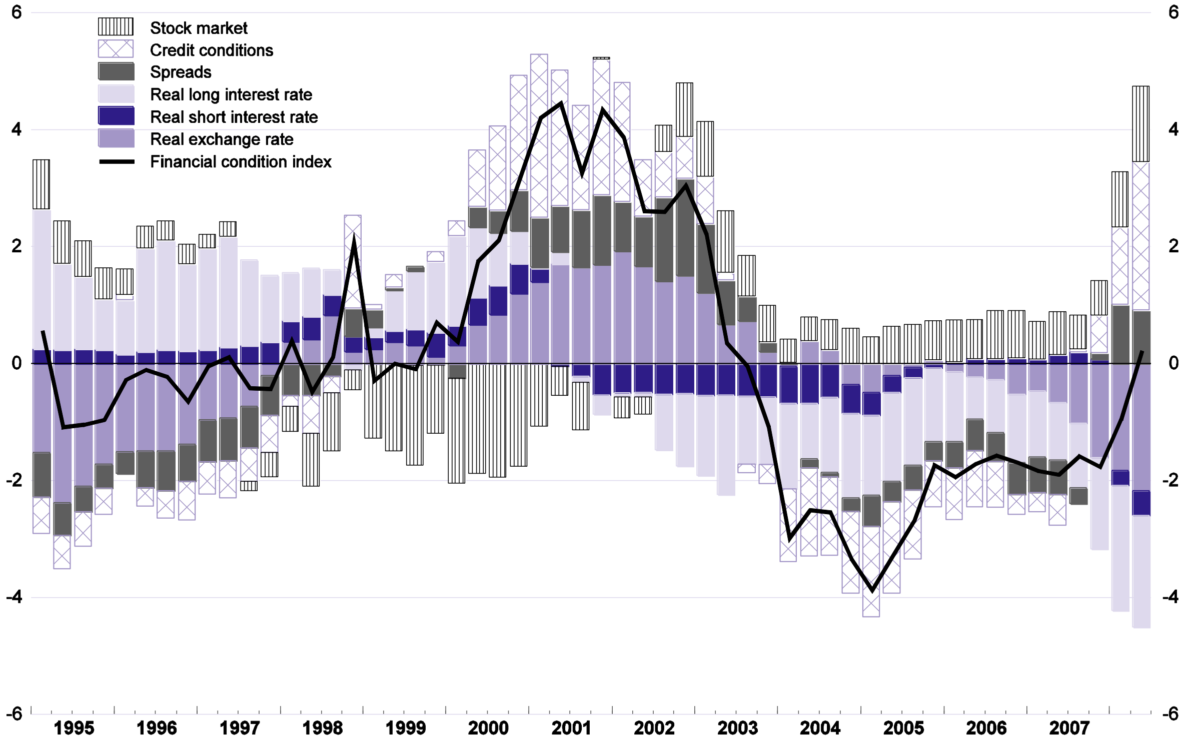
1. The synthetic measure is derived from risk proxies for corporate and emerging market bonds. In regression analysis, it seems to be well explained by a set of 'fundamentals' including global short-term interest rates and liquidity, corporate default rates and the OECD's leading economic indicators, a proxy for expectations of the near-term outlook for the OECD cyclical position. The 'predicted' values shown are the model predictions. See OECD (2006a).

Source:Datastream; and OECD calculations.

Overall financial market conditions are tight

The fallout from the turmoil is weighing on US growth via several channels. In an attempt to synthesise their effect on growth, a broad indicator of financial conditions has been constructed (Figure 1.5). The index comprises short- and long-term real interest rates on government paper, the effective real exchange rate as well as a measure of non-price credit tightening, bond market spreads and stock prices. On this indicator, financial conditions have tightened significantly since summer 2007 despite lower real short- and long-term

Figure 1.5. US financial conditions have tightened despite depreciation and monetary easing



Note: A unit increase in the index corresponds to an effect on GDP equivalent to an increase in real long-term interest rates of 1 percentage point. When necessary underlying variables for 2008Q2 have been projected in line with the other financial variables in this publication (Appendix 1.A2 for more details).

Source: OECD calculations (Appendix 1.A2).

interest rates and the real effective depreciation of the dollar. The overall negative impact on GDP implied by the tightening of the index to date would be slightly above 1% (for details of these calculations and the uncertainty surrounding them, see Table 1.14 in Appendix 1.A2).[6]

The turmoil is also weighing on activity elsewhere

In the euro area and the United Kingdom, write-downs and expected further losses appear much lower than in the United States, but banks have on average smaller capital cushions than in the United States and are also facing involuntary re-intermediation. Credit standards have already been tightened. In these economies, any restraints on the supply of bank and other types of credit could have a more significant impact on activity as firms rely more heavily on external financing than in the United States. However, with better growth

6. Other partial estimates of the impact of the deleveraging process on US activity (without considering second-round or wealth effects) range from 1 to 2% of GDP (Greenlaw *et al.*, 2008; Goldman Sachs, 2008; Roubini, 2008). These estimates depend on several key assumptions on the magnitude of the housing price correction, the extent of mortgage defaults and foreclosures, the defaults in other sectors such as commercial mortgages and credit card debt, the banks' exposure to those markets, their provisions, their ability to attract new capital, the expected adjustment in leverage and the type of assets on which deleveraging will weigh more.

prospects, there is less risk of major negative feedback effects taking hold in the euro area. So far, credit to non-financial corporations has continued to grow at a high pace although credit to households, notably for house purchases, has decelerated. The United Kingdom, where the housing sector has started to adjust, may experience more pronounced effects. Japan's banking sector and financial system has so far remained relatively unscathed by the turmoil. On the other hand, banks' credit default spreads have increased dramatically in Iceland, where banks' foreign branches have become so big in relation to the size of the economy (bank assets are nine times GDP) that serious doubts have emerged about the capacity of the Icelandic central bank to act as a lender of last resort to these banks. This has prompted the authorities to sharply increase their official foreign exchange reserves, including through currency-swap agreements with other Nordic central banks leading to some narrowing of credit default spreads.

Emerging markets are also affected

Financial markets in emerging economies have so far not been overly affected by the turmoil compared with past financial crises. Several of these countries have solid current account positions (with a number benefitting from high and rising commodity prices) while banks are to a large extent well capitalised and funded by domestic deposits. Signs of strains have, however, emerged in a few countries where private foreign currency denominated and/or public debt is high, the banking sectors are either not well capitalised or tend to be more dependent on wholesale funding in capital markets, and current account deficits are high. There is still a risk that a major financial crisis affecting one country would lead to a more generalised reassessment of emerging market risk.

Financial authorities have acted on several fronts

Faced with the risk of negative feedback effects becoming very destructive to both the financial system and growth, the financial authorities in several of the main OECD countries have taken actions. These have included steps to address the malfunctioning of key money and credit markets (Box 1.1) and, in some countries, containing systemic risks by organising rescues to prevent the failure of troubled institutions. The US authorities are also acting directly in the mortgage market by facilitating loan modifications and loosening capital requirements for government sponsored enterprises so that they can buy more mortgage-backed securities, while a number of other initiatives are pending. Finally, the cuts in US policy rates are having ancillary supportive effects by lowering the cost of resets for subprime loans, mitigating the impact of rising spreads on risky short term bonds, and by supporting banks' lending margins.

There are signs that the situation is stabilising

Likely reflecting some of these measures, signs have emerged that the situation for banks has improved. Apart from being able to sell off part of their loan portfolios, financial institutions have seen equity prices at least stabilising while the prices of credit default swaps have declined, pointing to some improvement in counterparty risks.

Box 1.1. **Measures taken to improve the functioning of money markets**

The stress in money markets reflects a combination of liquidity hoarding and heightened counterparty risks and its advent has tested the limits and adequacy of the traditional response tools of several central banks. In the event, normal operating procedures were modified and new facilities introduced. While several of the most important changes in operations were made by the Fed, which faced both greater money market tensions and had at the outset a more limited set of tools at its disposal,[1] a number of other central banks also changed methods and procedures. The figure below plots a measure of market stress from prior to the start of the turmoil to the present; the dates when some of the more important initiatives were introduced are noted with bracketed numbers that are referenced in the text.

- At the outset, financial institutions struggled to obtain credit at normal maturities. In the case of the euro area, the European Central Bank (ECB) introduced in mid-August of last year the three month supplementary longer-term refinancing operations (LTROs) (1). These facilities were renewed as tensions persisted and their maturity was lengthened to six months in mid-March.

- At about the same time, the Fed increased the maturity of loans offered to banks at the discount window, while cutting the discount rate, which in effect narrowed the premium (or penalty) for such financing, from 100 basis points to 50 and finally to 25 (2). In March of this year, the maturity of repurchase agreements offered to primary dealers was also increased with the creation of a new repo facility with a 28-day maturity, the single-tranche Open Market Operation Program (OMOP) (3).

- With US banks remaining reluctant to use the discount window, the Fed created the Term Auction Facility (TAF) (4) in which the same wide range of collateral as at the discount window is accepted but banks are able to bid anonymously.

- In order to ease strains on mortgage-backed securities (MBS) markets, the Fed also created (11 March) the Term Securities Lending Facility (TSLF) (5) for primary dealers where a wide range of MBS type collateral is accepted. The list of eligible collateral was extended in May to high grade asset-backed securities. On 21 April, the Bank of England also launched a scheme to allow banks to swap temporarily their higher quality mortgage-backed and other securities for UK Treasury Bills.

- Following the Bear Stearns crisis, on 14 March the Fed also announced the creation of the Primary Dealer Credit Facility (PDCF) which allows it to lend directly to primary dealers against a broad range of collateral (6).

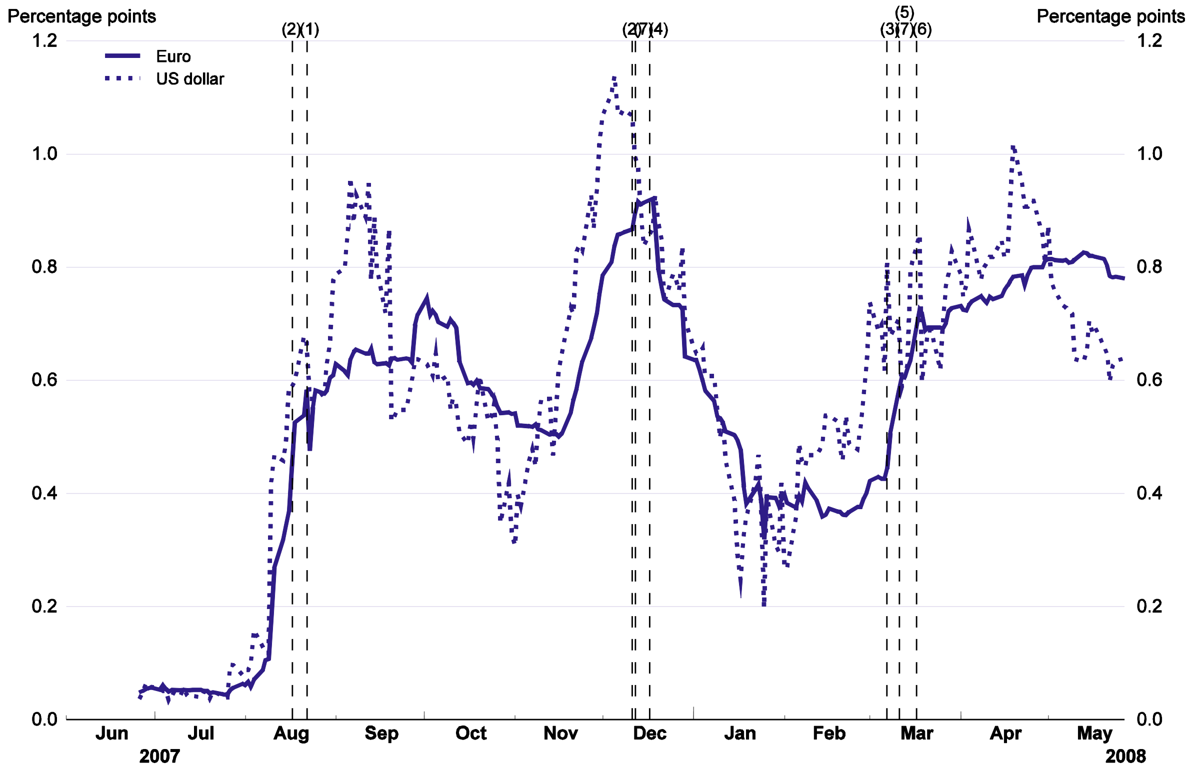
- Two coordinated actions (12 December 2007 and 11 March 2008 (7)) were conducted involving the Fed, the ECB, the Bank of England, the Bank of Canada and the Swiss National Bank aimed at easing strains in the interbank markets.

The purpose of these actions was to try to improve the functioning of these critical markets. In point of fact, these actions did not result in more liquidity being injected into the financial system. The total volume of refinancing operations has remained stable, with longer-term refinancing operations now accounting for about two thirds of the ECB's operations against less than a third before the turmoil. In the same way, the Fed's balance sheet has not expanded, rather the amount of securities held outright has been reduced by 30% as both repos and loans to both commercial banks (*via* the TAF) and primary dealers (*via* the PDCF) rose. While the implementation of exceptional and new procedures undoubtedly helped, money markets still remain under considerable stress. Central bank operations can do little to reduce counterparty risks that have arisen because of a lack of transparency and a need to recapitalise weak institutions; rather the purpose of these operations was to buy time while the price discovery process progresses and institutions strengthen their balance sheets. The temporary storage of unwanted MBS may also limit destructive price adjustments and help to initiate a slow revival of these markets. However, such moves by central banks have raised concerns about the amount of risk they are carrying on their balance sheets (Reinhart, 2008).

1. For a complete chronology of Fed actions as well of a detailed analysis of the Fed's new operations see Cecchetti (2008). Some of these changes put the Fed's operating procedures in line with other banks. In particular, the ECB and the Bank of Japan already accepted a wide range of collateral before the onslaught of the turmoil (Borio and Nelson, 2008).

Box 1.1. **Measures taken to improve liquidity conditions** (continued)

Money markets are still under stress



Note: Spread between three-month EURIBOR and EONIA three-month swap index for euro area; spread between three-month LIBOR and three-month overnight index swap for the United States. Numbers between brackets refer to the text.

Source: Datastream; and Bloomberg.

Further financial risks remain

Despite these encouraging signs financial headwinds are still likely to persist and in the projections shown here they are assumed to abate only during the first half of 2009. Over this period, further strains could arise from a number of sources, including: a more pronounced adjustment of housing prices and further mortgage-related losses; a severe adjustment in the US commercial real-estate market; or a longer than expected US recession that would in turn deepen financial market losses. The situation in vulnerable emerging markets could deteriorate if, for example, the foreign banks that have been important sources of credit in Eastern Europe curtailed financing.

Once financial turmoil abates the recovery may be rapid

There are also upside risks. The vicious circle of fire sales, falling asset prices, and the liquidity squeeze may come to an end earlier than expected. If so, financial conditions could rebound quickly and in a reversal of the previous situation, a positive feed-back loop between financial and real recoveries could start. In this event, where monetary policy has been eased sharply, it should be re-normalised quickly.

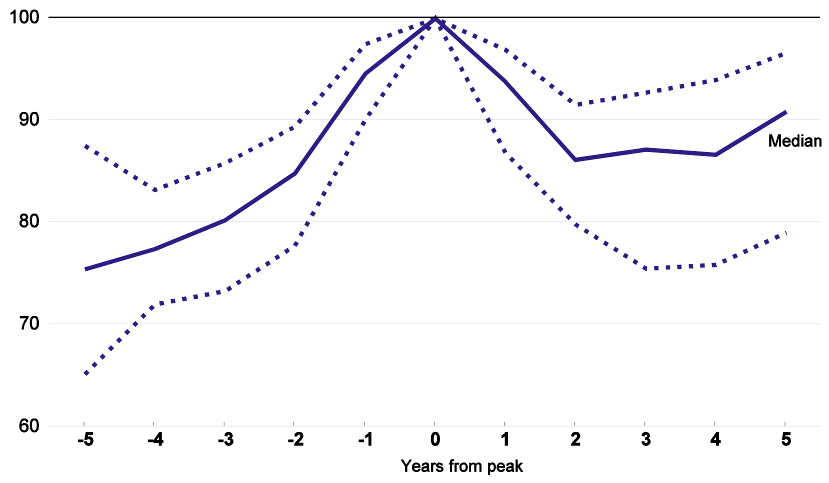
The downturn in the global housing cycle is gathering pace

Housing investment is contracting

During the upswing, the credit cycle and the housing cycle were related and so it is in the downswing. In 2006-07, two-thirds of OECD countries experienced a peak in housing investment as a share of GDP, relative to the previous ten years. Past episodes suggest that *per capita* housing investment typically falls by about 15% in the two years following a peak, although there is a wide range of different experiences and many of the most extreme downturns occurred after sharp increases in interest rates (Figure 1.6). The United States is clearly well underway in this adjustment process. In the euro area, housing investment, both as a share of GDP or in relation to population, peaked in the first half of 2007. Over the past year, housing investment has decelerated in the overwhelming majority of OECD countries and has fallen in at least one-third, although substantially only in the United States and Ireland (Figure 1.7).

Figure 1.6. Previous housing investment cycles in OECD countries

Residential investment per capita, index peak =100

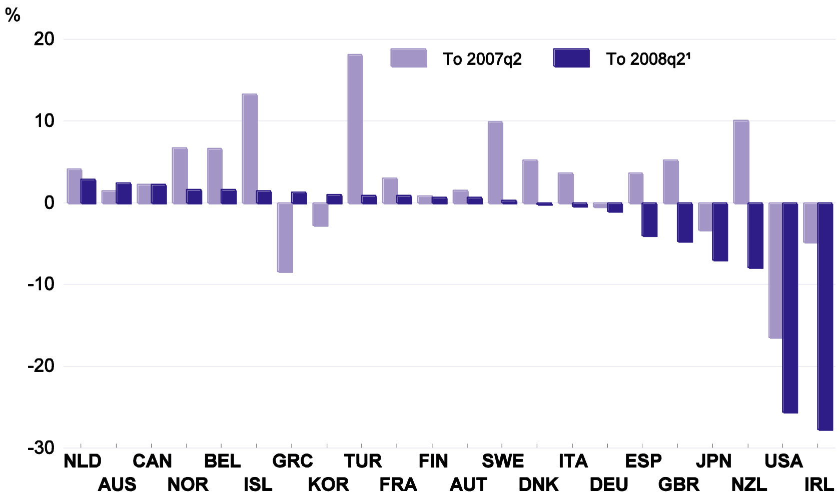


Note: Dotted lines show inter-quartile range (half of countries lie in this range).

Source: OECD Economic Outlook 83 database; and OECD calculations.

Figure 1.7. Real housing investment is decelerating in most countries

Year-on-year growth rate



1. Change in second quarter in 2008 is projected.

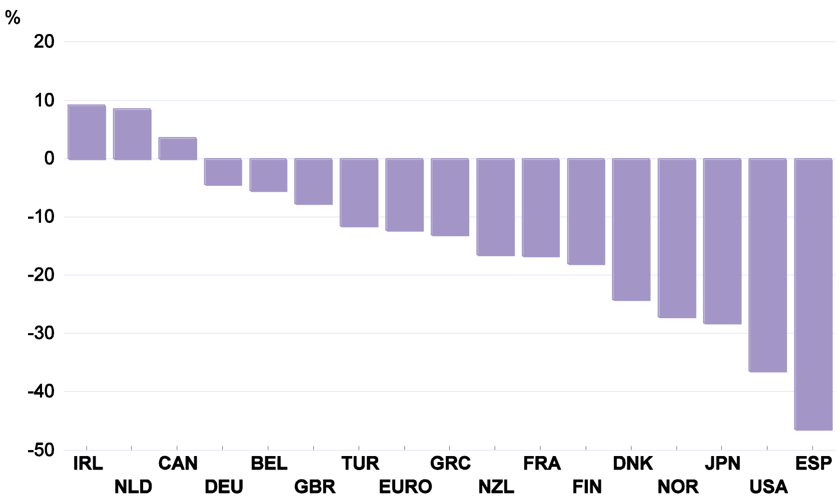
Source: OECD Economic Outlook 83 database.

Housing permits also indicate weak investment

Substantial drops in housing permits suggest that housing investment is likely to fall in many countries over the near term (Figure 1.8), although this indicator needs to be interpreted with care (Box 1.2). For the United States the continued decline in housing permits, as well as other advance indicators such as housing starts, is consistent with real housing investment continuing to fall substantially over coming quarters, and hence remain a major subtraction from GDP growth.

Figure 1.8. Residential permits are falling sharply

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



1. Monthly data mostly ending between December 2007 and March 2008; three-month average over the same three-month average in the previous year.

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

Box 1.2. **Housing permits as an advance indicator of housing investment**

Housing permits can be a useful leading indicator for housing investment, although the relationship is not such that a percentage change in permits translates into an equivalent percentage change in housing investment. This box reports empirical work to quantify the relationship between the two and uses recent permits data to examine which countries might experience a sharp fall in housing investment.

For each OECD country for which quarterly data is readily available, the change in (logged) residential investment was regressed on an intercept and up to four lags of the change in (logged) residential permits and up to four lagged dependent variables. Dummy variables were added for outliers. Where estimation over the full sample of available data led to failure of diagnostic tests, the sample estimation period was shortened. For a few countries (United Kingdom, Ireland, Korea and Netherlands) it is difficult to discern any simple stable historical relationship between residential investment and permits. For the 15 OECD countries for which data are readily available and it is possible to estimate a reasonable equation, the estimated long-run elasticity between building permits and residential investment is always well below unity; for some countries (United States, Canada, Belgium, New Zealand, Spain and Turkey) the elasticity is in the range 0.5–0.6, but for most other countries (Germany, Denmark, France, Greece, Japan, Norway and Sweden, as well as the euro area) the elasticity is in the range 0.15–0.3. Elasticities substantially less than unity can be explained by the fact that housing investment also covers expenditure on repairs, extensions which don't require permits as well as multi-dwelling housing. Full details of the estimated equations can be downloaded from the OECD internet site at: *www.oecd.org/eco/sources-and-methods*.

An additional one or two month's data on housing permits is typically available prior to the release of national accounts data on housing investment, although first releases of housing permit data may not always have full coverage which can bias the results in the direction of suggesting lower housing investment. The usefulness of permits as an advance indicator also depends on how far permits lead investment; for nearly all countries less than one-third of the long-run adjustment of investment to permits takes place in the same quarter.

Based on recent falls in housing permits (Figure 1.8) and the estimated relationships summarised here, there are a number of countries where housing investment growth may decelerate sharply; particularly Spain, Denmark and Finland, and to a lesser extent New Zealand, France and Turkey. In addition, housing investment in the United States is likely to continue to decline at a similar rate to that experienced recently, for at least a couple of quarters more.

There are exceptions to future weakness in housing investment

There are, however, some important exceptions to the general tendency for housing investment to act as a drag on future growth. Japan experienced a sharp fall in housing investment, down 27% in the second half of 2007, due to the poorly-prepared introduction of more stringent building regulations. However, following corrections of procedures and regulations, housing investment is recovering strongly, boosting growth in the near term. Germany never took part in the housing cycle and housing investment is historically low in relation to GDP and is unlikely to fall significantly in the near future.

Real house prices are falling in many countries

For all but a few of the OECD countries for which data is readily available, real house prices (deflated by the consumer price index) are clearly decelerating, and year-on-year real house prices are falling in about half of them (Table 1.4). In Germany and Japan real house prices have been falling modestly for a number of years (with no obvious tendency for this to become more pronounced), but in other countries real house prices have only begun falling within this past year and mostly within recent quarters.

Table 1.4. **Real house prices are slowing or falling**

	Per cent annual rate of change				Level relative to long-term average [1]		
	2000-2005	**2006**	**2007 [2]**	**Latest quarter [3]**	**Price-to-rent ratio**	**Price-to-income ratio**	**Lastest available quarter**
United States	5.6	4.6	-0.1	-4.0	126	107	Q1 2008
Japan	-4.6	-3.3	-0.8	-0.5	69	66	Q3 2007
Germany	-3.1	-1.8	-2.2	-3.0	71	64	Q4 2007
France	9.4	10.0	4.9	3.1	162	141	Q4 2007
Italy	6.5	4.1	2.9	3.3	128	117	Q3 2007
United Kingdom	9.8	3.9	8.4	4.0	171	148	Q1 2008
Canada	6.2	9.1	8.7	9.8	194	137	Q4 2007
Australia	7.8	4.1	8.7	9.1	181	149	Q1 2008
Denmark	5.7	19.4	2.7	-1.9	165	151	Q4 2007
Finland	4.0	8.4	5.5	0.7	151	106	Q1 2008
Ireland	7.9	10.5	-1.8	-5.4	127	127	Q4 2007
Netherlands	2.9	2.9	2.6	2.2	157	158	Q1 2008
Norway	4.5	10.7	11.5	-0.6	166	133	Q1 2008
New Zealand	9.7	6.9	8.3	4.3	163	155	Q4 2007
Spain	12.2	6.3	2.6	-1.1	197	154	Q1 2008
Sweden	6.0	10.5	8.4	8.8	166	126	Q4 2007
Switzerland	1.7	1.4	1.3	-2.0	84	76	Q1 2008
Euro area[4,5]	4.6	4.0	1.6	0.4	129	113	
Total of above countries[5]	4.2	3.6	1.6	-0.7	126	108	

Note: House prices deflated by the Consumer Price Index.
1. Long-term average = 100, latest quarter available.
2. Average of available quarters where full year is not yet complete.
3. Increase over a year earlier to the latest available quarter.
4. Germany, France, Italy, Spain. Finland, Ireland and the Netherlands.
5. Using 2000 GDP weights.

Source: Girouard et al. (2006).

US house prices will continue to fall…

The extent of the future fall in US house prices and its macroeconomic impact remains uncertain, particularly given that the rate of decline in house prices shows signs of accelerating.[7] The immediate prospect is for a continuation of falling house prices, at least through 2008, given the backlog of unsold properties on the market; the number of months' supply of existing single family homes at the current sales rate has risen from four to five months over the period 2000-06 to eleven months recently. The

7 . In the year to the first quarter of 2008 house prices fell by just over 3%, based on the price index produced by the Office for Federal Housing Enterprise Oversight (OFHEO), whereas the fall from the previous quarter, expressed at an annualised rate, was nearly 7%. The Case-Shiller US national house price index, which is more representative of houses purchased under different types of mortgage (including non-conventional ones) but less representative of houses purchased in rural areas, shows a more pronounced downturn, with house prices down by 14% in the year to the first quarter.

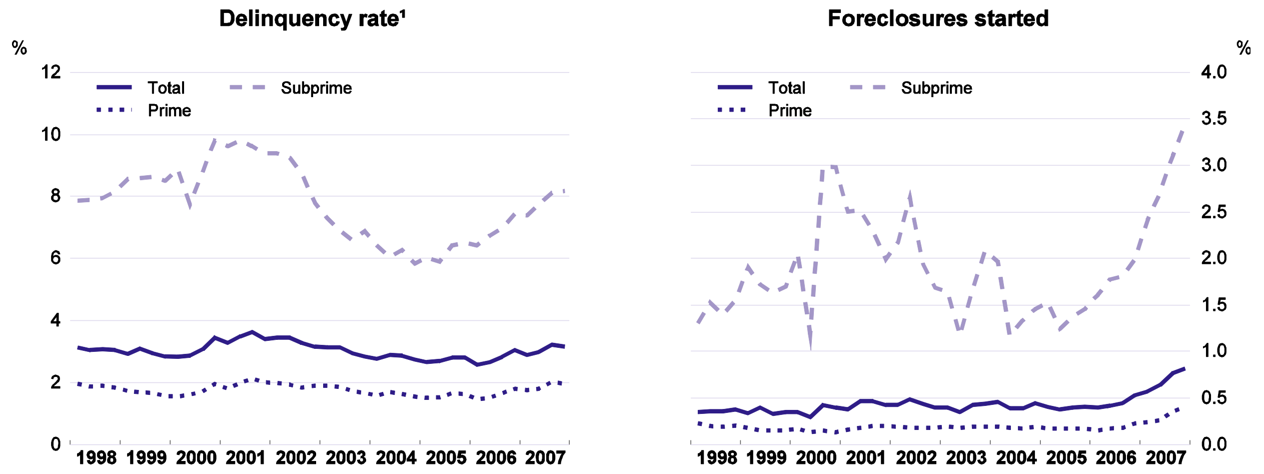
current projections incorporate a drop in nominal house prices (based on the OFHEO index) of 8% in the year to the end of 2008 and a further drop of 2% to the end of 2009.

… leading to higher foreclosures…

One reason for concern is that falling house prices are likely to boost delinquency and foreclosure rates (Figure 1.9) as the number of households with negative equity rises.[8] Indeed, there is some evidence to suggest that people have become more willing to default on mortgages (rather than credit cards or other forms of debt) than in the past. Falling property prices have also led to a pick-up in delinquency rates in the commercial property sector. These developments imply further bank losses and so risk exacerbating the credit crunch.

Figure 1.9. Delinquency and foreclosure rates are rising in the United States

Share of loans



1. Delinquent loans are those past due 30 days or more.

Source: Datastream.

... reducing consumption **via** ***wealth and collateral effects***

Falling house prices will drag down consumers' expenditure through a wealth effect. In relation to personal disposable income, housing wealth peaked at the end of 2006 while the estimated contribution it made to annualised growth in consumer's expenditure has declined from about ½ per cent in 2006 to about zero in the first quarter of 2008.[9] For every additional 10% fall in real estate wealth over the period to the end of 2009, annualised consumption growth might be reduced by about ½ percentage

8 . There may be a closer link between falling house prices and foreclosures in the United States than in the typical European country because of the "no recourse" nature of most mortgage loans. This means that, in the case of a default, if the value of the house is lower than the mortgage on it, the borrower is not liable for the difference. The borrower can walk away and send the keys to the bank (so called "jingle mail"). Even when the creditor may have recourse, the costs involved may sometimes be prohibitive.

9 . These calculations assume a steady decline in house prices until the end of 2009 and a marginal propensity to consume out of increased housing wealth of 3½ per cent (the magnitude of the effect incorporated in the Fed's FRB/US model) which is realised over the following eight quarters.

point during 2009. More controversially, some estimates suggest that the hit to consumption would be twice as large through a collateral effect as through a conventional wealth effect,[10] with housing serving as collateral for relatively cheap borrowing to finance consumption.

Some other countries are vulnerable to falling house prices

Other countries are also vulnerable to a major fall in house prices, particularly given that the rise in house prices in the United States since 2000, or their level in relation to income, does not appear exceptional in international comparison (Table 1.4 above). A number of factors have driven up the fundamental level of house prices in relation to income in many OECD countries, particularly low nominal and real interest rates and the liberalisation of mortgage finance. Beyond that, high inflation countries in the euro area, notably Ireland and Spain, stand out for having experienced, like the United States, a period of particularly low interest rates in the first half of this decade: in both Ireland and Spain average house price growth in the ten years to 2006 was in double digits and the highest in the OECD. Rapidly growing house prices fostered expectations of continuing capital gains, as for example evidenced by a booming buy-to-let market,[11] which led to some over-shooting of fundamentals. A correction of house prices is also now underway in the United Kingdom,[12] in part because much of the expansion in the mortgage market in recent years has been through banks which relied on the wholesale market for funds and which have been most adversely affected by the financial turmoil (such as Northern Rock).

House prices have a bigger effects will differ

The macroeconomic effects of any house price correction are likely to be larger among those countries where mortgage markets are more complete and so facilitate equity withdrawal. These countries -- the United States, United Kingdom, Canada, Australia and some Nordic countries -- also tend to be those where consumption is most strongly correlated with house prices (Catte *et al.*, 2004). However, among this group, falling house prices are only expected in the United States, United Kingdom and possibly Denmark.

Sharply rising commodity prices are fuelling concerns about inflation

Commodity prices have reached record highs

Oil prices have continued to trend up since the beginning of the year, recently exceeding $130 per barrel for Brent. Prices increased by less but are still at record levels if measured in terms of an international currency basket (SDRs) or in euros (Figure 1.10, upper panel). At the same time, the

10 . Muellbauer (2007) estimates a marginal effect from housing collateral which is about twice the size of the wealth effect incorporated in the FRB/US model, although this also depends on the state of the mortgage market.

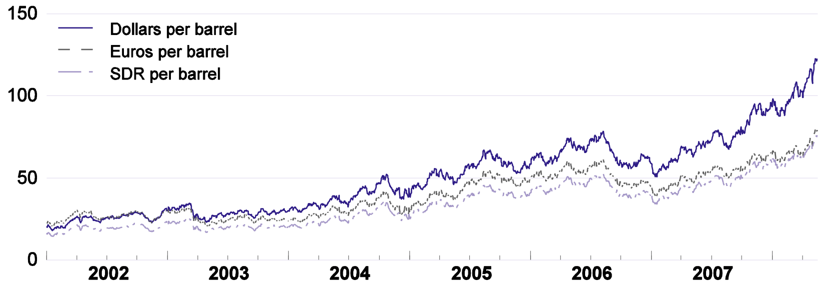
11 . In 2006 investors purchased 37% of new properties and 20% of second-hand properties in Ireland, whereas private landlords only account for 7% of the total stock of dwellings.

12 . The United Kingdom is one of the countries where analysis presented in previous *OECD Economic Outlooks* suggested that house prices are most at risk of a sharp correction. On the other hand, housing investment has not increased greatly as a share of GDP, mainly because of planning restrictions.

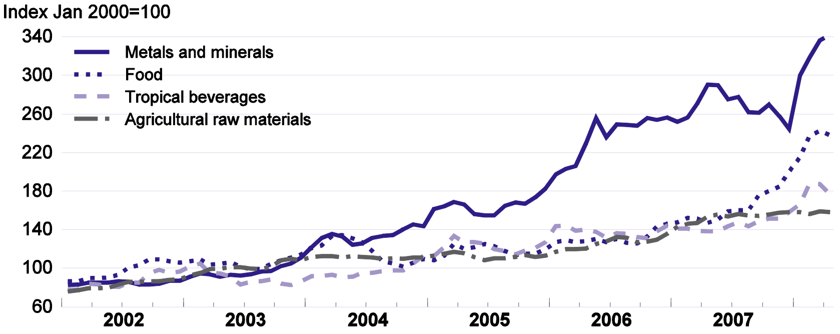
prices of a number of key commodities have also risen, in some cases also breaching previous records and, in the case of food, sparking social concerns in a number of primarily developing countries (Figure 1.10, lower panel).

Figure 1.10. Commodity prices hover at new heights

Brent crude



Food and metal prices



Source: Datastream; HWWI; IMF, Exchange Rates data; OECD Economic Outlook 83 database.

Oil demand has softened in the OECD area…

Oil demand in the OECD area levelled off in the first half of the decade and even fell over the past two years despite strong economic growth, with the fall in oil intensity of production accelerating (Figure 1.11). While the mild winter conditions account for part of the slackening in demand, steep price increases since the early years of the decade have been biting as well.[13]

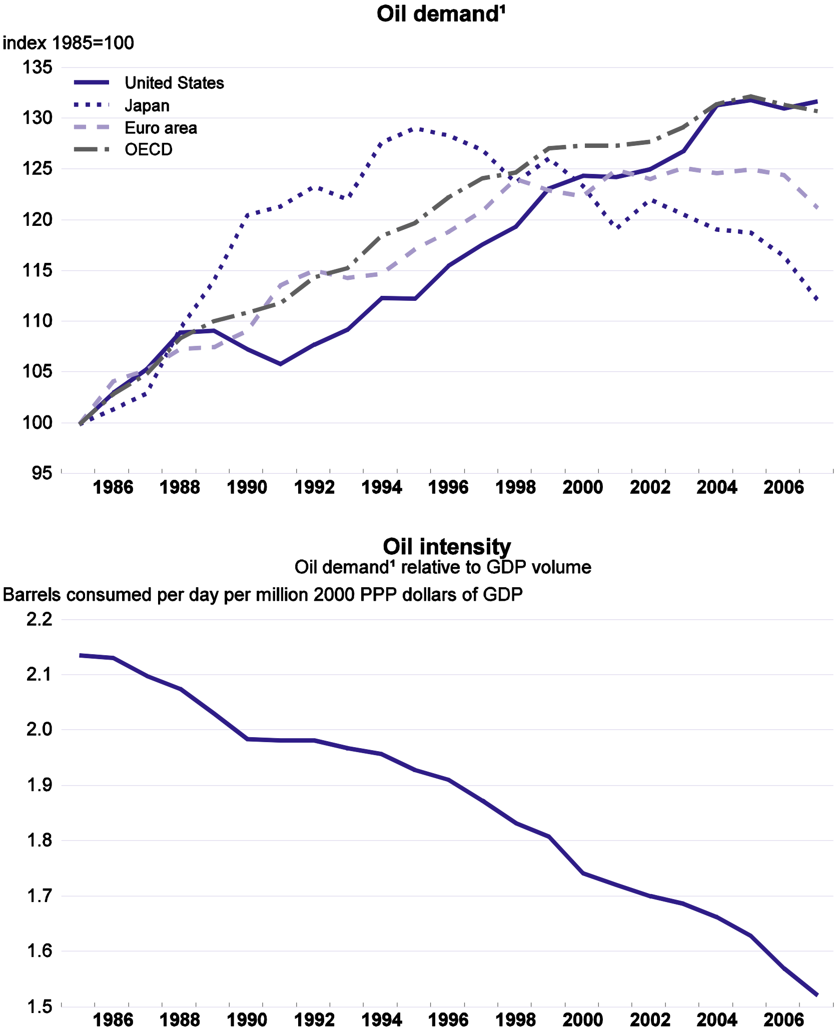
… but not elsewhere and prices are likely to remain high

A number of factors are working to offset the slackening in OECD demand and thereby boost prices, particularly high economic growth in emerging markets, where fuel consumption is often subsidised or where price regulation (as in China) prevents the pass through to end-users. At the same time, indications are that the growth of overall supply will also be

13. In particular, inter-fuel substitution has significantly contributed to the weakening in oil demand outside the transport sector, notably by switching from oil to natural gas in electricity generation. Estimates by the International Energy Agency (IEA) suggest that the long-run crude oil price elasticities with the OECD area are up to five times higher than annual elasticities. The difference between the short- and long-term elasticities is even larger for most regions outside the OECD (IEA, 2006).

subdued. There may also be a speculative element to recent oil price rises.[14] The central scenario considered here is based on the technical assumption that oil prices stabilise at a level of $120 per barrel, but given limits to short-term production capacity, demand or supply shocks could easily translate into high price volatility.

Figure 1.11. Oil demand in the OECD area



1. Oil demand: deliveries from refineries and primary stocks.

Source:IEA; and OECD Economic Outlook 83 database.

Other commodity prices have also risen steeply

In the first quarter of 2008, metal prices rebounded steeply from the declines seen between spring and the end of 2007. Buoyant demand, notably from China, and delays in extending production capacity have underpinned recent price hikes. Prices for food commodities and agricultural raw materials accelerated into 2008, reflecting expanding food

14 . Some (weak) evidence for this is the marked increase in net long positions of non-commercial traders in oil futures and options markets witnessed since the end of 2007.

demand in emerging markets and developing countries, rising energy costs, adverse weather conditions and increased use of crops for bio-fuel production and some elements of overshooting in a situation of low stocks and government interventions leading to segmentation of world markets. Going forward it is assumed that all non-oil commodity prices stabilise at around current high levels in nominal terms.

To date the OECD area has weathered these rising prices…

So far, OECD economies have weathered the rise in oil and commodity prices well. For oil, this reflects the marked reduction in oil intensity of production over past decades, better anchored inflation expectations and compensating increases in external demand. OECD exports will continue to benefit from the re-spending of buoyant revenues by oil producers, although with important differences across economies; the euro area in general -- and Germany in particular -- tends to benefit more than the United States and Japan (Box 1.3). At the same time, commodity exporting OECD countries (notably Canada, Australia, Norway and Mexico) have benefitted directly from rising prices.

... but they are putting pressure on inflation…

Food and energy account for about 15 to 20% and 5 to 10%, respectively, of consumer spending in major OECD countries and their rising prices have put upward pressure on consumer price inflation. As a result, headline inflation has risen above core inflation. This difference has been trending upwards over the past decade or more but has recently widened markedly (Figure 1.12).

… while disinflation from globalisation is diminishing

The sharp rise in commodity prices is part of the background to concern that the net disinflationary effect of globalisation may be diminishing rather more quickly than previously thought. In the past, the upward pressure on OECD inflation from higher global commodity prices is estimated to have been more than offset by the increasing penetration of manufactured goods with low and declining prices from developing economies in Asia (OECD, 2006b; Pain *et al.*, 2007). However, over the year to April the price of US imports from China has risen by about 4%, compared with an average fall over the previous three years of about ¾ per cent *per annum*. Moreover, penetration of Chinese imports into the United States has stopped increasing. It is, however, too early to judge whether this represents a permanent break; for one thing rising Chinese import prices may be due to the faster depreciation of the dollar. Moreover, it appears that Chinese imports are still pushing prices down in the euro area (import prices from China have been more or less flat over the past two years but their penetration of euro area markets has been increasing).

International imbalances are narrowing

In the wake of the turmoil exchange rates are adjusting

The ongoing financial turmoil has been accompanied by a period of more rapid adjustments in exchange rates (Figure 1.13). The dollar's depreciation *vis-à-vis* various OECD currencies has been large, particularly

Box 1.3. **The respending of oil revenues in OECD economies**

External demand by oil producers (here OPEC, Russia and Norway) has become a major force behind the growth of OECD area exports and this box examines a number of aspects related to this issue. Since 2002, when oil prices started to trend up, significantly boosting oil producers' revenues, exports of merchandised goods by the OECD area to these economies have increase by 170% (figure, top panel). Of the OECD areas' additional payments for oil imports (accumulated between 2002 and 2007) about half has returned in the form of additional exports to these oil producers. This average figure, however, masks considerable differences in the strength of respending across countries. For Germany, the additional amounts spent on imports of oil were fully matched by additional exports to these economies, whereas for the euro area on average the additional exports amounted to about two thirds of the additional oil bill (figure, middle panel). At the lower end, such respending totalled some 30% for the United States and about 20% for Japan. Despite these lower respending rates, for both countries the percentage increase over the period in exports to oil producers was roughly in line with the OECD average (figure, top panel), reflecting the fact that US and Japanese exports to oil producers were relatively small to begin with. In recent quarters, exports of the United States to these oil producers have increased steeply, which likely reflects a substitution effect in favour of US goods due to the effective depreciation of the dollar.

An important question is whether the respending relationship at an aggregate level has changed over this period of sharply rising prices from already high levels, possibly because producers would not immediately treat the associated gains in revenues as permanent, preferring instead to save a larger fraction than normal. However, based on regression analysis, in which exports from OECD countries to oil producers are related to oil producers' revenues, no significant evidence could be found that during the current period of rising oil prices the oil producers' propensity to respend their revenues in terms of imports from the OECD area differs from average respending patterns observed in the past. Oil price volatility might adversely affect respending in that it increases the oil exporters' revenues uncertainty. However, the statistical evidence for such a relationship is weak and not all measures of oil price volatility have increased recently.[1]

Regarding the timing of respending, vector auto-regression (VAR) analysis[2] suggests that the largest part of the oil exporters' demand for OECD area goods and services materialises within the first year after a revenue hike (figure, bottom panel). For the United States, respending is estimated to be essentially completed within the first year, suggesting that respending effects on the US current account balance in the wake of recent oil price hikes will be realised fairly quickly, assuming no further price increases. For the euro area significant respending effects will still be evident in the second year after a hike in oil-producers' revenues and for Japan in the second and third years. The estimates also suggest that on average the oil producers respond to a 1% hike in their export revenues by increasing imports from the OECD area by a bit over ½ per cent.

---

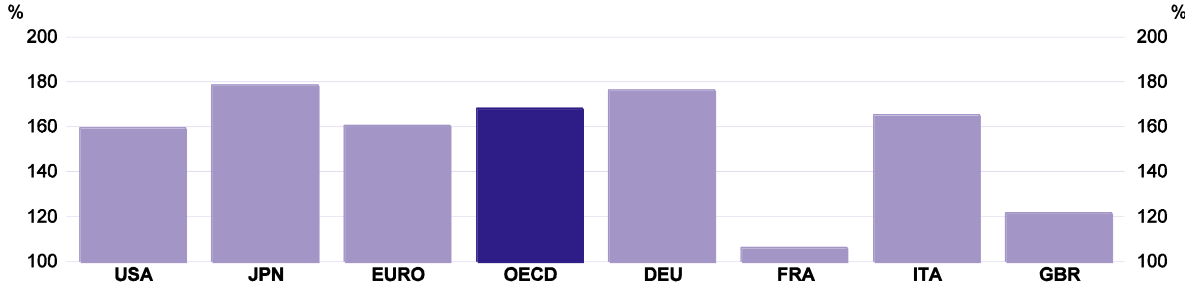
1. A series of simple error correction equations were estimated where oil exporters' imports were a function of their merchandise exports to the OECD (a rough measure of the oil exporters' export revenues), lagged oil producers' imports and different time-varying measures of oil price volatility. In all specifications, the volatility measure entered with a negative sign. However, only for one measure of volatility (the coefficient of variation of oil price changes calculated over the previous quarter) was the coefficient statistically different from zero at the 10% level. Moreover the coefficient of variation measure has not risen in the present episode of rising oil prices.

2. Bivariate VARs were estimated using monthly growth rates of oil producers' merchandise exports to the OECD and imports from different OECD economies (the OECD as a whole, the United States, Japan and the euro area) from 1993 to 2007. The estimated size of the response to an export shock varied across different OECD economies. However for various lag lengths for the models with imports from the OECD, a substantial majority of the response to the shock occurred within one year and the estimated medium-term response to the shock was broadly similar to the effect obtained from specifications with different lag lengths.

Box 1.3. **The respending of oil revenues in OECD economies** (continued)

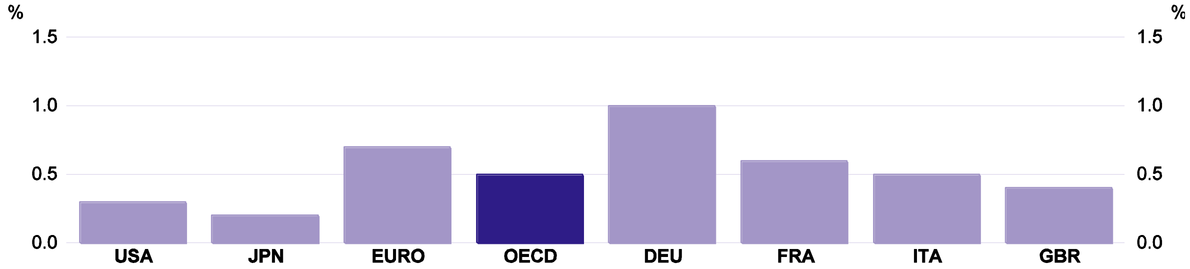
Trade with oil producers

Increase in exports to oil producers[1], 2002-07

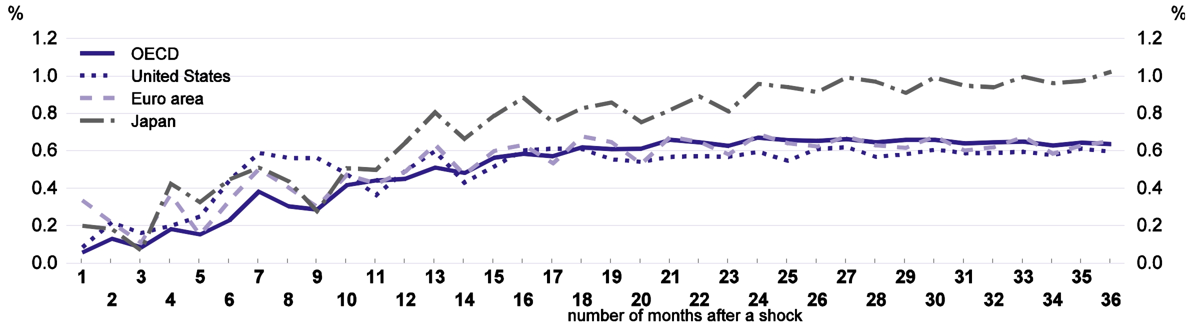


Respending rates by oil producers[1]

Additional exports to oil producers per additional imports from oil producers[1], accumulated 2002-07



Accumulated response of oil producers' import to one per cent shock to exports to OECD



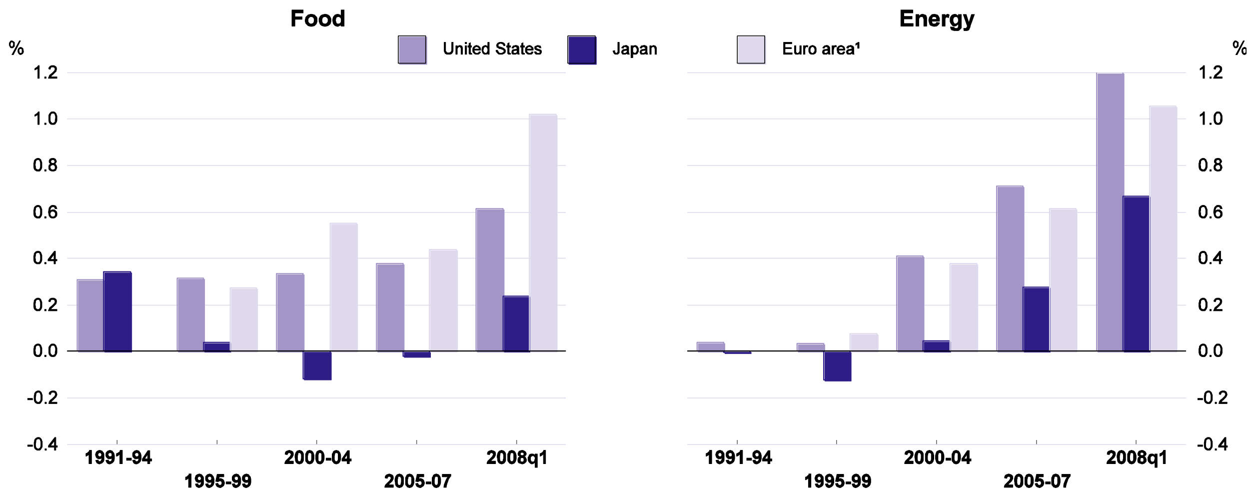
1. Oil producers: OPEC, Russia and Norway.

Source: OECD, Monthly Statistics of International Trade; and OECD calculations.

against those economies currently enjoying either relatively better cyclical positions or improvements in their terms of trade. Against currencies of emerging market economies, the adjustment has been significantly less, in part because of policies of several (notably China and a number of oil-exporting economies whose share in OECD trade is important) to maintain, to varying degrees, pegged exchange rates *vis-à-vis* the dollar.[15]

Figure 1.12. Contributions to headline consumer price inflation

Contribution to annual inflation rates



1. Euro area data reported from 1996.

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

The US trade deficit has declined

Changes in relative demand conditions coupled with shifts in real effective exchange rates, are projected to outweigh the effect of higher oil prices and so contribute to a reduction in the US trade deficit to 4¼ per cent of GDP in 2009, which would be its lowest level since 2002. Rough empirical estimates suggest that most of this improvement will be cyclical, although recent real exchange rate adjustments, to the extent they are not reversed, will make a more permanent contribution (Box 1.4).

The US investment income surplus may not persist

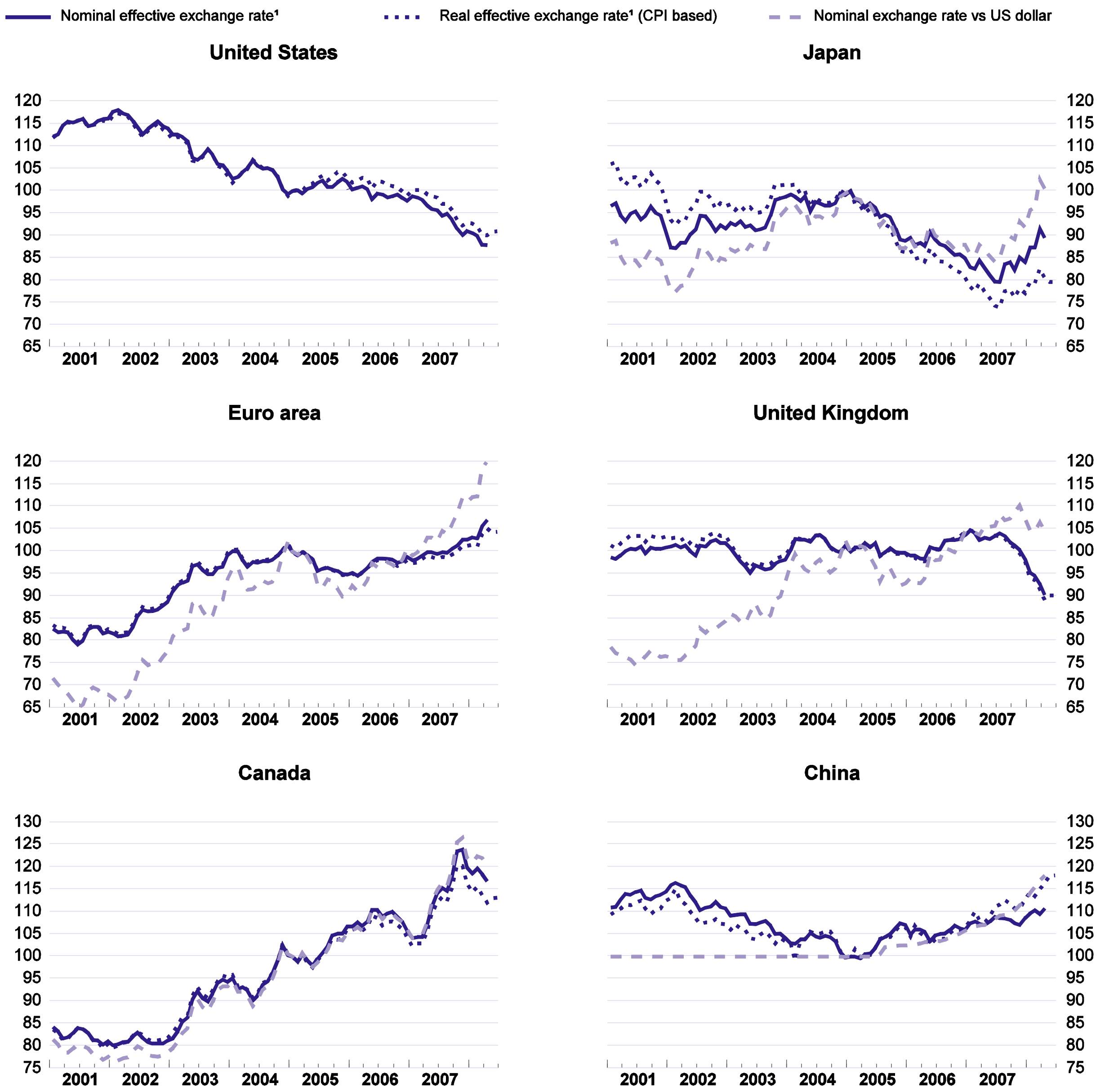
The net investment income surplus of the US current account has risen to about ¾ per cent of GDP from an average level of about half that over the period since 2000 as a result, not least, of valuation changes related to the depreciation of the dollar.[16] The continuing surplus on US net investment income, despite the relentless rise in US net foreign indebtedness, implies that foreigners have continuously suffered lower *ex post* returns on their holdings of US liabilities relative to what US residents have realised on their foreign asset positions. Recent empirical evidence suggests that part of the observed *ex post* return differential is due to poor timing of foreign

15 . Indeed, there is evidence to suggest that a large fraction of the US current account is being financed by official purchases from these economies. See OECD (2007b) for further discussion.

16 . A depreciation of the dollar by 10% *vis-à-vis* all other currencies should lead to an increase of 0.3% of GDP on the current account due to such valuation effects.

Figure 1.13. Exchange rates are adjusting

January 2005 = 100



1. Competitiveness-weighted effective exchange rate indices. Competitiveness weights are based on a double-weighting principle, taking into account the structure of competition in both export and import markets of the manufacturing sector of 42 countries. An increase of the index indicates a nominal or, respectively, real effective appreciation and a corresponding deterioration of the competitive position.

Source: OECD Economic Outlook 83 database.

Box 1.4. **The contribution of the activity cycle and exchange rate movements to changes in the trade balance**

Identifying the contribution of the activity cycle, the exchange rate and oil prices to changes in trade balances is useful in providing an estimate of how permanent any change is likely to be and, as regards the major economies, hence the extent to which underlying global imbalances may have improved. To this end, reduced form equations have been estimated for the United States, Japan and the euro area to explain the trade balance in goods and services as a share of GDP in terms of relative domestic demand gaps, the real exchange rate, with the balance of trade in oil separately distinguished.

For each OECD country a domestic demand gap is constructed as the ratio of total domestic demand to potential output. A relative domestic demand gap is then calculated as the difference between the own country domestic demand gap and a weighted average of the domestic demand gap in all competitor countries/regions, with weights reflecting the importance of the country/region as an export market. For non-OECD countries/regions, data limitations mean that a measure of the output gap is used in place of the total domestic demand gap and are calculated as the difference between actual GDP and a Hodrick-Prescott filter of GDP.

To isolate the effect of oil prices the dependent variable is taken to be the non-oil trade balance, with the oil trade balance then projected separately using an equation with oil prices, the domestic demand gap and a time trend as explanatory variables.

Key long-run properties of the equations are summarised in the table below, for further details see Ollivaud and Turner (2008). In all cases a fall in the real exchange rate is estimated to improve the trade balance, although only after a lag and an initial worsening in the trade balance consistent with a J-curve effect. The long-run response of the trade balance to a change in the relative domestic demand gap for the United States and the euro area is significantly larger than the share of trade in GDP. This may reflect, firstly, that marginal propensities to import are usually significantly higher than average propensities and, secondly, that if domestic demand is unusually strong it will not only attract a higher level of imports but may also lead to the diversion of export production to satisfy domestic demand.

Long-run properties of estimated reduced form equations

Per cent of GDP

	Change in the trade balance,		
	United States	Euro area	Japan
Effect of 10% fall in real exchange rate	0.65	0.29	0.47
Effect of 1% point change in the relative demand gap	-0.39	-0.54	-0.09

Source: OECD calculations.

Using the equation to assess recent history and to project the US trade balance

An estimate of the contribution from past and projected changes in the relative cyclical position of the US economy as well as from the fall in the dollar to the evolution of the US trade deficit can be gauged by using the estimated reduced form equations (figure).

- The fall in the real effective dollar since 2002 has contributed to an improvement in the trade balance, but given the long adjustment lags involved (as well as J-curve dynamics) this only began to materialise from 2005, since when it has contributed to a decline in the trade balance by around 0.3 percentage points of GDP. Similarly, the more pronounced recent fall in the real effective exchange rate since the onset of financial turmoil might contribute towards a further improvement in the trade balance by ½ percentage point of GDP (although part of this adjustment will only be completed after 2009).

- The equations can be used to provide an estimate of the cyclically-adjusted trade balance, which is calculated as the trade balance consistent with closed *output* gaps. Over the period 2002-05, the more buoyant cyclical position of the US economy has led to a decline in the trade balance by more than ½ of a percentage point of GDP. However, as US activity slows sharply relative to that of its trading partners, this cyclical contribution should be reversed contributing more than two percentage points of GDP to an improvement in the trade balance between 2006 and 2009.

- Partially offsetting these improvements is a deterioration in the trade balance on oil. The continued rise in oil prices since late 2003 has consistently contributed to a worsening in the US trade balance over recent years. The further sharp increase since the beginning of 2007 is likely to reduce the trade balance by just under ½ percentage point of GDP.

A mechanical projection using this equation suggests that the combination of these effects should lead to an overall reduction in the US trade balance by 1½ percentage points of GDP from 2007 to 2009 to a level of just under 4% of GDP in 2009. This is somewhat larger, but not greatly inconsistent with, the reduction implied by the main projections discussed elsewhere in this publication, which imply a trade balance of around 4¼ per cent of GDP in 2009. However, the equation results presented here suggest that a subsequent unwinding of cyclical positions, once all output gaps are eliminated, would mean that the US trade deficit would revert to about 5% of GDP.

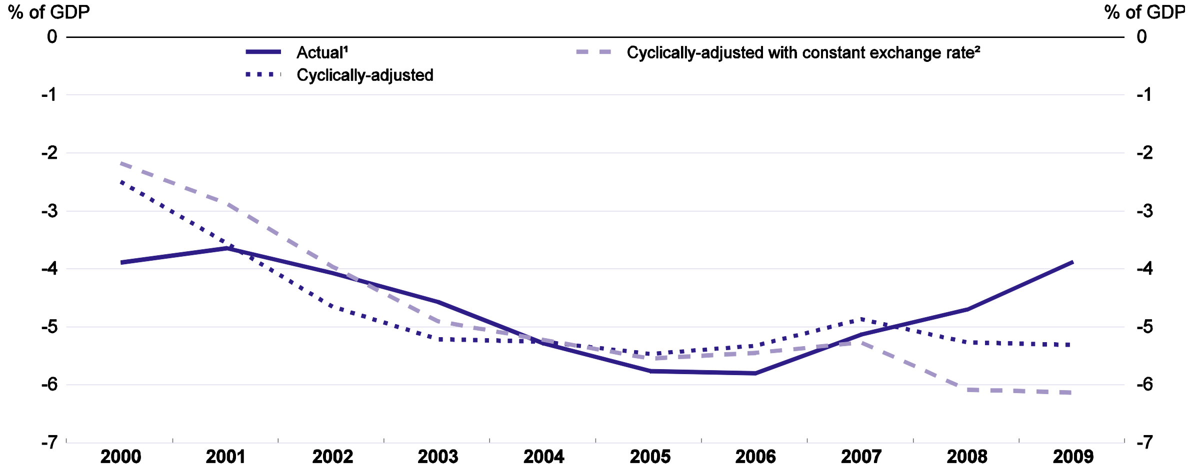
Box 1.4. **The contribution of the activity cycle and exchange rate movements to changes in the trade balance** (continued)

The near balance position of the euro area should decline somewhat over the projection period, driven mainly by past increases in the real effective exchange rate.

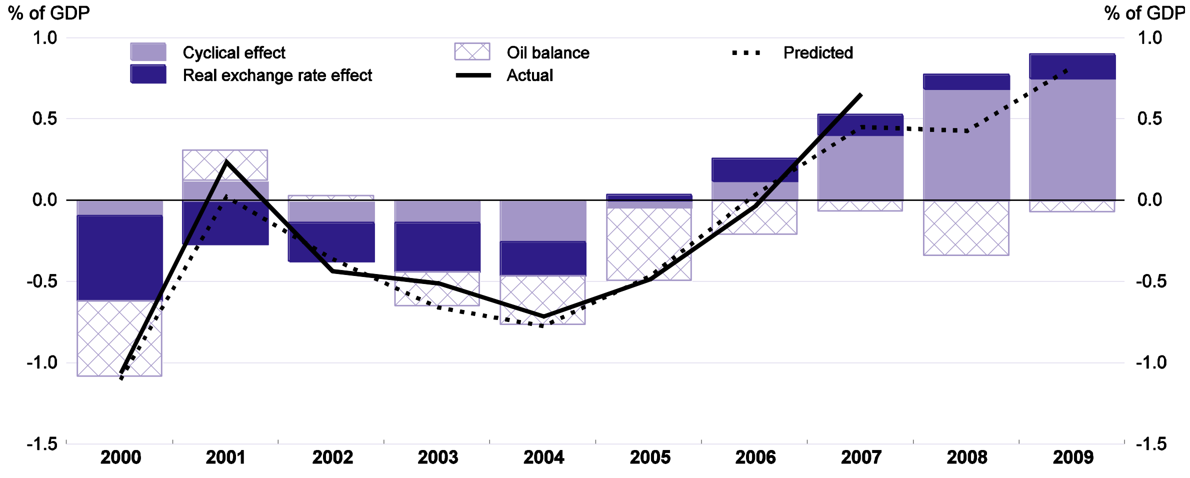
The substantial depreciation in the yen in real effective terms, starting in late 2004, accounts for about 1¼ percentages point of the rise in Japan's surplus, although the recent rise in the effective value of the exchange rate will contribute to a modest reversal along with the relatively more buoyant cyclical position as Japan is less affected by recent financial turmoil and housing downturns.

The evolution of the US trade balance in goods and services

Actual and cyclically-adjusted trade balance



Decomposition of the annual change



1. Over the projection the 'actual' is the equation prediction.

2. The steady state trade balance assuming the real exchange rate is stable at the average value for the period shown in the figure.

Source: OECD Economic Outlook 83 database; IMF, World Economic Outlook, April 2008; and OECD, International Trade by Commodity Statistics.

holders of US liabilities in shifting between bonds and equities in their portfolios when returns were at turning points (Curcuru *et al.*, 2007). If this is the source of the differential, it is unlikely to persist.

Imbalances are likely to ease

The decline in the US current account deficit, by about $90 billion between 2007 and 2009, is the most important element in a projected general easing of global imbalances, although as previously noted much of this improvement may be cyclical and therefore temporary (Table 1.5 and Appendix 1.A3). In addition, the surpluses of Japan and China are both

Table 1.5. **World trade slows while external imbalances decline**

	2005	2006	2007	2008	2009
Goods and services trade volume	Percentage change from previous period				
World trade[1]	8.2	9.5	7.1	6.3	6.6
of which: OECD	6.3	8.0	5.3	4.6	4.6
NAFTA	6.2	6.7	4.5	2.7	3.5
OECD Asia-Pacific	6.7	8.2	7.9	7.8	6.3
OECD Europe	6.2	8.7	5.0	4.6	4.6
Non-OECD Asia	13.5	13.1	10.3	8.6	10.4
Other non-OECD	10.6	11.2	11.9	10.9	10.2
OECD exports	6.1	8.5	6.1	5.6	5.3
OECD imports	6.4	7.6	4.5	3.6	3.9
Trade prices[2]					
OECD exports	3.4	3.6	7.7	10.7	1.9
OECD imports	4.8	4.6	7.3	12.2	2.2
Non-OECD exports	10.1	7.1	7.2	14.4	3.6
Non-OECD imports	4.3	4.2	6.5	10.5	3.7
Current account balances	Per cent of GDP				
United States	-6.1	-6.2	-5.3	-5.0	-4.4
Japan	3.7	3.9	4.8	4.4	4.4
Euro area	0.4	0.2	0.2	0.1	0.0
OECD	-1.5	-1.7	-1.4	-1.3	-1.1
	$ billion				
United States	-755	-811	-739	-717	-648
Japan	167	172	212	217	224
Euro area	42	25	29	8	5
OECD	-525	-639	-564	-565	-517
China	161	250	355	390	436
Dynamic Asia[3]	79	126	167	161	152
Other Asia	-12	-16	-21	-48	-58
Latin America	41	50	31	1	-23
Africa and Middle East	216	250	212	316	268
Central and Eastern Europe	64	63	15	44	8
Non-OECD	549	723	758	864	783
World	24	84	194	299	265

Note: Regional aggregates include intra-regional trade.
1. Growth rates of the arithmetic average of import volumes and export volumes.
2. Average unit values in dollars.
3. Dynamic Asia includes Chinese Taipei; Hong Kong, China; Indonesia; Malaysia; Philippines; Singapore and Thailand.

Source: OECD Economic Outlook 83 database.

expected to decline as a percentage of GDP (although not in nominal dollar terms), for the first time since 2001. Moreover, the surpluses of the non-OECD oil producing countries are expected to fall in 2009 as their spending catches up with higher, and more stable, oil revenues. The euro area current account balance may also decline modestly.

International linkages and the spillover of US financial turmoil to other economies

Financial shocks are dominating the outlook

Of the shocks that have hit the OECD area since the time of the previous *OECD Economic Outlook*, the deterioration in financial conditions stands out. The epicentre of the shock was the United States, where risk spreads (the difference between risky corporate and government bonds) have widened by 225 basis points, while equity prices have fallen by 10%. These developments spread into financial markets of the euro area and Japan, with risk spreads having risen by 125 and 80 basis points, respectively, and equity prices having declined by 17% and 16%, respectively. At the same time, the dollar has fallen against the other major currencies lending support to the US economy but tending to weaken activity elsewhere. This latter effect may partially explain the greater falls in euro area and Japanese equity prices.

The OECD Global Model is used to evaluate the effects

The OECD Global Model has been used to simulate how the United States economy and the other major economies (Japan, the euro area and China) have been affected by these shocks. The shocks to risk spreads are assumed to start to dissipate during the first half of 2009, while equity prices and exchange rates are kept at their current level over this year and next, consistent with the current *Outlook* projections. The simulations also take into account changes in projected developments in US housing investment and house prices since the end of 2007, and assume that monetary authorities follow a Taylor rule, while fiscal authorities target a fixed debt-to-GDP ratio over the medium term.[17] The simulated effects on GDP, inflation and current account balances are shown in Table 1.6. Policy rates ease in reaction to disinflationary pressures in all economies, compared to the baseline scenario with no additional turmoil from the end-2007 level. Even so, in the simulations US policy rates fall by less than has actually occurred, suggesting that the authorities have taken account of a wider range of factors. In the euro area, the simulations are consistent with the view that, had the additional turmoil not happened, then policy rates would have had to be raised to fight inflationary pressures.

The US economy is being hit hard by the shocks

The total effect of the additional turmoil that has occurred since the end of 2007 is estimated to lower US GDP by about ¾ per cent this year, building up to about 1¼ per cent in 2009. Given the larger output gap, inflation declines, with most of the effect likely to be seen next year. Weaker activity and the lower real exchange rate work to improve the current account.

17 . For some more details on specific shocks to each economy, see Appendix 1.A1.

Table 1.6. **Are other economies de-coupling from the US slowdown?**

	Effect of turmoil since end-2007, percentage deviation from baseline	
	2008	**2009**
United States		
GDP level	-0.70	-1.19
Inflation[1]	-0.06	-0.17
Current balance[2]	0.16	0.27
Euro area		
GDP level	-0.72	-1.25
Inflation[1]	-0.22	-0.45
Current balance[2]	0.05	-0.12
Japan		
GDP level	-0.46	-1.19
Inflation[1]	-0.36	-0.57
Current balance[2]	-0.66	-0.84
Total OECD		
GDP level	-0.56	-1.09
Inflation[1]	-0.07	-0.26
Current balance[2]	-0.05	-0.05
China		
GDP level	-0.29	-0.52
Inflation[1]	0.14	0.39
Current balance[2]	-0.15	-0.10

1. Consumer price deflator.
2. Per cent of GDP.
Source : OECD calculations. See text for description of the shocks.

The exchange rate amplifies direct effects on other economies

The simulations suggest that the euro area and Japan would be hit, more or less, equally hard by these shocks. But the direct effect of recent additional turmoil on the housing and financial markets account for only half of the total impact on activity, while the other half is due to the exchange rate adjustments, with output in the euro area and Japan being weakened by effective appreciation. China is negatively affected due to the assumed faster appreciation against the dollar and lower OECD demand for its goods. The overall effects of changes in exchange rates on the total OECD current account are relatively small, mainly redistributing trade and production among member countries. In conclusion, the analysis points to relatively limited scope for other OECD countries to de-couple from the US-centred financial shock. However, the shock hits at a time when US growth prospects were already weak whereas the outlooks for the euro area and Japan were more robust.

Growth prospects

Area wide growth is continuing to weaken

The assumptions underlying these projections are set out in Box 1.5. Activity in the OECD area is projected to remain subdued during 2008 with annualised growth reaching a trough of about ½ per cent in the second quarter of the year and remaining fairly weak for the remainder of the year. Growth subsequently firms gradually, reaching its potential rate by the second half of 2009.

Box 1.5. **Policy and other assumptions underlying the projections**

Fiscal policy assumptions are based as closely as possible on legislated tax and spending provisions (current policies or "current services"). Where policy changes have been announced but not legislated, they are incorporated if it is deemed clear that they will be implemented in a shape close to that announced. For the present projections, the implications are as follows:

- For the United States it is assumed that expiring tax provisions will be extended, including the relief for the Alternative Minimum Tax, without offsetting their effects on the budget. It is also assumed that the fiscal stimulus package and the projected slowdown in real activity will reduce the growth of tax receipts.
- In Japan, the scheduled hike in the pension contribution rate will increase government revenue by about 0.2% of GDP per year through 2009. The projections assume spending cuts in line with the FY 2008 budget and the medium-term fiscal reform plan. The impact of expected one-off factors on revenues is also included.
- In the euro area, fiscal consolidation stalls. For Germany a cut in corporate tax rates in 2008 (including a set of partially counterbalancing base-widening measures) as well as a net decrease in social security contribution rates (with a significant lowering of the unemployment insurance contribution rate overcompensating smaller increases in long-term care and health insurance contribution rates) are built into the projections, leading to revenue shortfalls of around 0.6% of GDP. For France, the main elements of the fiscal package that became effective in autumn 2007 include the reduction of income tax and employer social security contributions on overtime work, tax relief for interest paid on mortgage debt and for bequests or donations to family members, and the introduction of a ceiling on overall income tax paid by a single individual. For Italy, the projections incorporate a cut in the corporate tax rate in 2008 together with some measures advancing expenditure in the short run.

Policy-controlled interest rates are set in line with the stated objectives of the relevant monetary authorities, conditional upon the OECD projections of activity and inflation, which may differ from those of the monetary authorities. The interest rate profile is not to be interpreted as a projection of central bank intentions or market expectations thereof.

- In the United States, the target federal funds rate is assumed to remain stable at 2% until mid-2009. As the economic environment improves monetary stimulus is assumed to be withdrawn at a relatively rapid pace with the target rate assumed to be raised in three 50 basis points steps between the end of the second and third quarters of 2009. Thereafter two further 25 basis points steps are assumed to occur bringing the federal funds rate to 4% by the end of 2009.
- In the euro area, policy rates are assumed to remain unchanged over the next eighteen months as near-term growth is expected to weaken below the potential rate and past appreciation of the euro together with fading impacts from oil and commodity prices help contain inflationary pressures.
- In Japan, near-term growth weakness and stabilising commodity prices are projected to slow the rise in inflation, so that the short-term policy interest rate is assumed to remain at ½ per cent until mid- 2009 when it is increased by 25 basis points.

The projections assume generally unchanged exchange rates from those prevailing on 13 May 2008, at $1 equal to ¥ 104.44 and € 0.64 (or equivalently, € 1 equals $1.56). The Chinese renminbi is assumed to appreciate by 5% annually against the US dollar after 13 May 2008, when $1 was equal to CNY 6.99.

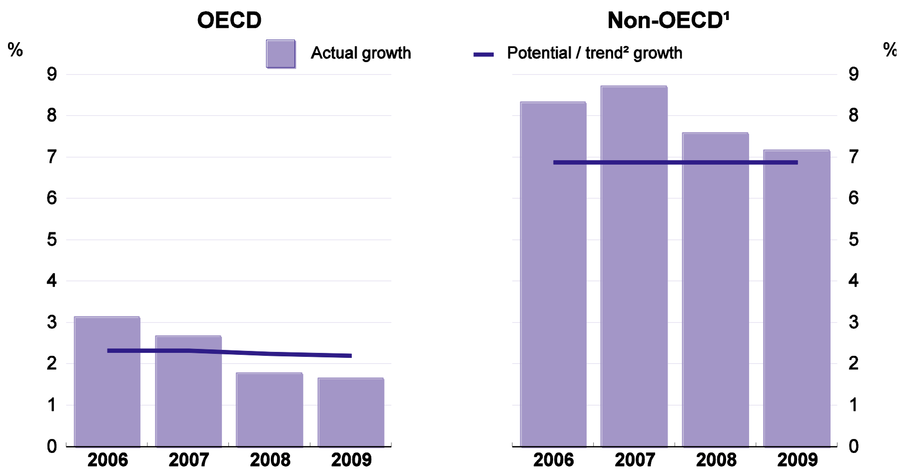
Over the projection period the price for a barrel of Brent crude is assumed to stabilise at around $120. It is assumed, in the nature of a technical assumption, that all non-oil commodity prices stabilise at around current high levels in nominal terms.

The cut-off date for information used in the projections is 23 May 2008. Details of assumptions for individual countries are provided in Chapter 2, "Developments in individual OECD countries and selected non-member economies".

Net exports play an important role in re-balancing growth

Growth in non-OECD countries is also expected to slow in 2008 and 2009, although only to rates which are close to the trend experienced since the beginning of the decade (Figure 1.14). Reflecting this difference, the support to OECD growth from net exports will be to a degree not experienced since following the oil price hikes in the mid-1970s and early 1980s. Moreover, within the OECD, net exports will play an important role in re-balancing output growth; US GDP growth in 2008 and 2009 may be mostly accounted for by unusually strong net exports stemming from stagnant domestic demand and a lower effective exchange rate, whereas the contribution of net exports to growth will be declining in both the euro area and Japan, where domestic demand is less affected by financial turmoil and housing downturns (Table 1.7).

Figure 1.14. Global growth is slowing



1. The non-OECD region is here taken to be a weighted average, using 2000 GDP weights and PPP's, of Brazil, Russian Federation, India, China and Dynamic Asia which together accounted for about two-thirds of non-OECD output in 2000.
2. Trend growth for the non-OECD is the average over the period 2000-06.

Source: OECD Economic Outlook 83 database.

Growth performance will reflect vulnerability to headwinds

Differences in growth performance among OECD countries over the next year and a half to a large degree reflect differences in their vulnerability to the headwinds. Those countries which are most affected, judged by the degree to which output is projected to be pushed below potential output (Figure 1.15), include: those most directly affected by financial turmoil, notably the United States and Iceland; those where housing downturns are most pronounced, especially the United States, Ireland and Spain; the United Kingdom, which is also more vulnerable

Table 1.7. **Slower domestic demand, partially offset by net exports**

Contributions to GDP growth, per cent of GDP in previous period [1]

	2005	2006	2007	2008	2009
United States					
Final domestic demand	3.5	2.9	1.9	0.3	0.2
of which: Business investment	0.8	0.7	0.5	0.1	-0.1
Residential investment	0.3	-0.3	-0.9	-1.0	-0.3
Private consumption	2.3	2.2	2.1	0.9	0.3
Stockbuilding	-0.2	0.1	-0.3	-0.1	0.0
Net exports	-0.2	-0.1	0.6	1.0	0.9
GDP	3.1	2.9	2.2	1.2	1.1
Japan					
Final domestic demand	1.7	1.4	0.8	0.7	1.1
of which: Business investment	1.3	0.7	0.3	-0.2	0.2
Residential investment	-0.1	0.0	-0.3	-0.1	0.2
Private consumption	0.8	1.1	0.8	0.9	0.7
Stockbuilding	-0.1	0.2	0.1	0.0	0.0
Net exports	0.3	0.8	1.1	1.1	0.2
GDP	1.9	2.4	2.1	1.7	1.5
Euro area					
Final domestic demand	2.0	2.6	2.3	1.5	1.4
of which: Business investment	0.5	0.8	0.8	0.5	0.2
Residential investment	0.2	0.3	0.1	-0.1	-0.1
Private consumption	1.0	1.1	0.9	0.7	0.9
Stockbuilding	0.0	0.0	0.0	0.0	0.0
Net exports	-0.2	0.2	0.4	0.2	0.0
GDP	1.7	2.9	2.6	1.7	1.4
OECD					
Final domestic demand	3.0	3.0	2.5	1.4	1.4
of which: Business investment	0.9	0.7	0.7	0.2	0.1
Residential investment	0.2	0.0	-0.3	-0.4	-0.1
Private consumption	1.7	1.8	1.7	1.1	0.9
Stockbuilding	-0.1	0.0	-0.1	0.0	0.0
Net exports	-0.2	0.1	0.3	0.4	0.3
GDP	2.7	3.1	2.7	1.8	1.7

1. Chain-linked calculation for stockbuilding and net exports in USA and Japan.

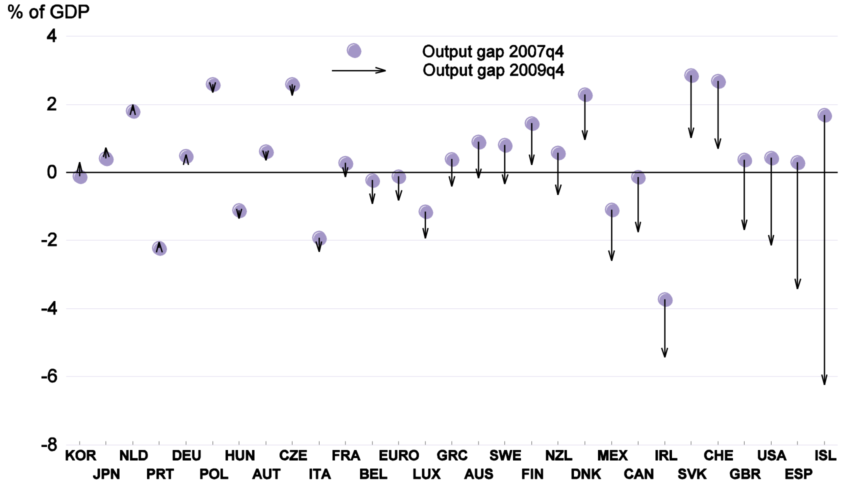
Source: OECD Economic Outlook 83 database.

because of the importance of financial markets and links between financial turmoil the mortgage market and the spending of households;[18] and those with closest links to the United States, in particular Canada and Mexico. And, while most OECD countries are to some extent vulnerable to higher commodity prices, the adverse effect they have on real disposable incomes will be damped by exchange rate appreciation in some economies, particularly the euro area, Canada, Australia and to a lesser extent Japan.

18. The United Kingdom is more vulnerable because a large proportion of the growth in mortgage lending in recent years has been provided by lenders (such as Northern Rock) that rely on funds from wholesale money markets (rather than depositors) which have been hit hard by financial turmoil, and also because, as previously discussed, there are close links between consumption and the housing market because of more complete mortgage markets allowing the possibility of mortgage equity withdrawal.

Figure 1.15. Vulnerability to headwinds differs across countries

Change in output gap, 2007q4-2009q4



Note: Countries are ranked according to the change in the output gap over the period 2007q4-2009q4.

Source:OECD Economic Outlook 83 database.

Slowdowns of activity in some OECD countries -- including Australia, New Zealand, some Nordics and Switzerland -- occur from elevated starting positions relative to potential and will help to contain inflationary pressures.

US activity will fall during 2008 and recover only in 2009

With financial markets remaining under considerable stress for the remainder of 2008 and residential construction continuing to adjust until the beginning of 2009, the US economy is heading for several quarters of very low growth. Rising unemployment, slow real income growth, tighter credit conditions and wealth losses associated with further declines in house prices act as major drags on consumption. The income tax rebates will bring some temporary support around the middle of the current year, but further slowing is expected in the fourth quarter. Business investment will also decline in the course of 2008, reflecting the deterioration in the outlook for demand and tight financial market conditions as well as a correction in the commercial property market. On the other hand, exports will remain as a strong driver of economic activity, benefitting from past dollar depreciation. Provided the housing market has bottomed out and the effects of financial turmoil begin to abate in early 2009, the recovery could gather pace in the second half of that year, but with growth above its potential rate only towards the end of the year. With the opening up of a substantial negative output gap and no further increases in energy and food prices, inflation is likely to decelerate to below 2% in 2009.

Euro area growth is set to fall below potential

In the euro area, after a weak second quarter (partly reflecting the reversal of temporary factors which boosted growth in the first quarter), GDP is projected to grow at an annualised rate of only about 1¼ per cent over the second half of this year. The pace of activity will then gradually pick up to around the potential rate by the second half of 2009. Export growth is less supportive of activity as the effective appreciation of the euro weighs on competitiveness. The ongoing adjustment in business investment will accentuate this weakness, reflecting normal cyclical responses to a weaker outlook for demand. Consumption growth remains unspectacular at below 1½ per cent *per annum* for the remainder of this year, constrained by real income growth which -- over and above the effect of structurally weak productivity growth -- is held back by weakening employment growth and high headline inflation. The level of housing investment is likely to fall, mainly due to major corrections underway in Spain and Ireland, but this only subtracts some 0.1 percentage point off area-wide growth. Divergences within the euro area are expected to widen; among the larger countries, output in Germany and France should remain close to potential whereas in Italy and especially Spain it is likely to fall well below. The gradual emergence of a negative area-wide output gap, together with weaker import price pressures is expected to moderate consumer price inflation so that both headline and core inflation are close to the objective of the European Central Bank (ECB) by the end of 2009.

Growth in Japan will decline but recover in 2009

The Japanese economy is projected to decelerate and grow at about 1¼ per cent for the remainder of 2008, picking up through 2009 to just above the potential growth rate of 1½ per cent. This reflects a weaker contribution to growth from both exports and business investment than in recent years. Slower export growth reflects losses in export market share consistent with an appreciation of the effective exchange rate by about 8% compared to its average value in 2007. Partly in consequence, business fixed investment is expected to continue its recent weakness through 2008, only picking up during 2009. On the other hand, housing investment should continue to grow strongly through 2008 as it reverts to trend following the recent regulatory change. A gradual improvement in consumption is the main basis of strengthening growth in 2009. With activity remaining slightly above potential, core consumer price inflation will rise, but only modestly, reaching ½ per cent by the end of the projection period.

Growth in the United Kingdom and Canada will fall sharply

Activity in the United Kingdom and Canada has decelerated more sharply than elsewhere. In the United Kingdom, the combination of house price adjustment and tighter financial conditions will weigh on consumption and investment. Canada is hit by both the stagnation in its main trading partner and the appreciation of its currency, although growth should recover though 2009 in tandem with the pick-up in the United States.

Despite some slowing emerging markets continue to grow robustly

The major emerging market economies should decelerate, but only moderately, for the most part because of policy reactions to address inflationary pressures. Nevertheless, they will continue as a major driver of the global economic expansion. The Chinese economy is still projected to grow at around double digit rates, despite monetary policy tightening, with the economy becoming increasingly oriented towards domestic demand. The Indian economy is likely to continue expanding on a strong albeit reduced growth path as external demand moderates. Growth in Russia, while remaining rapid, should moderate as terms-of-trade gains dissipate. In

Brazil the economy is expected to grow robustly supported by solid domestic demand, though this will be moderated by expected tighter monetary policy.

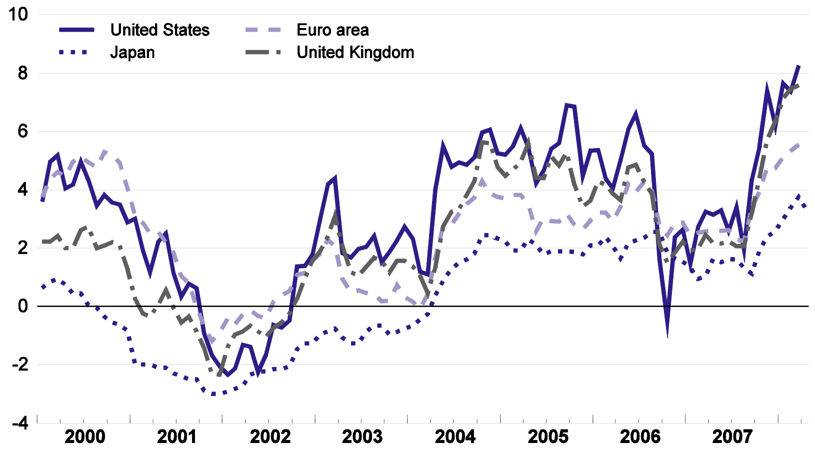
Macroeconomic policy requirements

The scope for policy mistakes is larger than usual

Macroeconomic policy needs to balance concern about a pronounced slowdown in activity, where risks have a fat tail on the downside, with a need to contain inflation at a time when headline numbers in many countries remain uncomfortably elevated (Figure 1.16) and sharply rising producer price inflation suggests additional future cost pressures (Figure 1.17). To compound the challenge, uncertainty about future growth potential is particularly high (Chapter 3). While lack of sufficient policy stimulus may risk unduly delaying the recovery, over-stimulus might put at risk one of the major macroeconomic policy achievements of the past decade, namely the anchoring of inflation expectations at low levels (Box 1.6). If this anchor were to slip, the costs of dealing with both current and future shocks would be much higher.

Figure 1.17. Producer price inflation has picked up sharply

Year-on-year, % change



Source: Datastream.

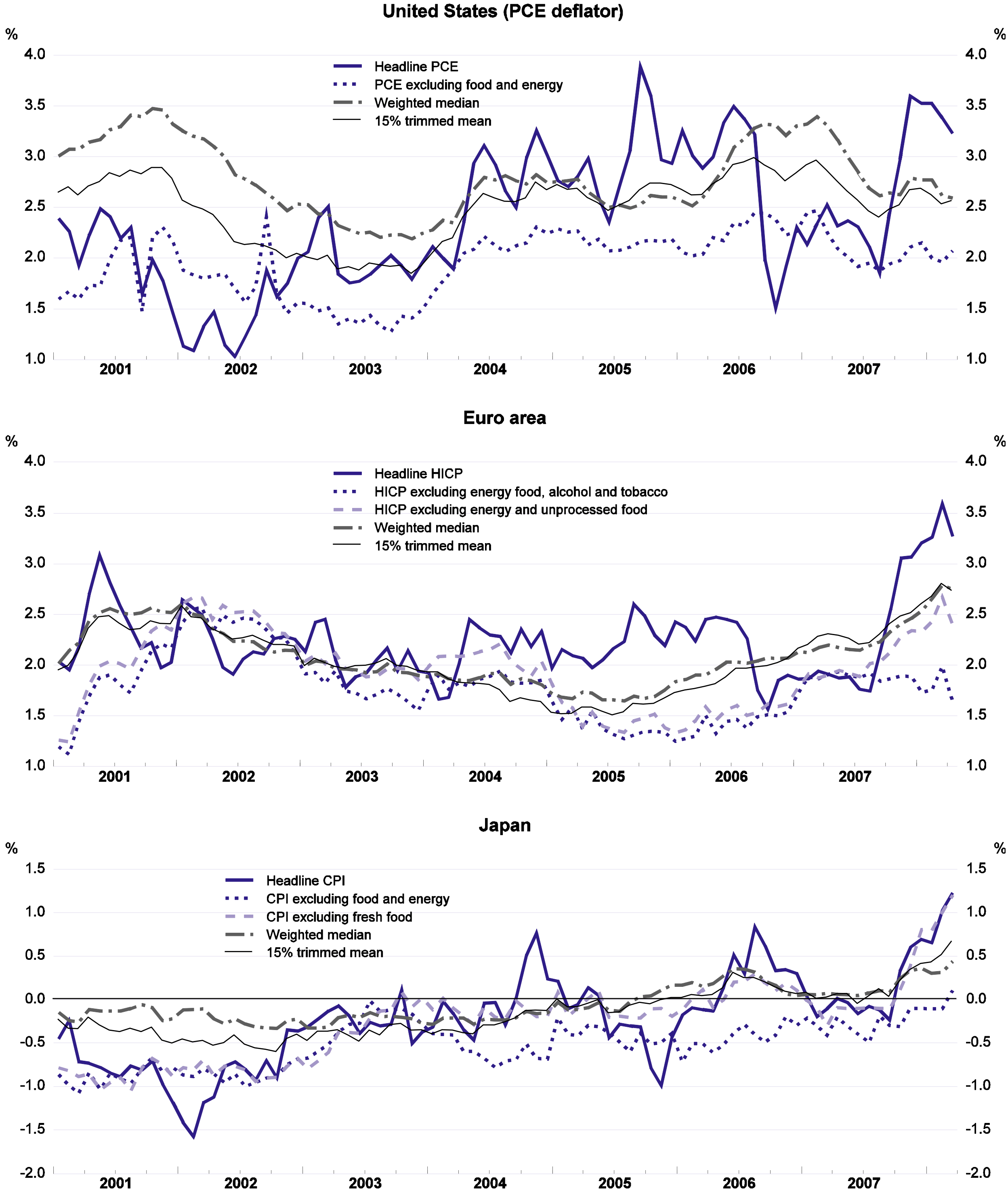
Monetary Policy

Further cuts in US policy rates are not needed

The weakness in activity has been, and will continue to be, more pronounced in the United States than elsewhere, and the monetary policy stance has accordingly already been eased substantially. Nevertheless, headline inflation (based on the personal consumption expenditure deflator) is still uncomfortably high at over 3% and there are signs of an upward shift

Figure 1.16. Headline and underlying inflation measures

12-month percentage change



Note: PCE refers to personal consumption expenditures, HICP to harmonised index of consumer prices and CPI to consumer price index.

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

Box 1.6. **Measuring inflation expectations**[1]

Longer-term inflation expectations are of key importance for monetary policy. When they are well anchored, the cost of maintaining price stability (in terms of lost output) in the face of an inflation shock tends to be lower. However, expected inflation cannot be directly observed, necessitating the use of proxy measures. Three commonly used ones are derived from surveys of consumer sentiment, views of professional forecasters and financial market data. Each provides useful information but is subject to problems of interpretation. Recently some of these indicators have been increasing in a number of OECD economies.

Consumer surveys often include information about inflation expectations. However such measures tend to closely follow recent inflation changes and are accordingly more informative about very near-term developments. Here, median responses concerning expectations five to ten years ahead are used. These have the advantage of excluding those survey respondents that give implausibly extreme values. For the United States, this measure has been around 3% for about two years, up from earlier in the decade. For the United Kingdom, the situation is less clear, in part because of the series' short history. The recent rise could reflect a possible link between inflation expectations and the prices of certain high-profile items like food and energy.[2]

Professional forecasters provide another and complementary source of inflation expectations. In addition, since this group likely has a greater incentive to forecast inflation well, their views may be more informative. A positive feature is that indications of uncertainty can be easily derived by looking at the dispersion of views. On the other hand, it is not always clear what is the underlying model on which the forecasts are based. In addition, to the extent that herding is present, measures of uncertainty may not be that informative. Bearing these caveats in mind, these measures suggest that the inflation expectations for the United States and the euro area remain well anchored at levels not far out of line from what is known about official views of price stability. This could as well be a reflection of central bank credibility. For Japan, on the other hand, survey based measures display a more erratic pattern, suggesting that the outlook for inflation has been less stable. That said, recently these expectations have risen to around 1½ per cent.

Financial markets are yet another important source of information about inflation expectations and the actors in these markets have an even greater incentive "to get it right". These measures are based on the difference between nominal government bond yields and similar maturity inflation indexed-bond yields. Movements in these differences, however, reflect not only changes in inflation expectations but also developments in liquidity and inflation risk premiums. In the current juncture, these factors could be driving the expectation measures. For example, during the current financial turmoil there are signs of a preference for liquidity with unusually large spreads in the United States between the yields of the relatively liquid, high demand "on-the-run" (the most recently issued) nominal bonds and the yields of other, "off-the-run" bonds.[3] As nominal government bond markets are typically more liquid than indexed ones, bond prices in these markets have likely increased relatively more due to these liquidity effects, depressing yields relative to those in indexed markets, with changes in the corresponding yield differential potentially underestimating changes in inflation expectations.[4]

For the United States, the adjusted Treasury Inflation Protected Securities (TIPS) measure tries to take account of these liquidity effects. However, even this measure is likely to be problematic. The adjustment assumes the inflation risk premium is constant over time, when it seems plausible that inflation uncertainty (and hence the inflation premium) has recently increased. For example, as weakness in the real economy increases, the risk of low inflation may have risen but the recent commodity price movements (and perhaps stimulatory monetary policy) have likely increased the chances of high inflation outcomes. All this is to suggest that the recent run-ups in the adjusted TIPS measure (and other financial market expectation measures) could be overstating changes in expectations (as an increase in the inflation premium will require higher nominal yields compared to indexed bond yields). One approach is to discount sudden moves in these expectation measures (as it is more plausible they reflect developments affecting financial market premiums rather than sudden changes in long-term inflation expectations) and to be aware that there are reasons for thinking that these measures could be either understating or overstating expectations.

Taking account of the above, the recent rise in the United States of the adjusted TIPS measure may be of concern if it persists when the outlook for the economy improves. In the euro area, as well, financial measures have moved up. However for both the United States and the euro area most measures are not substantially higher than they have been in recent history. Meanwhile, Japanese inflation expectations appear low. Expectations in the United Kingdom, which by a number of measures seem to have risen, are a potential cause for concern, although professional forecasters' expectations are well down from their late 2003 levels.

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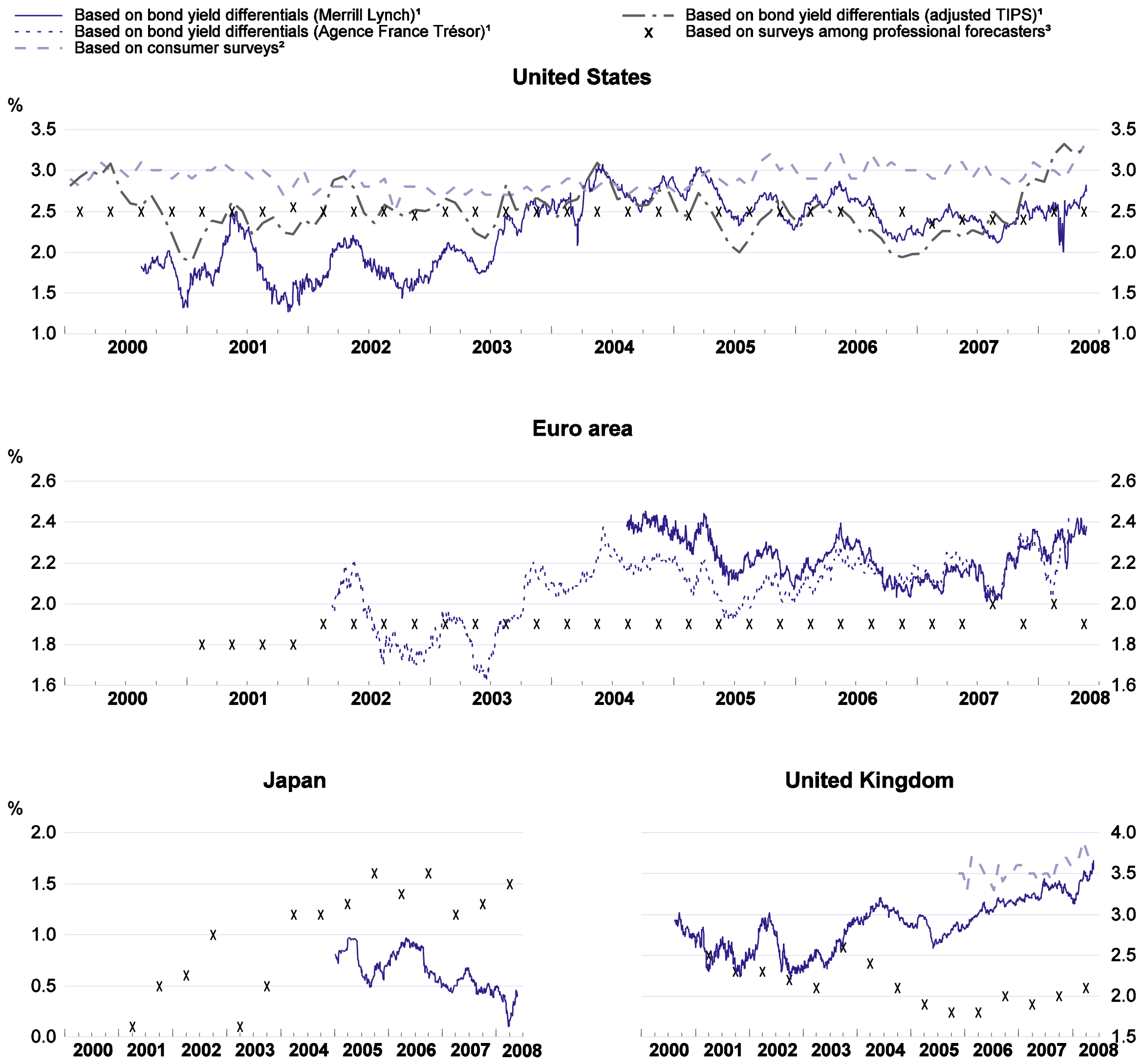
1. For more details, see Bank of England (2008b), ECB (2008) and Mishkin (2008).
2. Long time series of long-term consumer expectations collected on a consistent basis are not available for the euro area or Japan.
3. The ten-year spread, less than 10 basis points in July 2007, has recently risen to around 25 basis points. The rise in the adjusted TIPS differential relative to the Merrill Lynch differential in the figure below also reflects the increased preference for liquidity. In other markets, including outside the United States, there are also signs of increased preference for liquidity.
4. Inflation-linked swaps are another potential source of information as these should be unaffected by liquidity effects in bond yields.

Box 1.6. **Measuring inflation expectations** (continued)

Proxies for long-term expected inflation



1. Expected inflation implied by the yield differential between ten-year government benchmark and inflation-indexed bonds.
2. Expected consumer inflation five to ten years ahead (median forecast). Based on the University of Michigan Survey of Consumers for the United States and on the Citigroup/YouGov survey for the United Kingdom.
3. Expected average rate of consumer inflation over the next ten years for the United States, based on the Survey of Professional Forecasters (SPF) by the Federal Reserve Bank of Philadelphia. Expected harmonised consumer inflation rate five year ahead for the euro area, based on the SPF by the ECB. Expected average rate of consumer inflation six-to-ten years ahead for Japan and the United Kingdom based on Consensus Forecasts.

Source: Datastream; Agence France Trésor; University of Michigan Survey of Consumers; Citigroup; Consensus Forecasts; Federal Reserve Bank of Philadelphia; Federal Reserve Bank of Cleveland; and European Central Bank.

in inflation expectations, although core consumer price inflation has eased back to just over 2% recently. In these circumstances, the current accommodative monetary policy stance should be maintained until the recovery takes hold. Continued weak growth will rapidly open up an output gap with unemployment rising to over 6% in 2009. The consequent disinflationary pressure, together with flat commodity prices, should lead to both headline and core consumer price inflation converging towards 1¾ per cent. Once housing ceases to be a major drag and as the effects of financial turmoil abate, policy rates should be normalised quickly to ensure that inflation expectations remain anchored and to avoid feeding a new credit and asset price cycle (see below). On the basis of the projections presented here, this process should begin from the middle of 2009.

Policy rates should also remain on hold in the euro area…

The slowdown in activity in the euro area is expected to be more moderate while inflationary pressures are strong. Currency appreciation notwithstanding, headline inflation, as measured by the harmonised index of consumer prices, rose to 3.3% in April, up from 2% in the third quarter of last year. Different measures of underlying inflation continue to diverge: core inflation (excluding food, energy, alcohol and tobacco) is running below 2%, while most statistical measures of underlying inflation continue to trend upwards, as they have for several years, and are currently around 2½ per cent. Starting from a position where unemployment is about ½ percentage point below the estimated structural rate, unchanged policy rates are consistent with a period in which growth falls below potential rates and remains there until around the middle of next year, which should contain inflationary pressures in keeping with the ECB’s inflation objective. The ECB will have to stand ready to react, either if adverse effects from financial turmoil or housing are larger than expected, or if second-round effects from the recent spike in headline inflation feed through into inflation expectations and wage settlements.

… and in Japan until there is a clear exit from deflation

In Japan, headline consumer price inflation jumped to 1% in the first quarter, but this was entirely explained by a pick-up in food and energy prices, and excluding these items core inflation remains close to zero. There have, however, recently been some encouraging signs that Japan may eventually escape deflation: most statistical measures of underlying price pressures imply positive inflation rates; wages appear to have stopped falling; and residential land prices rose during 2007, after stabilising in 2006 and declining over the previous 15 years. Nevertheless, the weakening outlook for growth, and the need to let inflation rise to create some buffer against the risk of deflation, especially given the possible upward bias in the price index (OECD, 2008a), argue for keeping monetary policy on hold until there has been an unambiguous and permanent exit from deflation, which may not be until mid-2009.

Large policy rate cuts are warranted in the United Kingdom and Canada

Both Canada and the United Kingdom are likely to experience sharper falls in output relative to capacity than most other OECD countries. If this slowdown does emerge, further cuts in policy rates of the order of 75 basis points will be warranted. An important difference between the two countries is that in the United Kingdom there is more of a case for delaying the reduction to ensure that inflation expectations, which have recently shown signs of upward drift, are appropriately anchored, particularly given that headline inflation is likely to rise further in the near-term.

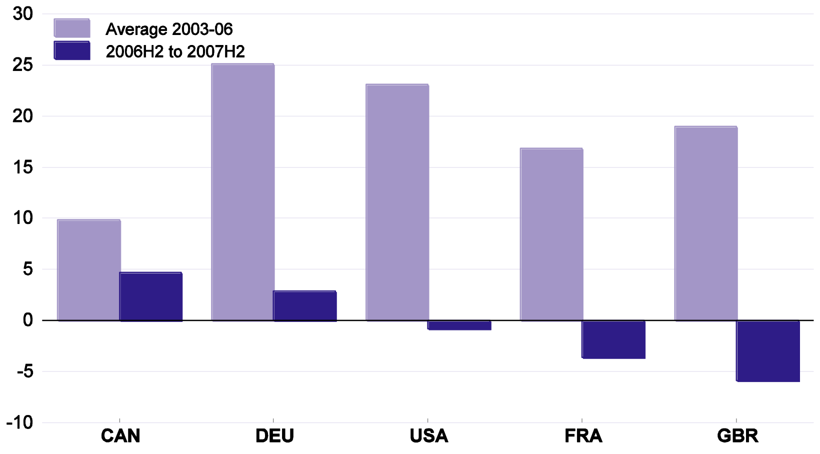
Fiscal Policy

The case for widespread fiscal activism is weak…

Concerns that financial turmoil may have blunted the conventional transmission mechanisms for monetary policy have raised the issue of whether expansionary fiscal policy is the more appropriate tool in the current conjuncture if stimulus is called for. Additionally, and still only relevant where stimulus is warranted, the credit and asset price cycle at the origins of the present financial turmoil was facilitated by a prolonged period of unusually low interest rates (see below) and the wish to avoid a repeat might argue in favour of relying relatively more on fiscal than monetary stimulus. On the other hand, although there has been some improvement over recent years, the current fiscal position in many countries still appears barely adequate to cope with future fiscal costs of ageing (Cournède, 2007). Moreover, the starting position may be much less favourable than it first appears. In particular, corporate tax receipts in many OECD countries have been unusually high as a consequence of the previously prolonged period of profit growth which has exhausted carry-forward provisions for tax losses, expanding income from capital gains from financial investments, and a disproportionally large contribution from the financial sector. There is already evidence of a pronounced deceleration in corporate tax revenues in the year to the end of 2007 in many of the largest OECD countries (Figure 1.18) and a fall in corporate tax receipts to longer-run average

Figure 1.18. Corporate tax revenues have slowed sharply

Annual percentage change



Source: OECD Economic Outlook 83 database.

shares in GDP would imply a loss in revenues of between ½ and 1 percentage point of GDP. In addition, buoyant asset prices, have also boosted sources of revenues, including personal income tax. A downturn which disproportionately affects the housing and financial sectors and abruptly reverses the trend in profitability could lead to a much sharper fall in tax receipts than allowed for in conventional cyclical adjustments of the fiscal balance (Joumard and André, 2008).

... as is that for targeted fiscal action in mortgage markets

A distinct but related issue is whether targeted fiscal support is warranted to ease adjustment in housing and mortgage markets. In general, the problem with such support is that, if it is limited in scope, it is difficult to avoid arbitrary discrimination between potential recipients. On the other hand, if support is widespread it risks not only being costly, but also delaying much needed adjustment of the housing market to levels supported by fundamentals as well as possibly encouraging future speculative behaviour in the housing market. These considerations may, however, still leave scope for action by the authorities to co-ordinate voluntary action by lenders and borrowers to avoid the high costs of foreclosure with little risk to current and future tax payers, which is the aim of the "Hope Now" initiative introduced last year in the United States. Recent proposals would take this initiative further by allowing the Federal Housing Authority (FHA) to guarantee new fixed-rate mortgages for distressed borrowers, providing agreement can be reached with their lenders to write down the value of the outstanding mortgage in line with more recent valuations. Such a guarantee might have a considerable effect on limiting foreclosures, but would expose the FHA to the risk of substantial losses if house prices were to fall more than anticipated.

Fiscal positions are set to deteriorate

The widespread and substantial improvement in OECD fiscal balances of recent years is moving into reverse (Table 1.8). In 2008 the area-wide deficit is projected to widen from just over 1½ to about 2½ per cent of GDP, with only about one quarter of the deterioration accounted for by cyclical factors. More tentatively, there should be some improvement in the OECD cyclically-adjusted fiscal balances in 2009, but this mainly reflects the temporary nature of the US fiscal stimulus.

There is a stronger case for US fiscal action

The case for fiscal stimulus in response to weaker activity is stronger in the United States than elsewhere: a significant output gap is expected to open up; there is greater uncertainty about the normal transmission mechanism of monetary policy; interest rates are already low; and the automatic fiscal stabilisers are much weaker than in most other OECD economies, particularly those in Europe. Indeed, with regard to the last point, without federal action, automatic stabilisers might even be perverse, given that most US states are forced by law to run balanced budgets, driving them to cut spending or raise taxes in downturns. Moreover, fiscal stimulus may be more effective in the United States, whereas European economies seem to be more subject to countervailing private sector saving responses (Cotis *et al*., 2004).

Table 1.8. **Fiscal positions are worsening**

Per cent of GDP / Potential GDP

	2005	2006	2007	2008	2009
United States					
Actual balance	-3.6	-2.6	-3.0	-5.5	-5.2
Cyclically-adjusted balance	-3.7	-2.9	-3.2	-5.2	-4.4
Cyclically-adjusted primary balance	-1.7	-0.9	-1.1	-3.1	-2.3
Gross financial liabilities	62.4	61.8	62.8	65.8	69.8
Japan					
Actual balance	-6.7	-1.4	-2.4	-1.4	-2.2
Underlying balance[2]	-5.7	-3.5	-3.0	-2.8	-2.7
Underlying cyclically-adjusted balance[2]	-5.3	-3.5	-3.1	-3.0	-2.9
Underlying cyclically-adjusted primary balance[2]	-4.5	-2.8	-2.4	-2.2	-2.0
Gross financial liabilities	175.3	171.9	170.3	170.9	170.3
Euro area					
Actual balance	-2.6	-1.3	-0.6	-1.1	-1.2
Underlying balance[2]	-2.8	-1.4	-0.7	-1.1	-1.2
Underlying cyclically-adjusted balance[2]	-2.1	-1.2	-0.7	-1.0	-0.8
Underlying cyclically-adjusted primary balance[2]	0.4	1.3	1.8	1.6	1.7
Gross financial liabilities	76.9	74.8	71.8	70.5	70.4
OECD[1]					
Actual balance	-3.0	-1.5	-1.5	-2.5	-2.6
Underlying balance[2]	-2.9	-1.7	-1.6	-2.7	-2.6
Underlying cyclically-adjusted balance[2]	-3.0	-2.1	-2.0	-2.9	-2.5
Underlying cyclically-adjusted primary balance[2]	-1.2	-0.3	-0.2	-1.1	-0.7
Gross financial liabilities	77.4	76.2	75.4	76.2	77.6

Note: Actual balances and liabilities are in per cent of nominal GDP. Cyclically-adjusted balances are in per cent of potential GDP. The primary cyclically-adjusted balance is the cyclically-adjusted balance less net debt interest payments.

1. Total OECD excludes Mexico and Turkey.
2. In this context "underlying" means that the balance has been purged of one-off and temporary measures, insofar as they have been identified. For European Union countries these adjustments are mainly taken from European Commission (2007).

Sources: OECD Economic Outlook 83 database, European Commission (2007), "Public Finances in Emu, 2007".

The US fiscal stimulus will give growth a boost around mid-2008

The US fiscal package appears to have the merits of being temporary and targeted. It includes individual tax rebates and temporary investment incentives worth just over 1.2% of GDP in fiscal year (FY) 2008. Estimates of the impact of the 2000 package, which it resembles, suggest that 20 to 40% of the rebate tends to be spent in the quarter in which it is received and over 60% of it within six months (Johnson *et al.*, 2006). In the present case, tax rebates, which will represent about two-thirds of the fiscal cost of the package, began to be implemented from May. If roughly half of the rebate is spent, there will be a temporary boost to GDP growth by about 1 to 1½ per cent in the second and third quarters of 2008 (at annualised rates), after which the level of activity will gradually revert to the underlying trend.

The US deficit may remain large beyond 2008

Because it is temporary the fiscal package will not figure in the US government budget for 2009. Nevertheless, the deficit may still deteriorate from 3% of GDP in 2007 to over 5% in 2009. About half of this deterioration reflects cyclical factors and much of the rest is explained by the fading of the recent exceptional contribution from corporate taxes.

The reduction in the euro area fiscal deficit has ended

The euro area's public finances have improved from a combined "underlying" (here taken to mean adjusted for one-off factors) cyclically-adjusted deficit of 2.1% of GDP before the 2001 slowdown to a deficit of only 0.6% of GDP in 2007. The euro area government deficit is projected to expand by around ½ per cent of GDP in 2008, about half of which is explained by cyclical factors and the rest by a more expansionary fiscal stance, which is more than accounted for by the largest countries.

Fiscal expansion is underway in Germany…

- In Germany, the underlying cyclically-adjusted fiscal balance is likely to fall from close to balance in 2007 to a deficit of nearly 1% of GDP in 2008, although this mainly reflects a long-planned structural tax reform rather than explicit counter-cyclical fiscal stimulus.

… and France

- In France, tax cuts are likely to increase the underlying cyclically-adjusted deficit from under 3% of GDP in 2007 to 3¼ per cent of GDP in 2008, although there may be some fall in 2009 due to announced measures to contain public spending. The headline deficit will still be close to the 3% Maastricht limit in 2009.

Further reductions in the structural deficit are not expected in Italy

- In Italy, the underlying cyclically-adjusted deficit has been reduced from 4% of GDP in 2005 to 1½ per cent of GDP in 2007, which is important given that public debt in excess of 100% of GDP is an impediment to growth (OECD, 2007a). However, this progress may be coming to an end, with the underlying cyclically-adjusted deficit expected to remain at 1½ per cent of GDP in 2008-09, and the headline deficit rising to 2¾ per cent of GDP in 2009.

Spain is implementing fiscal stimulus

- In Spain, where there may be more scope for fiscal measures given recent surpluses and the low level of government debt, the cyclically-adjusted surplus is expected to decline by nearly 1% of GDP in 2008. This reflects a tax stimulus package, additional support for the residential construction sector as well as the bringing forward of infrastructure spending.

Smaller "Excessive Deficit" EU countries will reduce large deficits

Smaller EU countries which have recently been subject to the Excessive Deficit Procedure -- Hungary, Portugal, Czech Republic and Slovak Republic -- are all expected to further reduce their deficits, so that the underlying cyclically-adjusted deficit is below 3% of GDP by 2009. Poland is an exception with the underlying cyclically-adjusted deficit rising to over 3½ per cent in 2009.

The UK fiscal deficit will exceed 3% of GDP again

The general government deficit in the United Kingdom has averaged more than 3% of GDP over the past five years and is likely to increase well above this in 2008 and 2009. This reflects cyclical factors, the disappearance of temporary revenue buoyancy and a fiscal stimulus for the 2008/09 tax year in the form of a temporary tax cut for those on lower incomes.

Fiscal consolidation is stalling in Japan

Japan has reduced its underlying fiscal deficit from 8% of GDP in 2003 to around 3% in 2007. But gross government debt has continued to rise, reaching around 170% of GDP in 2007. In the coming two years little further progress is expected towards achieving the government target of a primary surplus for central and local governments combined by FY 2011, which is an essential first step towards reducing the government debt ratio in the 2010s. The huge stock of government debt combined with rapid population ageing and other long-term spending pressures mean that delaying fiscal consolidation will incur considerable costs (Cournède, 2007; OECD, 2008a).

Longer-term lessons from the current episode of financial turmoil

Regulatory control of financial markets needs to be reformed

Recent financial turmoil has prompted a review of financial markets' prudential and regulatory frameworks both at the national level and through a wide range of international fora. For example, the Financial Stability Forum (FSF)[19] has recently presented a report making recommendations in several areas (FSF, 2008). The long list of recommendations notably includes: strengthening the Basel II capital treatment of structured credit and securitisation activities; pressing banks to better assess and manage risks associated with off-balance sheet exposures; reviewing the role of ratings by both investors and regulators combined with pressures on rating agencies to improve the quality of these ratings; and aligning the financial industry compensation models with long-term, firm-wide profitability. Against the background of increased internationalisation of financial institutions the FSF also recommends that authorities clarify and strengthen cross-border arrangements for managing crises and dealing with weak banks. While this recommendation may be especially relevant for the euro area, as a currency union with several independent supervisory and regulatory institutions, diverse deposit insurance schemes and no harmonised procedure to deal with bank failures, the need to extend and tighten regulatory and supervisory coverage may be particularly acute in the United States where intervention to prevent the failure of a highly inter-connected but lightly-regulated institution might otherwise create problems of moral hazard.

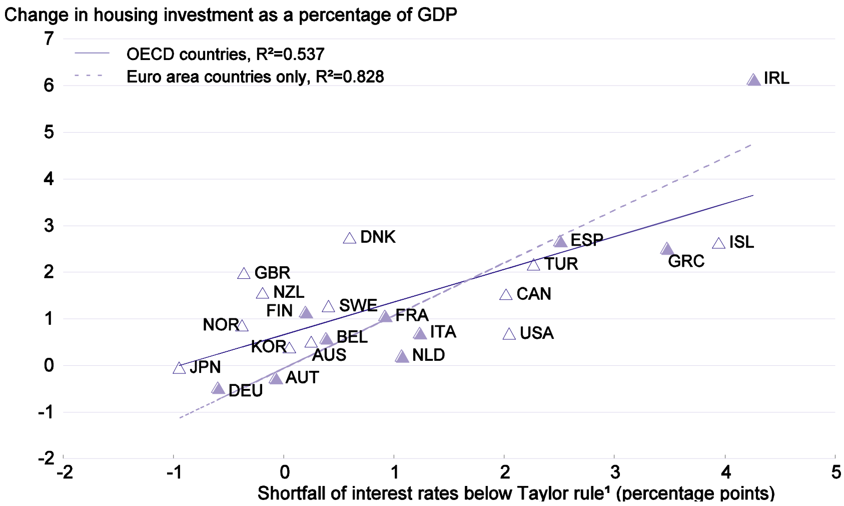
Loose monetary policy may have contributed to imbalances

The current episode also highlights a long-standing debate about the conduct of monetary policy during credit and asset price booms. The current bout of financial turmoil itself was preceded by a run-up in asset prices which, in retrospect, may have been partially caused by the accommodative stance of monetary policy over the first half of the decade -- however well motivated in terms of averting risks from deflation and corporate scandal -- although this remains an area of controversy in the United States (see Taylor, 2007; and Negro and Otrok, 2007, for opposing views). During the same period, incomplete business cycle convergence within the euro area

19 . The FSF brings together national authorities responsible for financial stability in major international financial centres, international financial institutions and committees of central bank experts to promote international financial stability through information exchange and co-operation in financial market supervision.

resulted in a situation where, for some member countries including Ireland and Spain in particular, monetary policy rates were persistently and significantly below what traditional rules-of-thumb would have suggested.[20, 21] Over the 2001-06 period, the cross-country correlation between various indicators of housing market buoyancy and the deviation between actual euro area interest rates and country-specific rule-of-thumb rates is striking and, while somewhat weaker, this correlation also seems to exist when looking at a broader country sample (Figure 1.19).

Figure 1.19. Low interest rates and the housing investment boom, 2001-06



Note: Filled triangles refer to euro area countries.

1. Average shortfall of short-term interest rates below those implied by a Taylor rule, see Ahrend *et al.* (2008).

Source: OECD calculations.

But using monetary policy to combat potential bubbles may be difficult

The issue of whether and how central banks should react to possible asset price misalignments remains controversial. One view is that the presence of a bubble can only be established with sufficient certainty once it has burst, and that central banks should only clean up the fallout from a collapsed bubble *ex post* (Greenspan, 2002). On the other hand, it may be argued that asset price misalignments are no more difficult to identify than other unobservables (such as output gaps or structural unemployment rates) regularly relied upon for making monetary policy decisions, and high growth in credit aggregates may be helpful in identifying unsustainable asset price increases (Borio and Lowe, 2004). Recent Australian experience has been cited as a successful example of preventing an asset price boom from getting out of hand (Gruen *et al.*, 2003). Monetary policy action is likely to be more useful in the earlier stages of a bubble, because tightening

20 . Taylor rules, relating interest rates to inflation and the output gap, are used as the benchmark rule for this analysis, for further details see Ahrend *et al.* (2008).

21 . In a monetary union the central bank obviously has to focus on the currency area in its entirety when setting interest rates, even if this has diverging effects on asset prices which, potentially, may lead to financial imbalances in some member countries.

shortly before a bubble bursts can worsen the ensuing economic decline, but it is in the early stages that a bubble is particularly difficult to detect. That said, monetary policy reaction to the bursting of a bubble has often involved rapid and large cuts in interest rates which have often been followed by a very gradual process of normalisation. Somewhat greater symmetry between the down- and the upside may be desirable. In any case, for areas sharing the same currency, or countries with fixed exchange rate regimes, a monetary policy option to fight unwarranted asset price booms upfront does not exist.

There is greater scope for using macro-prudential instruments

An alternative approach to tackling the build-up of a financial bubble, as well as providing a better buffer against its subsequent bursting, might involve "macro-prudential" instruments (Borio and White, 2004). This could include making capital adequacy, loss provisioning[22] or reserve requirements dependent on measures of credit growth or risks of overvaluation of assets, although a potential drawback is that this may single out the banking sector and so result in a shift of activity to unregulated non-banking financial institutions. Such measures may entail some efficiency costs, but especially, though not exclusively, for areas in monetary unions, such costs should be set against the risk of being exposed to financial shocks with no ability to respond through monetary policy.

22 . An option to make banks behaviour less pro-cyclical is to enforce a dynamic provisioning framework by which banks make provisions based on the losses expected when loans are originated rather than on actual losses. In such a framework, provisions rise during credit booms before losses materialise, helping to protect banks when actual losses increase (Mann and Michael, 2002). Such a framework has operated in Spain since 1999 (Bank of Spain, 2002), although it has not prevented strong credit growth to the residential construction sector during the recent housing boom, and bank solvency ratios in 2007 (at around the peak of the boom) were no better than in the EU on average (Bank of Spain, 2007).

APPENDIX 1.A1
ESTIMATED RESPONSES OF OECD ACTIVITY TO VARIOUS SHOCKS

General features of the OECD Global Model

The OECD's new model can be used to assess the effects of shocks

In this Appendix, the new OECD Global Model (Hervé *et al.*, 2007) is used to evaluate the response of the major economies to a variety of shocks and to provide more detail on the analysis of financial spillovers described in the main text. The model itself is highly aggregated in terms of country coverage, identifying specifically the United States, the euro area, Japan and China. The other countries in the OECD and the rest of the world are combined into various groups that reflect the strength of trading links with one or more of the individual economies identified. The model's focus is on the global linkages between these economies and the accompanying feedback mechanisms. It identifies explicitly the channels through which changes in a variety of important variables affect growth and inflation through trade, exchange rates and international financial linkages.

Responses to a variety of shocks

It identifies important linkages between economies

A number of stylised shocks were chosen to reflect the various risks surrounding the current outlook. These include simulated responses of growth and inflation in the three major OECD economies to changes in US house prices, non-OECD demand, risk premia, exchange rates and oil prices, as shown in Table 1.9. Except where otherwise stated, nominal bilateral exchange rates are held constant. The monetary authorities are assumed to follow a Taylor rule and set short-term interest rates taking into account the deviation of output from potential as well as the difference between actual inflation and what is known about central bank inflation objectives. Regarding fiscal policy, the authorities are assumed to target a fixed debt-to-GDP ratio over the medium term.

A shock to US house prices remains localised…

- In the projections, the fall in US house prices is assumed to end by the second quarter of 2009. As an illustration of their impact, the model suggests that an additional 10% drop in house prices would lower US activity by ⅓ per cent through both wealth and collateral effects and this would spill over into lower imports, improving the current account. Inflation would be lower but by a small amount. Spillover effects to the other major economies are minimal.

Table 1.9. **Estimated impacts if risks materialise**

Difference from OECD Economic Outlook No. 83 projection, percentage points

	Weaker US house prices[1]		Lower emerging market demand[2]		Continued financial turmoil[3]		Depreciation of the dollar[4]		Further oil price shock[5]	
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
United States										
Output growth	-0.2	-0.3	-0.1	-0.1	-0.3	-0.4	0.4	0.3	-0.1	-0.2
Inflation	0.0	-0.1	0.0	0.0	0.0	-0.1	0.2	0.3	0.2	0.1
Japan										
Output growth	0.0	0.0	-0.1	-0.3	-0.2	-0.3	0.0	-0.2	-0.1	-0.2
Inflation	0.0	0.0	-0.1	-0.1	-0.1	-0.1	0.0	-0.2	0.2	0.1
Euro area										
Output growth	0.0	0.0	0.0	-0.1	-0.1	-0.2	-0.2	-0.1	-0.1	-0.1
Inflation	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	0.2	0.1

1. US house prices fall by 10%.
2. Domestic demand in emerging markets falls by 1%.
3. Risk premiums rise by 50 basis points in all countries.
4. The US dollar falls by 10% against all currencies.
5. The reported effects are for a 10% shock to oil prices relative to baseline; in the present case this is equivalent to an increase of $12 per barrel relative to the baseline assumption of $120 per barrel. These ready reckoner effects are approximately linear in percentage terms, although significantly larger shocks need to be re-evaluated on a specific basis.

Source: OECD calculations.

… as does a decline in emerging market demand

- Emerging market economies have become important drivers of growth for the OECD area and in these projections they are assumed to continue growing at a robust pace, driven by healthy domestic demand, with less of a reliance on trade. The effects of a 1% reduction in domestic demand in emerging markets on the OECD economies would be distributed according to the importance of trade with these economies. Japan, with closer trade ties with a number of these economies (notably China), would be affected by more and would also see a small drop in its inflation rate.

On the other hand changes to risk spreads…

- A further 50 basis point increase in risk spreads in all countries (a proxy for financial turmoil) would have significant effects across countries. The US economy would be hit the hardest as households' consumption is more sensitive to interest rates. The other two main OECD economies would also be affected, but to a lesser degree, with Japan feeling more of the shock than the euro area in part because of the lack of scope for policy to respond. Inflation is lowered in all economies by a small amount.

… exchange rates…

- A feature of the current conjuncture has been the adjustment in exchange rates, with the US dollar depreciating in both nominal and effective terms against the euro and the yen. A further 10% depreciation of the US dollar in nominal terms against each economy would boost US activity through trade as well as raise inflation. The counterpart would be lower activity and inflation in the euro area and Japan.

… or oil prices tend to affect all economies

- The other important feature of the existing economic situation has been the continuous rise in the price of oil, which recently peaked at over $130 (per barrel of Brent). A 10% further increase in oil prices would slow growth in the major economies on the order of a tenth in the first year of the shock cumulating to two tenths by the second year. These simulations assume that respending out of extra oil revenues remains unchanged and that there are no second-round effects into core inflation. They also do not allow for possible adverse effects on potential output.

Details on the spillover of financial market risks

The details behind the simulations of US financial turmoil

Table 1.10 provides more detail on the simulations of the effects of the change in financial market conditions and exchange rates described in the main text. It is important to note that summing across rows in this table does not produce a figure that adds up to the total effects shown in

Table 1.10. **Details underlying the simulations of turmoil since end-2007**

	Global shock		US housing price		US housing investment		Risk premia		Exchange rates		Equity price	
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
United States												
GDP level	-0.7	-1.2	-0.1	-0.4	-0.1	0.0	-0.3	-0.6	0.1	0.2	-0.3	-0.8
Inflation[1]	-0.1	-0.2	0.0	-0.1	0.0	-0.1	0.0	-0.1	0.1	0.1	-0.1	-0.1
Current balance[2]	0.2	0.3	0.0	0.1	0.1	0.0	0.0	0.1	0.0	0.1	0.0	0.1
Euro area												
GDP level	-0.7	-1.3	0.0	0.0	0.0	0.0	0.0	-0.2	-0.4	-0.6	-0.3	-0.4
Inflation[1]	-0.2	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.3	-0.1	-0.1
Current balance[2]	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.1	-0.1	-0.3	0.2	0.2
Japan												
GDP level	-0.5	-1.2	0.0	-0.1	0.0	0.0	0.0	-0.2	-0.3	-0.7	-0.1	-0.3
Inflation[1]	-0.4	-0.6	0.0	0.0	0.0	0.0	0.0	-0.1	-0.3	-0.4	-0.1	-0.1
Current balance[2]	-0.7	-0.8	0.0	0.0	0.0	0.0	0.0	-0.1	-0.6	-0.7	0.0	-0.1
Total OECD												
GDP level	-0.6	-1.1	-0.1	-0.2	-0.1	0.0	-0.1	-0.4	-0.1	-0.2	-0.3	-0.5
Inflation[1]	-0.1	-0.3	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	-0.1	-0.1
Current balance[2]	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.2	0.0	0.0
China												
GDP level	-0.3	-0.5	0.0	-0.1	-0.1	0.0	-0.1	-0.2	-0.1	0.0	-0.1	-0.3
Inflation[1]	0.1	0.4	0.0	0.0	0.0	0.0	0.0	-0.1	0.2	0.6	0.0	-0.1
Current balance[2]	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.1	-0.1	-0.1

1. Consumer price deflator.
2. Per cent of GDP.
Source: OECD calculations. See text for description of the shocks.

Table 1.6 above because of the various endogenous responses contained in the model when all shocks are applied simultaneously and different policy reactions. That said, looking at the shocks individually does provide important insights on the relative importance of individual components and the different mechanisms involved.

The shocks have several components

The specific component shocks in the simulations illustrating changes since the previous *Outlook* in November are:

- *US housing price:* 10% decrease in US house prices.

- *US housing investment*: starting in the first quarter of 2008, investment relative to GDP declines at a decreasing rate until the fourth quarter of 2009.

- *Risk premia*: For the United States, the risk spread (225 basis points) is the amount by which US high yield corporate spreads rose between November 2007 and March 2008. Over the same period, the spread of BBB bonds in the euro area rose by 120 basis points, while Baa spreads in Japan rose by 80 basis points. These spreads are assumed to persist through 2008 and then are gradually removed starting in the first half of 2009.

- *Exchange rates*: appreciations against the dollar in 2008 and 2009 occur in the euro area (9 and 10%) and in Japan (7 and 8%). Commodity exporters such as Canada experience mild depreciations (2.7 and 2.5%), and in China there is an additional 2% appreciation for both years.

- *Equity prices*: the 10% fall in equity prices in the US remains through 2008 and 2009, as do reductions in the euro area and Japan of 17% and 16%, respectively.

APPENDIX 1.A2
QUANTIFYING THE EFFECT OF FINANCIAL CONDITIONS ON US ACTIVITY

The impact of financial conditions on activity

Financial conditions affect activity through several channels…

This appendix explores ways to quantify the effect of financial headwinds on the US economy, where currently such effects are judged to be large. That economy also has the advantage of having a wide range of financial market variables with a sufficiently long enough time series to allow estimation. There is abundant empirical evidence regarding the effect of interest rates, the exchange rate and asset prices on GDP or its component expenditures. There is also empirical evidence to show that bond spreads have significant explanatory power for the US business cycle (for example Gertler and Lown, 2000, and Mody and Taylor, 2003). Moreover, recent work has found a significant impact of non-price credit standards, as measured by responses to the federal loans officer's survey, on US growth (Lown and Morgan, 2004, Estrella, 2004, and Deutsche Bank, 2008).

… including non price credit conditions

Numerous studies, some of which are summarised in Table 1.11, have constructed various financial conditions indices (FCIs) which attempt to provide a single summary measure of the overall stance of financial conditions. Most of these incorporate effects from asset prices as well as interest rates and the exchange rate. However, there does not seem to have been any attempt to incorporate into a single FCI asset price effects, risk spreads and non-price credit conditions as well as interest rates and the exchange rate.

Table 1.11. **Summary table of previous work to construct financial conditions indices**

Study	Countries covered	Financial variables included[1]	Comments
Goldman Sachs (2000)	United States	Stock market capitalisation/GDP	Weights based on GDP effects derived from Fed's macro model
Goodhart and Hofmann (2001)	Each of the G7	Real house prices, real equity prices	Alternative Financial Conditions Indice (FCI)'s calculated both from reduced form and Vector Auto Regression (VAR) estimation
Gauthier, Graham, Liu (2004)	Canada	Real housing prices, real US equity prices, US high yield spread	Alternative FCI's calculated from reduced form, VAR estimations and factor analysis
Mayes and Virén (2001)	11 European countries	Real house prices, real asset prices	Reduced form equations

1. In addition to (low-risk) interest rates and the exchange rate.
Source: OECD calculations.

Empirical work underlying the construction of a financial conditions index

Econometric estimations

Using econometric techniques…

The weight of each variable in the FCI is based on the relative effect of a one-unit change in that variable on US GDP. Estimation was undertaken using two methods: an unrestricted vector auto-regression (VAR) to explain GDP growth and a reduced form equation for the output gap. In both cases potential financial explanatory variables which were investigated included: real short-term interest rates, real long-term interest rates, the real effective exchange rate, various measures of bond spreads, stock market capitalisation and real housing wealth (both expressed as a share of GDP and taken as the deviation from trend, following Goodhart and Hofmann, 2001). In addition, the VAR estimation included core inflation and oil prices in the specification (the latter as an exogenous variable). The estimations were carried out on quarterly data spanning the period 1990Q4 to 2007Q3.[23]

… the impact of each financial variable on GDP is estimated

The estimated average effect on GDP after four to six quarters following a shock to each financial variable is reported in Table 1.12 for a preferred specification from both the reduced form and VAR.[24] The main findings from these results are as follows.

Credit standards always play an important role…

- The non-price measure of credit availability[25] has a significant, correctly signed and similar effect in both the VAR and reduced form estimations; a net 10 percentage points tightening in the survey response on lending conditions reduces GDP by about ¼ percentage point after four to six quarters. The magnitude of these effects is smaller, but not dissimilar to those obtained by Lown and Morgan (2004).[26]

23 . The estimation period is limited by availability of data for the Federal Loan Officer Survey, which starts in 1990.

24 . For the VAR, generalised impulse functions are calculated to determine the FCI weights, following the approach proposed by Peseran and Shin (1998) (and used by Gauthier *et al.* (2004) in their construction of an FCI for Canada), which has the merit that responses are invariant to the ordering of the variables.

25 . The Federal Loan Officers Survey provides responses on the number of banks tightening credit standards over a three-month period, so that, depending on how banks interpret the questionnaire, it does not necessarily provide an absolute measure of the credit standards rather than a measure of how they have changed. However, alternative functional forms of the survey responses, in which they were variously accumulated over time, invariably led to deterioration in goodness-of-fit in the empirical estimation. Cunningham (2006) expresses some scepticism about the information content of the loan officer survey responses, but this is mainly related to responses regarding consumer and real estate loans rather than those to businesses.

26 . Lown and Morgan (2004) report a peak effect on GDP of -0.5% for a shock to credit standards of 8 percentage points.

Table 1.12. **The estimated effects on GDP from shocks to financial variables**

	Shock	Effect on GDP (%) after 4-6 quarters: Reduced form equation	Effect on GDP (%) after 4-6 quarters: VAR
Real short-term interest rates	100 basis point increase	-0.09	-0.06
Real long-term interest rates	"	-0.52	-0.10
High yield bond spread	"	-0.04	-0.23
Baa rated bond spread	"	-0.52	--
Credit standards tightening	10% percentage point increase	-0.27	-0.23
Real exchange rate (deviation from trend)	"	-	-1.14
Stock market capitalisation (ratio to GDP, de-trended)	"	-0.52	-

Source: OECD calculations.

... as do corporate bond spreads

- The corporate bond spread and the high yield bond spread are always correctly signed and statistically significant when included separately in the reduced form estimation, but due to collinearity between the variables it is difficult to find them both significant simultaneously.

The impact of "safe" bond rates varies with the estimation technique

- In both the VAR and reduced form estimation, interest rates are correctly signed, with a more powerful effect from real long-term rates than short-term rates. However, the magnitude of the effect of interest rates on GDP is more than three times stronger in the reduced form estimation than the VAR.

The real exchange rate is only weakly significant

- The real effective exchange rate variable is rarely statistically significant in the reduced form estimation and is excluded from the preferred specification summarised in Table 1.12. There is an economically sizeable (but statistically weak) effect from the real exchange rate in the VAR specification.

Results on assets prices are mixed

- Stock market capitalisation had a strong, well determined effect in the reduced form estimation, that is substantially greater than suggested by back of the envelope calculations regarding a conventional wealth effect operating through consumption. It was not significant in the VAR. This difference may be due to problems of causality and simultaneity in the reduced form estimation where it may be difficult to distinguish whether an increase in equity prices today is *causing* a future increase in activity (*via* a wealth effect) or is *anticipating* it (perhaps in response to some other financial news). This is borne out by Goodhart and Hoffman (2001), who in estimating FCIs for the G7 countries found a much lower effect of the stock market effect on GDP in a VAR than in a reduced form. Various measures of housing wealth were always statistically insignificant and/or incorrectly signed and so omitted from both estimation methods.

Computing the financial conditions index

The weights derived from the reduced form

The preferred FCI is based on the reduced form equation

The retained preferred specification is based on the reduced form equation for the output gap explained by the real long-term interest rate, dynamic (*i.e*. temporary) effects from real short-term interest rates, the real exchange rate, spreads on high-yield and Baa corporate bonds, stock market capitalisation, as well as non-price credit standards (for more details on the estimations see Guichard and Turner, 2008). Weights of the variables in the FCI (Table 1.13) are based on the relative effect of a one unit change in the relevant variable on GDP, evaluated as the average effect on the level of GDP after four to six quarters, a horizon chosen because of its relevance to monetary policy. To attenuate the impact of simultaneity and causality that may affect the weight of the stock market variable, instead of using the result from the estimation, the weight has been calibrated on the basis of a "3½ cents" wealth effect operating through consumption (similar to that used in the Federal Reserve's FRB/US model). A weight of 0.15 has been imposed on the real exchange rate, which is the weight used in the OECD MCI and derived from large-scale macro model simulations.

Table 1.13. **The weights used to construct the financial condition indices**

		Weights used in construction of index		
	Standard deviation, 1990-2007	**OECD Monetary Conditions Index (MCI)**	**Financial Conditions Index (FCI)**	**VAR FCI**
Real short-term interest rates (%)	1.74	**1.00**	0.20	0.24
Real long-term interest rates (%)	1.21		**1.00**	**1.00**
High yield bond spread (%)	-0.20		0.08	0.94
Baa rated bond spread (%)	0.51		0.91	
Credit standards tightening (net % survey response)	21.5		0.05	0.11
Real exchange rate (deviation from trend)	0.08	0.15	0.15 [1]	0.15 [1]
Stock market capitalisation (ratio to GDP, de-trended)	0.21		-0.04	-0.04

1. Indicates an imposed coefficient. In the case of the Vector Auto Regression (VAR) the freely estimated weight of the real effective exchange rate is three times larger than the imposed one.

Source: OECD calculations.

The weights derived from the VAR

A VAR based FCI gives more weight to current financial stress

A potential advantage of the VAR estimation over the reduced form estimation in that it better takes into account the feedback between all variables, which is particularly important when dealing with financial variables. The main difference in the weights from using the reduced form or the VAR to compute the FCI is that the financial variables reflecting the current stress on financial and credit market have a much larger weight in the latter. This is because the effects of the real long term rates, on which the weights are normalised, are much lower in the VAR than the reduced form. As for the reduced form, a weight of 0.15 has been imposed on the real exchange rate. Although equity wealth variables had a non-significant impact on GDP in the VAR estimations, this variable was added by using the same calibrated weights as in the reduced form.

Comparing the evolution of narrow monetary conditions and broader financial conditions

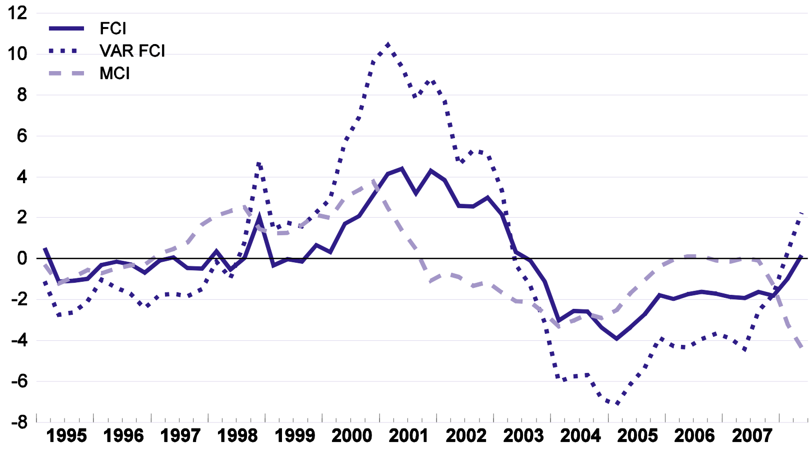
Narrow monetary conditions have loosened during the turmoil

In order to contrast the recent evolution of narrow monetary with broader financial conditions, the main financial variables have, where necessary, been projected to give values for 2008Q2: the interest rates and exchange rates are those projected in the current *OECD Economic Outlook*; and interest rate spreads and stock market capitalisation remain at their most recently observed values. On this basis, narrow monetary conditions have been loosened significantly since the summer; the dollar has continued to depreciate and the federal funds rate has been cut by 325 basis points since August, which has mostly been reflected in the three-month euro-dollar deposit rate (the rate used in the construction of the OECD's monetary conditions index) (Figure 1.20). Moreover, monetary conditions are relatively easy when compared with the average stance since the mid-1990s.

While broader financial conditions have tightened

This contrasts markedly with the current state of broader financial conditions, as measured by both FCIs, which have tightened since the summer reflecting the tightening in non-price credit standards and the increase in spreads for riskier borrowers. The overall tightening of the FCI since 2007Q2 could reduce GDP by a little more than 1 percentage point over the projection period (Table 1.14). While the tightening of credit standards combined with higher spreads and lower share prices could remove as much as 2.7% of GDP over the projection period, this negative impact is partly compensated by the monetary stimulus, lower real long-term rates and dollar depreciation. The tightening (and the implied

Figure 1.20. Comparison of monetary (MCI) and financial (FCI) condition indexes



Source: OECD calculations.

impact on activity) is more pronounced for the FCI using the weights derived from the VAR as non price credit standards and spreads play a much prominent role in that index.

Table 1.14. Accounting for the tightening in financial conditions since the onset of the financial turmoil

Component of the Financial Conditions Indice (FCI)	Change 2007 Q2 to 2008 Q2[1]	Contribution to change in FCI	Estimated effect on GDP after 4-6 quarters
Net percentage of banks tightening standards	59.1	3.0	-1.6
Change in high yield spreads (percentage points)	3.5	0.3	-0.1
Change in AAB rated bond spreads (percentage points)	1.4	1.2	-0.7
Change in stock market capitalisation as a % of GDP (percentage points of GAP)	-0.1	0.6	-0.3
Total negative factors	0.0	5.1	-2.7
Change in real short-term interest rates (percentage points)	-2.9	-0.6	0.3
Change in real long term interest rates (percentage points)	-0.9	-0.9	0.5
Change in real exchange rate (%)	-10.0	-1.5	0.8
Total supportive factors		-3.0	1.6
Total		2.0	-1.1

1. 2008 Q2 is estimated.
Source: OECD calculations.

APPENDIX 1.A3
THE MEDIUM-TERM REFERENCE SCENARIO

Area-wide potential growth to ease to below 2%

The medium-term reference scenario illustrates a supply-side driven dynamic path that closes output gaps by 2014. Underpinning the projections are several technical assumptions -- described in Box 1.7. Tables 1.15 to 1.17 provide an overview of the scenario to 2014. The main feature is that, over the period from 2010 to 2014, potential GDP growth for the OECD area as a whole is expected to slow -- to below 2% *per annum* by 2014. This mainly reflects an expected slowing of working age population growth and trend participation rates. In light of anticipated negative effects on potential output growth from higher oil prices and higher financial risk premia, potential growth is also assumed to be slightly lower (between 0.1% and 0.2%) in all OECD countries than would otherwise be the case (Chapter 3). Given the technical nature of the assumptions that underlie this scenario, it is mainly intended to serve as a benchmark for the analysis of global interlinkages and transmission of local shocks, as discussed in the main text.

Scenario starts with output gaps that are generally negative

The output gap for the OECD area is now expected to be negative at the end of the short-term projection period in 2009. By assumption, actual GDP will be moving toward potential and therefore grows slightly faster than potential over the medium-term horizon. At the same time OECD-wide unemployment is assumed to fall gradually to an underlying structural rate of about 5½ per cent of the labour force by 2014.[27]

Fiscal imbalances remain

The real price of oil is assumed to be unchanged over the period, so has no further inflationary impact. In fact, the negative output gaps at the beginning of the scenario suggest a decline of inflation during the medium-term scenario. This occurs in many countries but is partially masked in aggregate by increasing Japanese inflation. Aggregate OECD-wide inflation is thus stabilising at just under 2% *per annum*. Fiscal balances for the area as a whole improve slightly given the assumption of growth returning to potential. Nonetheless, deficits on average remain just under 2½ per cent of GDP, reflecting continuing large structural deficits in the major economies and lack of specific policies to deal with them.

27 . A recent re-estimation of NAIRUs (Gianella *et al.*, 2008) resulted in some changes to the estimated NAIRU for a few countries.

Table 1.15. **Medium-term reference scenario summary**

Per cent

	Real GDP growth 2010-2014	Inflation rate[1] 2009	Inflation rate[1] 2014	Unemployment rate[2] 2009	Unemployment rate[2] 2014	Current balance[3] 2009	Current balance[3] 2014	Long-term interest rate 2009	Long-term interest rate 2014
Australia	2.8	3.1	2.5	4.7	5.1	-4.6	-2.8	6.1	6.5
Austria	1.8	2.3	1.9	4.8	5.2	3.3	2.7	4.4	4.7
Belgium	1.8	2.0	1.9	7.2	7.9	0.9	0.8	4.4	4.7
Canada	2.5	1.1	2.0	6.3	6.0	-0.8	1.6	4.2	5.2
Czech Republic	3.5	2.9	2.0	4.4	4.9	-1.8	-1.8	4.8	5.0
Denmark	1.0	2.6	1.9	3.7	4.2	0.7	1.6	4.4	4.8
Finland	1.9	2.4	1.9	6.0	6.9	2.4	0.6	4.4	4.7
France	1.7	2.2	1.9	7.6	8.0	-1.6	-0.9	4.3	4.7
Germany	1.4	1.7	1.9	7.4	8.2	7.7	7.4	4.3	4.7
Greece	3.5	3.1	1.9	7.7	8.7	-15.2	-13.6	4.5	4.7
Hungary	3.4	3.7	2.0	7.6	6.1	-4.1	-4.0	7.1	5.0
Iceland	4.5	6.0	2.8	5.7	3.0	-8.6	-14.7	10.3	6.7
Ireland	5.5	2.1	1.9	6.5	4.7	-3.8	-5.1	4.4	4.7
Italy	1.5	2.0	1.9	6.5	6.1	-2.6	-2.6	4.6	4.8
Japan	1.1	0.3	1.0	3.8	4.0	4.4	3.5	2.1	3.3
Korea	4.6	3.2	3.0	3.1	3.4	-1.0	0.9	5.8	6.9
Luxembourg	4.7	2.1	1.9	4.9	5.2	9.2	4.4	3.9	4.7
Mexico	4.5	3.4	3.2	3.6	3.2	-2.0	-1.7	7.0	7.0
Netherlands	1.0	2.8	1.9	2.7	3.5	5.9	5.2	4.4	4.7
New Zealand	2.3	2.2	2.0	3.8	4.0	-8.1	-6.0	6.4	5.7
Norway	2.8 [4]	2.5	2.0	2.8	3.3	18.6	16.7	4.5	4.7
Poland	3.4	5.4	2.0	6.9	8.2	-5.6	-2.8	5.9	5.6
Portugal	1.6	2.2	1.9	7.9	6.8	-11.6	-11.3	4.5	4.7
Slovak Republic	6.2	3.6	2.9	9.6	6.2	-3.1	-2.9	4.5	4.7
Spain	3.3	3.0	1.9	10.7	8.1	-9.8	-8.2	4.3	4.7
Sweden	2.2	2.4	1.9	4.4	4.6	8.4	7.5	4.9	4.7
Switzerland	2.1	1.5	1.0	3.8	3.7	11.0	11.4	3.3	3.0
Turkey	6.8	7.5	4.6	10.5	7.9	-5.3	-4.9	17.2	9.2
United Kingdom	2.4	2.9	2.0	5.8	5.4	-3.1	-3.0	4.8	5.5
United States	2.5	2.0	1.9	6.1	4.9	-4.4	-4.4	4.4	5.2
Euro area	1.9	2.2	1.9	7.4	7.3	0.0	0.0	4.4	4.7
Total OECD	2.4	2.0 [5]	1.9 [5]	6.0	5.5	-1.1	-1.1	4.3 [5]	5.0 [5]

Note: For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Percentage change from the previous period in the private consumption deflator.
2. Per cent of labour force.
3. Per cent of nominal GDP.
4. Including oil-sector.
5. Excluding Turkey.

Source: OECD Economic Outlook 83 database.

Table 1.16. **Fiscal trends in the medium-term reference scenario**

As a percentage of nominal GDP

	Financial balances[1]		Net financial liabilities[2]		Gross financial liabilities[3]		Gross public debt (Maastricht definition)[4]	
	2009	2014	2009	2014	2009	2014	2009	2014
Australia	1.7	1.6	-9	-14	14	9	..	..
Austria	-0.8	-1.0	34	33	61	60	58	58
Belgium	-0.9	-1.1	70	63	85	78	81	75
Canada	-0.5	0.0	22	18	65	62	..	..
Czech Republic	-1.3	-1.1	-8	-1	31	28	..	..
Denmark	3.0	2.2	-9	-19	25	15	19	9
Finland	3.8	3.6	-73	-79	39	33	33	27
France	-2.9	-2.9	37	45	73	80	67	75
Germany	-0.2	-0.5	42	38	63	59	63	58
Greece	-2.1	-2.0	64	58	98	92	90	84
Hungary	-3.5	-2.9	54	57	73	72	..	..
Iceland	-1.0	1.0	1	1	23	23	..	..
Ireland	-2.6	-0.8	5	11	35	41	30	36
Italy	-2.7	-1.8	91	87	117	113	104	100
Japan	-2.2	-3.6	88	94	170	177	..	..
Korea	4.4	4.5	-42	-51	25	16	..	..
Luxembourg	1.3	3.3	-44	-43	10	-5	..	..
Netherlands	1.5	0.7	24	16	47	39	41	33
New Zealand	1.8	2.0	-15	-21	21	16	..	..
Norway	17.1	12.4	-165	-196	76	47	..	..
Poland	-2.7	-2.7	22	27	54	60	..	..
Portugal	-2.0	-0.9	44	43	72	72	64	64
Slovak Republic	-1.6	-1.1	8	11	39	31	..	..
Spain	-0.3	0.9	19	14	41	35	34	29
Sweden	2.7	2.9	-25	-34	37	28	31	21
Switzerland	0.1	-0.1	12	10	57	55	..	..
United Kingdom	-3.7	-2.7	35	43	52	60	49	57
United States	-5.2	-4.6	52	64	70	82	..	..
Euro area	-1.2	-1.0	43	41	70	69	66	64
Total of above OECD countries	-2.6	-2.4	44	49	78	82		

Note : For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. General government fiscal surplus (+) or deficit (-) as a percentage of GDP.
2. Includes all financial liabilities minus financial assets, as defined by the System of National Accounts (where data availability permits) and covers the general government sector, which is a consolidation of central government, state and local government and the social security sector.
3. Includes all financial liabilities, as defined by the System of National Accounts (where data availability permits) and covers the general government sector, which is a consolidation of central government, state and local government and the social security sector.
4. Debt ratios are based on debt figures for 2007, provided by Eurostat, and GDP figures from national authorities, projected forward in line with the OECD projections for GDP and general government financial liabilities.

Source: OECD Economic Outlook 83 database.

Table 1.17. **Growth in total economy potential output and its components**

Annual averages, percentage points

	Output gap	Potential GDP growth		Potential labour productivity growth (output per employee)		Potential employment growth		Components of potential employment[1]: *Trend participation rate*		*Working age population*		*Structural unemployment*[2]	
	2009	2005-2009	2010 2014	2005-2009	2010 2014	2005-2009	2010 2014	2005-2009	2010 2014	2005-2009	2010 2014	2005-2009	2010 2014
Australia	-0.1	3.2	2.8	1.1	1.4	2.0	1.4	0.3	0.1	1.6	1.3	0.1	0.0
Austria	0.3	2.1	1.9	1.7	1.6	0.4	0.3	0.1	0.0	0.3	0.3	0.0	0.0
Belgium	-1.0	2.3	1.6	1.2	1.5	1.1	0.2	0.3	0.2	0.8	0.0	0.0	0.0
Canada	-2.0	2.8	2.0	1.2	1.4	1.6	0.6	0.2	0.1	1.2	0.5	0.2	0.0
Denmark	1.2	1.5	1.3	1.1	1.4	0.4	-0.1	0.1	0.0	0.1	-0.1	0.1	0.0
Finland	0.4	3.2	2.0	2.5	2.4	0.7	-0.3	0.2	0.1	0.3	-0.4	0.2	0.0
France	-0.2	1.9	1.7	1.1	1.1	0.8	0.6	0.0	0.0	0.6	0.6	0.1	0.0
Germany	0.5	1.4	1.5	1.3	1.3	0.1	0.2	0.5	0.2	-0.4	0.0	0.1	0.0
Greece	-0.3	4.1	3.4	2.9	3.2	1.2	0.2	0.6	0.4	0.4	-0.2	0.2	0.0
Iceland	-5.9	4.8	3.2	2.8	2.2	1.9	0.9	-0.4	0.3	2.3	0.6	0.0	0.0
Ireland	-4.7	5.0	4.5	1.5	1.8	3.5	2.7	1.0	0.8	2.5	1.9	0.0	0.0
Italy	-2.3	1.3	1.1	0.5	1.2	0.8	-0.1	0.5	0.1	0.0	-0.2	0.2	0.0
Japan	0.7	1.5	1.2	1.9	1.9	-0.3	-0.7	0.3	0.2	-0.7	-0.9	0.0	0.0
Netherlands	1.5	1.8	1.3	1.3	1.1	0.5	0.2	0.4	0.3	0.1	-0.1	0.0	0.0
New Zealand	-0.8	2.7	2.2	1.0	1.4	1.7	0.7	0.5	0.2	1.1	0.6	0.1	0.0
Norway[3]	2.5	3.6	3.3	2.4	2.6	1.2	0.6	-0.1	0.0	1.1	0.6	0.1	0.0
Poland	2.4	4.8	3.9	3.2	3.7	1.5	0.3	-0.5	0.0	0.4	-0.4	1.6	0.7
Portugal	-2.1	1.7	1.2	1.2	1.1	0.5	0.1	0.4	0.0	0.2	0.0	-0.1	0.0
Spain	-3.0	3.2	2.7	0.2	1.1	3.0	1.6	0.9	0.2	1.7	1.3	0.4	0.1
Sweden	-0.5	2.9	2.1	2.1	2.2	0.8	-0.1	0.1	0.1	0.6	-0.2	0.0	0.0
Switzerland	0.8	2.3	2.3	1.2	1.6	1.1	0.6	0.3	0.0	0.8	0.6	0.0	0.0
United Kingdom	-1.5	2.7	2.1	1.8	1.9	0.9	0.3	0.0	0.0	0.8	0.3	0.0	0.0
United States	-2.2	2.5	2.1	1.8	1.7	0.7	0.4	-0.5	-0.7	1.2	1.1	0.0	0.0
Euro area	-0.8	2.0	1.7	1.1	1.3	0.9	0.4	0.4	0.1	0.4	0.3	0.1	0.0
Total of above OECD countries	-1.1	2.3	1.9	1.5	1.6	0.7	0.3	-0.1	-0.3	0.8	0.6	0.1	0.0

1. Percentage point contributions to potential employment growth.
2. Estimates of the structural rate of unemployment are from Gianella *et al.* (2008), based on the concepts and methods described in OECD (2000).
3. Excluding the oil sector.
Source: OECD Economic Outlook 83 database.

Potential growth: lower in the United States…

Potential output growth for the United States is projected to decline to an annual rate of just over 2% by 2014. This mainly reflects continued decreases in potential employment growth. With output below potential in 2009, GDP growth is projected to exceed that of potential, whilst inflation stabilises at just under 2% in the medium term. Without new policies aimed at fiscal consolidation, the general government deficit remains substantial

-- staying above 4½ per cent of GDP in 2014.[28] Public debt therefore rises substantially, with general government financial liabilities, whether on a net or gross basis, being among the highest in the OECD as a share of GDP by the end of the period – only Italy and Japan would have higher net debt.

Box 1.7. **Assumptions underlying the medium-term reference scenario**

The medium-term reference scenario is conditional on the following stylised assumptions for the period beyond the short-term projection horizon:

- Gaps between actual and potential output are eliminated by 2014 in all OECD countries.
- Unemployment returns to its estimated structural rate (the NAIRU) in all OECD countries by 2014.[1]
- Oil and other commodity prices remain unchanged in real terms.
- Exchange rates for all countries remain unchanged in nominal terms.
- Monetary policies are directed at keeping inflation low, or bringing inflation in line with medium-term objectives.
- Fiscal policies are assumed to remain broadly unchanged (with the cyclically-adjusted primary budget deficit/surplus held approximately constant from one year to the next),[2] subject to OECD assessment of specific influences implicit in currently legislated tax and expenditure measures.
- Consistent with the analysis set out in Chapter 3, potential growth has been adjusted down marginally from 2010 on for all member countries to reflect the impact of continuing high oil prices and higher financial risk premia on the supply side.

The main purpose of the medium-term reference scenario is to provide a basis for comparisons with other scenarios based on alternative assumptions and to provide insights on the possible build-up or unwinding of specific imbalances and tensions in the world economy over the medium term. The reference scenario does not embody a specific view about the nature or timing of future cyclical events.

1. Estimates of the structural rate of unemployment are from Gianella *et al.,* (2008). The concept and measurement of structural unemployment rates are also discussed in OECD (2000).
2. This implicitly assumes that the authorities take measures to offset underlying changes in primary structural balances.

… with some European economies slowing while others maintain momentum

Potential output growth in the euro area, at around 1¾ per cent *per annum* in the medium term, is lower than in the United States. This reflects less favourable trends in labour productivity -- a continuation of post-1995 outcomes. With output below potential in 2009 in the euro area, the output gap is closed slowly with actual GDP growth just under 2% *per annum*. In contrast, the new European Union member countries are generally projected to have substantially higher rates of potential (and actual) growth, albeit slowing during the period.

28 . The tax cuts of 2001 and 2003 are assumed to remain in place.

Net debt falls in several economies

Unemployment in the euro area is assumed to stabilise at an annual structural rate just under 7½ per cent while inflation stabilises at under 2% *per annum*. The fiscal deficit for the euro area as a whole stabilises at 1% of GDP without additional fiscal measures. On the basis of present policy settings, significant reductions in net debt (as a percentage of GDP) of euro area economies occur in Belgium, Germany, Greece, Netherlands, and Spain, whilst a substantial increase occurs in France. Amongst other European economies, Poland and the United Kingdom experience substantial increases in net debt.

For Japan growth slows in line with potential

Japan's potential output growth is projected to decline over the period to be just over 1% by 2014. This reflects the effects of population ageing -- which more than offsets projected increases in trend labour productivity. With Japan operating somewhat above potential going into 2010, GDP growth is projected to slow over the medium term to 1% *per annum* by 2014, with consumer price inflation also converging to around 1%. The public deficit in Japan is projected to deteriorate over the medium term to just over 3½ per cent of GDP in 2014, pushing gross public sector liabilities to just under 180% of GDP. This deterioration is largely structural, arising from an increase in ageing-related expenditures and increasing interest payments, despite annual increases in social security contributions assumed to take place over the period.

World trade remains robust…

World trade growth is projected to pick up to over 10% *per annum* (nominal) over the medium term. This is faster than during recent periods, but reflects in part the projected recovery in economic growth within the OECD -- combined with continued robust and trade-intensive growth in China and Dynamic Asia. In contrast, OECD trade grows more slowly at just under 5½ per cent *per annum* over the projection period.

… but current accounts fail to adjust

For the OECD area as a whole, the current account deficit remains relatively stable, at just over 1% of GDP. Since exchange rates are, by assumption, not changing over the medium term, and other trend factors such as potential growth remain stable, there is little adjustment in regional imbalances. For the euro area, the current account remains close to balance. The US current account deficit is projected to persist, staying just under 4½ per cent of GDP in 2014. Japan's surplus is projected to decrease to around 3½ per cent of GDP in 2014.

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APPENDIX 1.A4

SUPPLEMENTARY TABLES

Real GDP

Percentage changes from previous year

	2002	2003	2004	2005	2006	2007	2008	2009	Fourth quarter 2006	2007	2008	2009
Australia	4.0	3.4	3.4	3.0	2.6	4.1	2.9	2.7	2.6	4.2	2.7	2.9
Austria	0.7	1.0	2.2	2.3	3.3	3.3	2.3	1.7	3.5	3.0	1.7	2.1
Belgium	1.4	1.0	2.7	2.0	2.9	2.8	1.7	1.7	2.8	2.4	1.4	2.1
Canada	2.9	1.9	3.1	3.1	2.8	2.7	1.2	2.0	1.9	2.9	0.8	2.9
Czech Republic	1.9	3.6	4.5	6.4	6.4	6.5	4.5	4.8	6.1	6.6	3.6	5.1
Denmark	0.5	0.4	2.3	2.5	3.9	1.8	1.2	0.6	3.5	1.9	0.7	0.5
Finland	1.6	1.9	3.7	3.1	4.8	4.3	2.8	2.3	4.9	3.8	2.3	2.5
France	1.1	1.1	2.2	1.9	2.4	2.1	1.8	1.5	2.2	2.2	1.4	1.8
Germany	0.0	-0.2	0.6	1.0	3.1	2.6	1.9	1.1	3.9	1.8	1.5	1.5
Greece	3.9	5.0	4.6	3.8	4.2	4.0	3.5	3.4	4.3	3.6	3.5	3.6
Hungary	4.4	4.2	4.8	4.1	3.9	1.3	2.0	3.1	3.3	0.5	3.1	2.8
Iceland	0.1	2.4	7.7	7.5	4.4	3.8	0.4	-0.4	4.0	4.6	-2.0	1.0
Ireland	6.4	4.3	4.3	5.9	5.7	4.0	1.5	3.3	5.0	1.3	5.1	2.3
Italy	0.3	0.1	1.4	0.7	1.9	1.4	0.5	0.9	2.5	0.1	1.0	1.1
Japan	0.3	1.4	2.7	1.9	2.4	2.1	1.7	1.5	2.5	1.5	1.7	1.6
Korea	7.0	3.1	4.7	4.2	5.1	5.0	4.3	5.0	4.2	5.9	3.3	6.0
Luxembourg	4.1	2.1	5.2	4.8	5.9	4.6	3.0	4.0	..	..	..	..
Mexico	0.8	1.4	4.2	2.8	4.8	3.3	2.8	3.3	4.3	3.8	2.0	4.1
Netherlands	0.1	0.3	2.2	1.5	3.0	3.5	2.3	1.8	2.9	4.3	1.0	2.5
New Zealand	4.8	4.3	4.1	2.8	2.3	3.4	1.3	2.1	3.3	2.8	1.0	2.3
Norway	1.5	1.0	3.9	2.7	2.5	3.5	2.6	1.8	2.3	4.6	1.1	2.1
Poland	1.4	3.9	5.3	3.6	6.2	6.6	5.9	5.0	..	..	..	..
Portugal	0.8	-0.8	1.5	0.9	1.3	1.9	1.6	1.8	1.6	2.0	1.7	1.7
Slovak Republic	4.8	4.8	5.2	6.6	8.5	10.4	7.3	6.1	8.8	12.2	4.2	7.6
Spain	2.7	3.1	3.3	3.6	3.9	3.8	1.6	1.1	4.0	3.5	0.6	1.5
Sweden	2.4	2.1	3.5	3.3	4.5	2.8	2.1	2.1	4.1	2.6	1.6	2.6
Switzerland	0.4	-0.2	2.5	2.4	3.2	3.1	2.0	1.4	2.9	3.6	0.8	1.9
Turkey	6.2	5.3	9.4	8.4	6.9	4.5	3.7	4.5	..	..	..	..
United Kingdom	2.1	2.8	3.3	1.8	2.9	3.0	1.8	1.4	3.2	2.8	1.2	1.7
United States	1.6	2.5	3.6	3.1	2.9	2.2	1.2	1.1	2.6	2.5	0.3	1.9
Euro area	0.9	0.8	1.8	1.7	2.9	2.6	1.7	1.4	3.2	2.1	1.4	1.7
Total OECD	1.6	1.9	3.2	2.7	3.1	2.7	1.8	1.7	3.1	2.6	1.3	2.2

Note: These numbers are working-day adjusted and hence may differ from the basis used for official projections.
Source: OECD Economic Outlook 83 database.

Real private consumption expenditure

Percentage changes from previous year

	2002	2003	2004	2005	2006	2007	2008	2009	Fourth quarter 2006	2007	2008	2009
Australia	3.8	3.6	5.9	3.0	2.9	4.5	3.7	2.9	3.7	5.0	2.6	3.1
Austria	0.0	1.1	1.7	2.3	2.0	1.5	1.1	1.5	1.8	1.4	1.2	1.7
Belgium	0.7	0.9	1.2	1.4	2.2	2.4	1.2	1.7	1.7	2.6	1.1	2.0
Canada	3.6	3.0	3.4	3.8	4.2	4.7	4.3	3.0	4.5	5.4	3.0	3.3
Czech Republic	2.2	6.0	2.9	2.4	5.5	5.6	2.8	4.0	6.3	4.0	3.1	4.3
Denmark	1.5	1.0	4.7	5.2	3.8	2.5	2.9	1.0	3.1	4.5	1.0	0.9
Finland	2.3	4.7	2.8	3.7	4.2	3.6	2.8	2.6	4.2	2.9	3.0	2.3
France	2.4	1.9	2.5	2.5	2.5	2.5	1.6	1.7	2.0	2.8	1.2	2.1
Germany	-0.8	0.2	-0.2	0.1	1.1	-0.5	0.9	1.7	2.2	-1.5	1.8	1.8
Greece	4.2	5.0	4.7	4.2	4.2	3.2	2.8	2.8	..	..	..	..
Hungary	10.6	8.3	2.7	3.4	1.8	-0.5	1.4	2.1	0.1	-0.4	2.3	1.7
Iceland	-1.5	6.1	6.9	13.0	4.4	4.2	-0.9	-4.0	0.3	7.7	-5.6	-2.8
Ireland	4.1	2.9	4.0	7.4	5.3	5.4	3.0	2.6	5.7	4.4	2.6	2.9
Italy	0.2	0.8	0.7	0.9	1.1	1.5	0.7	1.2	1.2	1.0	1.2	1.4
Japan	1.1	0.4	1.6	1.3	2.0	1.5	1.6	1.2	1.7	1.1	1.6	1.4
Korea	7.9	-1.2	-0.3	3.6	4.5	4.5	3.2	3.4	3.9	4.6	2.9	3.5
Luxembourg	5.8	1.0	2.1	3.7	2.1	2.0	2.0	2.2	..	..	..	..
Mexico	1.6	2.3	4.1	5.1	5.0	4.1	3.2	4.2	3.4	4.8	3.2	4.7
Netherlands	0.9	-0.2	1.0	0.7	-0.8	2.1	2.1	1.2	-1.5	3.2	1.6	1.3
New Zealand	4.6	5.9	6.0	5.0	2.5	4.3	1.5	2.2	2.5	3.5	1.5	2.6
Norway	3.1	2.8	5.6	4.0	4.7	6.4	3.9	2.6	5.8	6.5	3.0	2.5
Poland	3.4	1.9	4.3	2.0	4.8	5.2	6.1	5.7	..	..	..	..
Portugal	1.3	-0.1	2.5	2.0	1.1	1.5	1.4	1.6	1.3	1.8	1.2	1.8
Slovak Republic	5.5	1.7	4.6	6.5	5.6	7.1	4.7	4.7	7.0	6.1	4.4	4.9
Spain	2.8	2.9	4.2	4.2	3.8	3.2	1.2	1.1	3.7	2.7	0.9	1.2
Sweden	2.6	2.0	2.6	2.7	2.5	3.1	2.6	2.6	2.3	3.1	2.6	2.6
Switzerland	0.1	0.9	1.6	1.8	1.5	2.1	1.8	1.5	0.9	2.5	1.5	1.6
Turkey	4.7	10.2	11.0	7.9	4.6	4.6	3.0	4.1	..	..	..	..
United Kingdom	3.5	2.9	3.4	1.5	2.0	3.1	1.9	0.6	2.8	2.4	1.2	1.3
United States	2.7	2.8	3.6	3.2	3.1	2.9	1.2	0.4	3.4	2.6	0.3	1.0
Euro area	0.9	1.2	1.5	1.7	1.9	1.6	1.3	1.6	2.0	1.2	1.4	1.8
Total OECD	2.3	2.1	2.9	2.7	2.8	2.6	1.8	1.4	2.8	2.4	1.4	1.8

Note: These numbers are working-day adjusted and hence may differ from the basis used for official projections.
Source: OECD Economic Outlook 83 database.

Real total gross fixed capital formation

Percentage changes from previous year

	2002	2003	2004	2005	2006	2007	2008	2009	Fourth quarter 2006	2007	2008	2009
Australia	17.2	8.6	7.8	8.0	4.9	8.1	6.2	5.0	2.5	8.2	6.3	5.0
Austria	-3.8	2.5	1.8	1.5	3.1	4.0	2.0	1.8	4.2	3.2	1.7	2.0
Belgium	-2.3	-0.3	7.5	6.7	4.2	5.7	3.9	3.5	3.1	8.5	2.4	4.3
Canada	1.6	6.2	7.7	8.5	7.2	4.1	2.8	1.8	4.9	4.7	1.1	2.7
Czech Republic	5.1	0.4	3.9	2.3	5.5	6.1	8.6	7.8	5.4	7.9	7.7	7.8
Denmark	0.1	-0.2	3.9	6.2	14.0	6.1	2.2	-1.9	13.3	4.6	0.4	-2.9
Finland	-3.1	4.0	3.6	3.6	4.9	7.5	4.0	3.3	2.2	10.6	0.1	5.4
France	-1.6	2.2	3.3	4.5	5.0	4.9	3.1	1.4	5.7	3.9	2.0	1.8
Germany	-6.3	-0.2	-1.1	1.3	7.0	5.1	2.7	0.5	6.9	2.4	1.5	1.4
Greece	10.7	15.4	6.0	0.7	14.8	4.4	5.8	6.1	..	..	..	..
Hungary	10.2	2.2	7.6	5.3	-2.8	0.4	4.2	6.2	-4.3	2.1	6.4	5.2
Iceland	-14.0	11.1	28.1	35.7	20.4	-14.9	-5.7	-5.6	17.0	-29.0	0.0	-3.2
Ireland	3.4	5.7	6.9	11.9	3.0	-0.1	-9.2	1.5	2.5	-12.1	1.1	1.2
Italy	4.0	-0.4	1.5	1.3	2.8	0.7	0.5	0.4	..	..	..	..
Japan	-4.9	-0.5	1.4	3.1	1.3	-0.5	-1.2	1.3	2.7	-3.6	0.8	1.6
Korea	6.6	4.0	2.1	2.4	3.6	4.0	1.8	3.8	4.6	2.8	2.0	4.1
Luxembourg	4.4	4.4	0.2	1.9	4.9	13.7	4.6	5.2	..	..	..	..
Mexico	-0.7	0.4	7.5	7.6	9.9	6.6	7.8	7.6	6.8	8.8	6.5	8.3
Netherlands	-4.5	-1.5	-1.6	3.0	7.2	5.1	5.8	2.8	11.4	2.6	5.3	2.8
New Zealand	10.8	10.2	11.6	3.9	-1.6	4.9	1.9	0.9	-2.5	7.7	-1.2	1.7
Norway	-1.1	0.2	10.2	13.3	7.3	9.6	4.9	1.3	0.5	16.9	-5.7	5.0
Poland	-6.3	-0.1	6.4	6.5	15.6	19.3	16.5	11.3	..	..	..	..
Portugal	-3.5	-7.4	0.2	-0.9	-1.0	3.2	3.0	3.1	-2.6	8.7	1.0	3.6
Slovak Republic	0.2	-2.7	4.8	17.6	8.4	7.9	8.0	8.6	5.5	8.2	7.9	8.9
Spain	3.4	5.9	5.1	6.9	6.8	5.9	0.0	-2.8	7.0	4.8	-2.6	-2.1
Sweden	-1.8	1.4	5.7	8.9	7.7	8.0	4.1	2.1	9.2	7.4	2.0	2.3
Switzerland	-0.5	-1.2	4.5	3.8	4.1	2.7	-0.7	1.0	3.1	0.6	-0.1	1.6
Turkey	14.7	14.2	28.4	17.4	13.3	3.3	2.0	4.7	..	..	..	..
United Kingdom	3.6	1.1	5.9	1.5	7.6	6.2	0.5	0.9	9.6	4.1	-1.5	1.8
United States	-3.5	3.2	6.1	5.8	2.6	-2.0	-5.2	-1.7	-0.8	-0.7	-7.2	1.9
Euro area	-1.4	1.4	2.0	3.3	5.5	4.3	2.0	0.8	5.8	2.9	1.1	1.3
Total OECD	-1.2	2.4	4.9	5.0	4.5	1.9	-0.5	0.7	3.4	1.7	-1.6	2.3

Note: These numbers are working-day adjusted and hence may differ from the basis used for official projections.
Source: OECD Economic Outlook 83 database.

Real total domestic demand

Percentage changes from previous year

	2002	2003	2004	2005	2006	2007	2008	2009	Fourth quarter 2006	2007	2008	2009
Australia	6.3	6.0	5.6	4.4	2.8	6.0	4.2	3.3	3.0	6.3	3.4	3.4
Austria	-0.9	1.7	1.8	1.9	1.5	1.5	0.4	1.9	2.0	1.0	1.1	1.6
Belgium	0.7	0.9	2.8	2.1	3.2	3.3	2.4	2.1	2.6	4.1	1.3	2.4
Canada	3.2	4.5	4.2	4.9	4.4	4.3	3.6	2.6	3.4	6.4	1.6	3.1
Czech Republic	3.8	4.2	3.1	1.6	5.6	5.6	3.6	4.0	5.5	4.6	4.7	4.6
Denmark	1.7	0.2	4.3	3.4	6.0	2.7	2.2	0.4	5.5	3.1	1.0	0.1
Finland	1.3	3.7	3.7	4.3	3.0	3.8	2.6	2.4	3.0	3.7	2.1	2.6
France	1.2	1.7	3.1	2.6	2.6	2.9	1.5	1.4	2.4	2.6	1.3	1.7
Germany	-2.0	0.6	-0.7	0.5	2.1	1.1	1.7	1.4	0.8	1.0	2.3	1.6
Greece	5.1	6.7	4.9	3.0	5.5	4.5	3.5	3.4	..	..	..	..
Hungary	6.5	6.2	3.8	1.4	1.0	-0.3	1.1	2.6	0.4	-0.3	2.2	2.3
Iceland	-2.3	5.7	9.9	15.8	9.3	-2.3	-3.0	-3.0	4.3	-4.3	-2.5	-1.7
Ireland	4.5	3.9	3.8	8.0	5.7	2.8	-0.2	2.6	5.7	-1.2	2.8	2.4
Italy	1.3	0.9	1.2	0.9	1.8	1.2	0.5	1.0	2.3	0.1	1.2	1.1
Japan	-0.4	0.8	1.9	1.7	1.6	1.0	0.7	1.2	1.9	0.1	1.1	1.4
Korea	7.4	0.6	1.5	3.2	4.2	4.1	3.1	3.6	3.7	4.7	2.6	3.6
Luxembourg	2.6	3.1	3.3	4.4	0.8	3.7	2.3	3.1	..	..	..	..
Mexico	0.8	0.7	4.4	3.5	5.4	4.5	4.3	4.9	3.9	5.8	3.8	5.3
Netherlands	-0.4	0.4	0.5	0.9	3.4	2.6	2.5	1.5	3.4	2.4	2.2	1.7
New Zealand	5.8	6.0	7.4	4.3	1.0	5.0	1.7	2.1	2.8	4.1	1.2	2.3
Norway	2.3	1.7	6.7	5.5	5.5	5.4	4.3	2.1	4.1	7.5	0.6	2.8
Poland	0.9	2.7	6.0	2.4	7.3	8.3	8.5	6.4	..	..	..	..
Portugal	0.0	-2.1	2.7	1.6	0.3	1.6	1.6	1.7	0.0	3.1	1.0	2.0
Slovak Republic	4.1	-0.7	6.0	8.5	6.5	5.9	8.8	5.2	2.1	11.9	4.8	5.3
Spain	3.2	3.8	4.8	5.1	4.8	4.3	1.5	0.7	5.1	3.6	0.6	1.1
Sweden	1.4	1.7	2.0	3.1	3.4	4.1	1.6	1.9	3.4	3.1	1.9	1.9
Switzerland	0.1	0.5	1.9	1.8	1.4	0.3	2.4	1.3	1.0	1.1	1.0	1.5
Turkey	8.7	8.6	11.5	9.2	6.7	5.5	3.4	4.2	..	..	..	..
United Kingdom	3.2	2.8	3.8	1.6	2.8	3.7	1.5	1.0	3.4	3.7	0.5	1.5
United States	2.2	2.8	4.1	3.1	2.8	1.5	0.1	0.2	2.1	1.6	-0.7	1.2
Euro area	0.4	1.5	1.7	2.0	2.7	2.3	1.5	1.4	2.4	1.8	1.7	1.6
Total OECD	1.8	2.3	3.3	2.8	3.0	2.4	1.4	1.3	2.6	2.3	0.9	1.8

Note: These numbers are working-day adjusted and hence may differ from the basis used for official projections.
Source: OECD Economic Outlook 83 database.

Contributions to changes in real GDP in OECD countries

As a per cent of real GDP in the previous period

	2006	2007	2008	2009
Australia				
Final domestic demand	3.6	5.3	4.3	3.5
Stockbuilding	-0.8	0.9	0.0	0.0
Net exports	-0.9	-1.8	-1.4	-0.3
GDP	2.6	4.1	2.9	2.7
Austria[1]				
Final domestic demand	2.1	2.1	1.5	1.7
Stockbuilding	-0.1	-0.2	0.0	0.0
Net exports	1.8	1.7	1.3	0.0
GDP	3.3	3.3	2.3	1.7
Belgium[1]				
Final domestic demand	2.0	2.9	1.9	2.0
Stockbuilding	1.1	0.3	0.3	0.0
Net exports	-0.1	-0.6	-0.8	-0.3
GDP	2.9	2.8	1.7	1.7
Canada[1]				
Final domestic demand	4.7	4.4	3.9	2.7
Stockbuilding	-0.2	0.0	-0.2	0.0
Net exports	-1.4	-1.6	-2.3	-0.6
GDP	2.8	2.7	1.2	2.0
Czech Republic[1]				
Final domestic demand	4.2	4.5	3.5	4.0
Stockbuilding	1.4	1.0	0.0	0.0
Net exports	0.9	1.1	1.1	1.0
GDP	6.4	6.5	4.5	4.8
Denmark[1]				
Final domestic demand	5.3	3.0	2.5	0.4
Stockbuilding	0.6	-0.3	-0.4	0.0
Net exports	-1.8	-0.8	-1.0	0.2
GDP	3.9	1.8	1.2	0.6
Finland[1]				
Final domestic demand	3.0	3.4	2.4	2.2
Stockbuilding	-0.3	0.1	0.0	0.0
Net exports	2.1	0.6	-0.1	0.0
GDP	4.8	4.3	2.8	2.3
France[1]				
Final domestic demand	2.8	2.7	1.8	1.5
Stockbuilding	-0.1	0.2	-0.3	0.0
Net exports	-0.3	-0.8	0.2	0.0
GDP	2.4	2.1	1.8	1.5

	2006	2007	2008	2009
Germany[1]				
Final domestic demand	2.0	1.0	1.3	1.4
Stockbuilding	-0.1	0.0	0.2	-0.1
Net exports	1.1	1.6	0.4	-0.3
GDP	3.1	2.6	1.9	1.1
Greece				
Final domestic demand	6.7	5.1	4.0	3.9
Stockbuilding	-0.4	0.1	0.0	0.0
Net exports	-2.0	-1.3	-0.1	-0.6
GDP	4.2	4.0	3.5	3.4
Hungary				
Final domestic demand	1.4	-1.7	1.0	2.6
Stockbuilding	-0.3	1.3	0.0	0.0
Net exports	2.8	1.6	1.0	0.6
GDP	3.9	1.3	2.0	3.1
Iceland[1]				
Final domestic demand	9.3	-1.7	-1.4	-3.2
Stockbuilding	1.1	-1.0	-0.3	0.0
Net exports	-6.1	6.5	4.1	2.8
GDP	4.4	3.8	0.4	-0.4
Ireland[1]				
Final domestic demand	4.2	3.5	-0.2	2.2
Stockbuilding	0.7	-1.0	0.0	0.0
Net exports	0.6	2.1	1.6	1.1
GDP	5.7	4.0	1.5	3.3
Italy[1]				
Final domestic demand	1.4	1.3	0.7	1.0
Stockbuilding	0.4	0.0	-0.2	0.1
Net exports	0.1	0.1	-0.1	-0.1
GDP	1.9	1.4	0.5	0.9
Japan[1]				
Final domestic demand	1.4	0.8	0.7	1.1
Stockbuilding	0.2	0.1	0.0	0.0
Net exports	0.8	1.1	1.1	0.2
GDP	2.4	2.1	1.7	1.5
Korea				
Final domestic demand	4.0	4.1	2.5	3.2
Stockbuilding	-0.2	-0.4	0.2	0.0
Net exports	1.3	1.3	1.6	1.8
GDP	5.1	5.0	4.3	5.0

1. Chain-linked calculations for stockbuilding and net exports.

Source: OECD Economic Outlook 83 database.

(cont'd) **Contributions to changes in real GDP in other OECD countries**

As a per cent of real GDP in the previous period

	2006	2007	2008	2009		2006	2007	2008	2009
Luxembourg[1]					**Spain[1]**				
Final domestic demand	2.2	3.9	2.2	2.3	Final domestic demand	5.2	4.6	1.7	0.8
Stockbuilding	-1.5	-1.0	-0.5	0.0	Stockbuilding	0.1	0.0	0.0	0.0
Net exports	5.2	2.0	2.2	1.8	Net exports	-1.2	-0.7	0.0	0.3
GDP	5.9	4.6	3.0	4.0	GDP	3.9	3.8	1.6	1.1
Mexico					**Sweden[1]**				
Final domestic demand	6.3	4.5	4.5	5.2	Final domestic demand	2.9	3.0	2.1	1.7
Stockbuilding	-0.7	0.1	0.0	0.0	Stockbuilding	0.2	0.7	-0.6	0.0
Net exports	-0.8	-1.4	-1.7	-1.9	Net exports	0.8	-1.2	0.2	0.3
GDP	4.8	3.3	2.8	3.3	GDP	4.5	2.8	2.1	2.1
Netherlands[1]					**Switzerland**				
Final domestic demand	3.2	2.7	2.2	1.3	Final domestic demand	1.6	1.8	0.9	1.2
Stockbuilding	-0.1	-0.2	0.1	0.1	Stockbuilding	-0.3	-1.6	1.2	0.0
Net exports	-0.1	1.0	-0.4	0.4	Net exports	1.9	2.9	-0.2	0.3
GDP	3.0	3.5	2.3	1.8	GDP	3.2	3.1	2.0	1.4
New Zealand[1]					**Turkey**				
Final domestic demand	2.0	4.6	2.2	2.2	Final domestic demand	7.1	4.3	2.7	4.4
Stockbuilding	-0.7	0.3	-0.5	0.0	Stockbuilding	-0.1	1.5	0.8	0.0
Net exports	1.3	-1.7	-0.5	0.0	Net exports	-0.3	-1.6	0.2	0.1
GDP	2.3	3.4	1.3	2.1	GDP	6.9	4.5	3.7	4.5
Norway[1]					**United Kingdom[1]**				
Final domestic demand	3.9	5.3	3.4	1.8	Final domestic demand	3.0	3.5	1.8	1.0
Stockbuilding	0.7	-0.6	0.3	0.0	Stockbuilding	0.0	0.4	-0.2	0.0
Net exports	-2.1	-0.9	-1.1	0.1	Net exports	0.0	-0.6	0.3	0.4
GDP	2.5	3.5	2.6	1.8	GDP	2.9	3.0	1.8	1.4
Poland[1]					**United States[1]**				
Final domestic demand	7.0	8.2	8.6	6.9	Final domestic demand	2.9	1.9	0.3	0.2
Stockbuilding	0.4	0.4	0.2	0.0	Stockbuilding	0.1	-0.3	-0.1	0.0
Net exports	-1.1	-1.7	-2.7	-1.6	Net exports	-0.1	0.6	1.0	0.9
GDP	6.2	6.6	5.9	5.0	GDP	2.9	2.2	1.2	1.1
Portugal					**Euro area**				
Final domestic demand	0.2	1.7	1.7	1.9	Final domestic demand	2.6	2.3	1.5	1.4
Stockbuilding	0.1	0.0	0.1	0.0	Stockbuilding	0.0	0.0	0.0	0.0
Net exports	1.1	0.1	-0.2	0.0	Net exports	0.2	0.4	0.2	0.0
GDP	1.3	1.9	1.6	1.8	GDP	2.9	2.6	1.7	1.4
Slovak Republic					**Total OECD**				
Final domestic demand	7.2	6.1	4.9	5.0	Final domestic demand	3.0	2.5	1.4	1.4
Stockbuilding	-0.5	-0.1	3.8	0.0	Stockbuilding	0.0	-0.1	0.0	0.0
Net exports	1.7	4.3	1.6	0.9	Net exports	0.1	0.3	0.4	0.3
GDP	8.5	10.4	7.3	6.1	GDP	3.1	2.7	1.8	1.7

1. Chain-linked calculations for stockbuilding and net exports.

Source: OECD Economic Outlook 83 database.

Output gaps

Deviations of actual GDP from potential GDP as a percentage of potential GDP

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Australia	0.4	0.1	-1.1	-0.4	-0.1	0.3	0.4	0.0	0.9	0.5	-0.1
Austria	1.9	2.6	1.3	-0.5	-1.8	-1.9	-1.7	-0.7	0.4	0.6	0.3
Belgium	0.3	1.9	0.5	-0.4	-1.5	-0.9	-1.1	-0.5	-0.1	-0.7	-1.0
Canada	0.9	2.8	1.3	1.3	0.3	0.4	0.5	0.4	0.2	-1.3	-2.0
Czech Republic	-1.9	-0.8	-1.1	-2.4	-2.6	-2.2	-0.3	1.1	2.1	1.7	1.9
Denmark	0.1	1.4	0.2	-1.0	-1.9	-1.0	-0.1	2.0	2.1	1.8	1.2
Finland	0.3	2.1	1.1	-0.4	-1.5	-0.9	-1.0	0.7	1.5	1.1	0.4
France	0.6	2.0	1.3	0.2	-0.7	-0.4	-0.4	0.1	0.3	0.2	-0.2
Germany	-0.2	1.8	1.7	0.3	-1.3	-2.0	-2.3	-0.6	0.5	0.9	0.5
Greece	-1.0	-0.5	-0.2	-0.5	0.4	1.0	0.9	0.9	0.7	0.2	-0.3
Hungary	0.0	0.6	0.2	0.3	0.4	1.1	1.4	1.6	-0.2	-1.3	-1.2
Iceland	0.5	0.3	1.0	-1.3	-1.7	2.0	4.4	2.6	1.6	-2.2	-5.9
Ireland	3.8	5.0	3.4	2.7	1.0	-0.2	0.2	0.7	-0.3	-3.4	-4.7
Italy	-0.5	1.6	1.8	0.6	-0.9	-0.9	-1.5	-1.1	-1.2	-2.0	-2.3
Japan	-2.0	-0.3	-1.4	-2.3	-2.4	-1.4	-0.9	0.0	0.5	0.7	0.7
Luxembourg	1.2	3.8	1.5	0.9	-1.5	-1.1	-1.2	-0.8	-1.0	-2.2	-2.3
Netherlands	2.5	3.5	2.7	0.2	-1.7	-1.4	-1.9	-0.9	0.7	1.3	1.5
New Zealand	-1.0	-0.2	-0.6	0.9	0.9	1.8	1.4	0.0	0.4	-0.7	-0.8
Norway[1]	2.6	2.5	2.1	0.8	-0.9	0.5	1.9	3.1	5.2	4.6	2.5
Poland	0.3	0.3	-2.2	-3.7	-2.8	-0.8	-0.8	0.8	1.9	2.6	2.4
Portugal	3.0	4.4	3.8	2.1	-0.9	-1.1	-1.9	-2.2	-2.2	-2.3	-2.1
Spain	-0.5	1.1	1.1	0.0	-0.6	-0.8	-0.6	-0.1	0.3	-1.2	-3.0
Sweden	0.7	2.0	0.1	-0.5	-1.3	-0.8	-0.2	1.3	0.9	0.1	-0.5
Switzerland	2.0	4.0	3.4	1.9	-0.3	0.1	0.4	1.4	2.1	1.6	0.8
United Kingdom	0.1	1.1	0.7	0.2	0.3	0.9	-0.3	-0.2	0.2	-0.5	-1.5
United States	1.3	2.1	0.1	-0.9	-1.0	0.0	0.5	0.7	0.4	-0.8	-2.2
Euro area	0.3	1.9	1.6	0.3	-1.0	-1.1	-1.3	-0.5	0.0	-0.3	-0.8
Total OECD	0.4	1.6	0.4	-0.6	-1.0	-0.5	-0.3	0.2	0.4	-0.3	-1.1

Note: The methodology used is described in Giorno et al., "Potential output, output gaps and structural budget balances", OECD Economic Studies, No. 24, 1995/I.

Source: OECD Economic Outlook 83 database.

GDP deflators
Percentage changes from previous year

	2002	2003	2004	2005	2006	2007	2008	2009	Fourth quarter 2006	2007	2008	2009
Australia	2.9	2.9	3.9	4.3	4.8	3.8	6.4	4.1	4.8	3.1	7.1	3.2
Austria	1.6	1.3	2.0	1.7	1.9	2.3	2.4	1.7	2.1	2.7	1.8	2.1
Belgium	1.9	1.6	2.5	2.5	2.0	1.6	2.1	2.0	1.8	1.9	2.3	2.0
Canada	1.1	3.3	3.2	3.4	2.4	3.1	2.8	1.5	0.9	3.8	2.5	1.2
Czech Republic	2.8	0.9	4.5	-0.2	1.7	3.4	7.0	2.5	2.7	3.1	7.2	2.4
Denmark	2.3	1.6	2.3	3.1	2.0	1.5	3.3	2.4	1.3	2.9	2.6	2.5
Finland	1.3	-0.4	0.7	0.2	1.6	2.3	2.4	2.0	2.1	2.9	1.6	2.1
France	2.4	1.9	1.6	2.0	2.5	2.5	2.7	2.4	2.6	2.3	2.8	2.2
Germany	1.4	1.2	1.1	0.7	0.6	1.8	2.1	1.8	0.6	1.9	2.6	1.4
Greece	3.7	3.5	3.4	3.3	3.4	2.9	4.0	3.1	..	..	..	..
Hungary	7.8	5.8	4.4	2.2	3.7	5.4	5.1	3.1	2.7	6.3	4.2	2.9
Iceland	5.7	0.7	2.5	2.8	9.0	5.5	9.1	6.2	11.1	3.3	11.7	3.4
Ireland	4.6	2.6	2.2	2.7	2.3	1.4	1.5	2.1	0.8	1.7	2.3	2.1
Italy	3.4	3.1	2.6	2.1	1.8	2.3	2.3	2.4	0.8	2.7	2.6	2.2
Japan	-1.5	-1.6	-1.1	-1.2	-1.0	-0.8	-1.1	0.2	-0.6	-1.3	-0.4	0.3
Korea	2.8	2.7	2.7	-0.2	-0.5	1.2	1.1	1.0	-0.6	1.2	1.4	1.0
Luxembourg	2.1	5.0	1.5	4.4	6.3	2.1	1.3	1.8	..	..	..	..
Mexico	6.9	8.5	7.4	5.6	4.5	3.2	5.3	3.4	0.4	6.8	3.6	3.3
Netherlands	3.8	2.2	0.7	2.1	1.9	1.2	1.4	2.2	1.9	0.7	1.8	2.2
New Zealand	1.1	1.5	3.7	1.8	2.4	4.1	3.9	1.8	2.9	5.5	1.4	2.7
Norway	-1.8	3.0	5.3	8.7	8.4	2.3	8.3	1.8	3.7	6.0	6.3	0.7
Poland	2.2	0.4	4.1	2.6	1.5	3.2	5.6	6.6	..	..	..	..
Portugal	3.9	3.2	2.4	2.5	2.7	3.0	2.7	2.1	3.0	2.7	2.2	2.0
Slovak Republic	3.9	5.3	5.9	2.4	2.9	1.1	2.3	3.5	2.8	-0.5	4.4	2.8
Spain	4.3	4.1	4.0	4.2	4.0	3.1	3.2	2.2	3.7	2.9	3.3	1.5
Sweden	1.6	1.8	0.9	0.9	1.5	3.1	2.2	2.1	1.5	3.3	1.7	2.4
Switzerland	0.5	1.0	0.6	0.3	1.6	1.4	1.4	1.8	1.5	1.5	1.5	1.8
Turkey	37.4	23.3	12.4	7.1	9.3	8.1	9.5	7.3	..	..	..	..
United Kingdom	3.1	3.1	2.6	2.3	2.7	3.1	2.6	2.3	2.7	3.0	2.7	2.0
United States	1.7	2.1	2.9	3.2	3.2	2.7	1.9	1.7	2.7	2.6	1.8	1.8
Euro area	2.6	2.2	1.9	1.9	1.9	2.2	2.4	2.2	1.8	2.2	2.6	1.9
Total OECD	2.6	2.5	2.5	2.3	2.4	2.3	2.2	2.0	2.0	2.3	2.3	1.9

Source: OECD Economic Outlook 83 database.

Consumer prices

Percentage changes from previous year

	2002	2003	2004	2005	2006	2007	2008	2009	Fourth quarter 2006	2007	2008	2009
Australia	3.0	2.8	2.3	2.7	3.5	2.3	4.1	3.1	3.3	3.0	4.0	2.9
Austria	1.7	1.3	2.0	2.1	1.7	2.2	3.1	2.2	1.5	3.2	2.7	1.9
Belgium	1.6	1.5	1.9	2.5	2.3	1.8	3.7	2.0	2.0	2.7	3.0	1.9
Canada	2.3	2.8	1.9	2.2	2.0	2.1	1.3	1.3	1.4	2.4	1.5	1.2
Czech Republic	1.8	0.1	2.8	1.9	2.6	3.0	6.8	2.9	1.5	5.0	6.3	2.6
Denmark	2.4	2.1	1.2	1.8	1.9	1.7	3.3	2.6	1.7	2.2	3.5	2.4
Finland	2.0	1.3	0.1	0.8	1.3	1.6	3.5	2.5	1.2	2.0	3.6	2.5
France	1.9	2.2	2.3	1.9	1.9	1.6	3.5	2.4	1.5	2.5	3.3	2.2
Germany	1.4	1.0	1.8	1.9	1.8	2.3	2.9	2.1	1.3	3.1	2.4	2.1
Greece	3.9	3.4	3.0	3.5	3.3	3.0	4.2	3.2	3.2	3.6	3.7	3.0
Hungary	5.3	4.7	6.7	3.6	3.9	8.0	6.3	3.7	6.4	7.1	5.6	3.4
Iceland	5.2	2.1	3.2	4.0	6.7	5.1	9.8	6.0	7.2	5.2	10.7	3.5
Ireland	4.7	4.0	2.3	2.2	2.7	2.9	3.4	2.1	2.5	3.2	3.2	1.9
Italy	2.6	2.8	2.3	2.2	2.2	2.0	3.6	2.1	2.0	2.6	3.4	1.7
Japan	-0.9	-0.2	0.0	-0.6	0.2	0.1	0.9	0.4	0.3	0.5	0.6	0.5
Korea	2.7	3.6	3.6	2.8	2.2	2.5	4.0	3.2	2.1	3.4	3.8	2.8
Luxembourg	2.1	2.5	3.2	3.8	3.0	2.7	4.0	2.1	..	..	..	..
Mexico	5.0	4.5	4.7	4.0	3.6	4.0	4.4	3.3	4.1	3.8	4.0	3.2
Netherlands	3.9	2.2	1.4	1.5	1.7	1.6	2.4	3.0	1.5	1.6	2.9	2.5
New Zealand	2.7	1.8	2.3	3.0	3.4	2.4	3.4	2.8	2.6	3.2	3.2	2.5
Norway	1.3	2.5	0.5	1.5	2.3	0.7	3.6	2.5	2.5	1.4	3.0	2.8
Poland	1.9	0.7	3.4	2.2	1.3	2.5	4.5	5.5	..	..	..	..
Portugal	3.7	3.3	2.5	2.1	3.0	2.4	3.0	2.2	2.5	2.7	2.9	2.0
Slovak Republic	3.1	8.6	7.5	2.7	4.5	2.8	4.0	3.6	3.9	3.2	3.6	3.6
Spain	3.6	3.1	3.1	3.4	3.6	2.8	4.6	3.0	2.6	4.0	4.1	2.6
Sweden	2.2	1.9	0.4	0.5	1.4	2.2	3.2	2.8	1.5	3.1	2.8	2.3
Switzerland	0.6	0.6	0.8	1.2	1.1	0.7	2.2	1.5	0.5	1.7	1.7	1.4
Turkey	45.0	21.6	8.6	8.2	9.6	8.8	9.6	7.5	..	..	..	..
United Kingdom	1.3	1.4	1.3	2.0	2.3	2.3	3.0	2.5	2.7	2.1	3.3	2.1
United States	1.6	2.3	2.7	3.4	3.2	2.9	3.9	2.2	1.9	4.0	3.3	1.8
Euro area	2.3	2.1	2.2	2.2	2.2	2.1	3.4	2.4	1.8	2.9	3.1	2.1

Note: For the United Kingdom, the euro area countries and the euro area aggregate, the Harmonised Index of Consumer Prices (HICP) is used. In the United Kingdom the HICP is known as the Consumer Price Index .

Source: OECD Economic Outlook 83 database.

Private consumption deflators

Percentage changes from previous year

	2002	2003	2004	2005	2006	2007	2008	2009	Fourth quarter 2006	2007	2008	2009
Australia	2.7	2.2	1.2	1.7	2.8	2.4	3.8	3.1	2.7	2.7	4.1	2.9
Austria	1.3	1.6	1.6	1.6	1.9	2.1	3.1	2.3	1.9	2.9	2.6	2.0
Belgium	1.3	1.6	2.7	2.9	2.4	1.9	3.6	2.0	2.2	2.9	3.0	1.9
Canada	2.0	1.6	1.5	1.7	1.4	1.5	1.1	1.1	1.0	1.7	1.1	1.0
Czech Republic	1.2	-0.4	3.3	0.9	2.3	2.9	7.1	2.9	1.8	4.5	6.3	2.6
Denmark	1.7	1.3	1.3	2.1	2.1	1.9	2.9	2.6	1.1	2.2	3.5	2.4
Finland	2.1	-0.3	1.0	0.5	1.5	1.6	3.2	2.4	1.7	2.0	3.7	1.9
France	1.0	1.9	1.9	1.8	2.2	2.0	3.0	2.2	1.9	2.6	2.8	2.1
Germany	1.2	1.5	1.6	1.5	1.4	1.7	2.2	1.7	1.1	2.1	2.0	1.7
Greece	2.5	2.7	2.4	3.3	3.5	3.1	4.3	3.1	..	..	..	..
Hungary	3.9	4.1	4.6	3.8	3.3	6.6	6.5	3.7	4.9	6.6	5.7	3.4
Iceland	4.8	1.3	3.0	1.9	7.6	4.5	9.0	6.0	9.2	3.7	10.7	3.5
Ireland	5.1	3.9	1.5	1.4	2.6	3.4	3.4	2.1	2.3	4.6	2.5	2.0
Italy	2.9	2.8	2.6	2.2	2.7	2.2	3.5	2.0	2.3	2.8	3.3	1.5
Japan	-1.4	-0.9	-0.7	-0.8	-0.3	-0.5	0.3	0.3	-0.3	-0.2	0.3	0.4
Korea	2.8	3.4	3.5	2.6	2.1	2.6	4.0	3.2	1.8	3.2	4.0	2.8
Luxembourg	0.5	2.1	2.6	2.9	2.9	2.5	3.3	2.1	..	..	..	..
Mexico	5.3	7.1	6.6	3.3	3.4	4.3	4.3	3.4	4.1	4.5	3.6	3.3
Netherlands	3.0	2.4	1.0	2.1	2.3	1.7	2.8	2.8	1.7	2.1	3.0	2.4
New Zealand	1.8	0.3	1.1	1.8	2.8	1.7	2.7	2.2	2.5	2.1	2.7	1.9
Norway	1.4	3.0	0.7	1.1	2.1	0.7	3.2	2.5	2.5	0.8	3.0	2.8
Poland	3.3	0.4	3.0	2.1	1.2	2.3	3.9	5.4	..	..	..	..
Portugal	3.0	2.9	2.5	2.7	3.3	2.7	3.0	2.2	2.9	2.8	2.9	1.9
Slovak Republic	2.8	6.5	7.4	2.6	4.9	2.6	3.7	3.6	3.4	3.4	3.6	3.6
Spain	2.8	3.1	3.6	3.4	3.4	2.8	4.6	3.0	3.1	3.9	3.7	2.7
Sweden	1.7	1.7	0.9	1.2	0.9	1.3	2.5	2.4	0.7	1.9	2.9	2.1
Switzerland	0.9	0.4	0.8	0.8	1.4	0.9	1.8	1.5	1.0	1.3	1.7	1.4
Turkey	38.5	23.4	10.8	8.3	9.8	8.2	9.5	7.5	..	..	..	..
United Kingdom	1.6	1.9	1.7	2.5	2.4	2.6	3.2	2.9	2.1	2.8	3.7	2.2
United States	1.4	2.0	2.6	2.9	2.8	2.5	3.2	2.0	1.9	3.4	2.9	1.6
Euro area	1.9	2.1	2.1	2.1	2.2	2.1	3.1	2.2	2.0	2.7	2.8	2.0
Total OECD	2.3	2.3	2.3	2.2	2.3	2.2	3.0	2.1	1.9	2.8	2.8	1.9

Source: OECD Economic Outlook 83 database.

Unemployment rates

	2002	2003	2004	2005	2006	2007	2008	2009	Fourth quarter 2006	2007	2008	2009
Australia	6.3	5.9	5.4	5.0	4.8	4.4	4.2	4.7	4.5	4.3	4.4	4.8
Austria	5.4	5.6	5.7	5.7	5.4	5.0	4.8	4.8	5.2	4.9	4.8	4.8
Belgium	7.5	8.2	8.4	8.5	8.2	7.5	7.0	7.2	7.9	7.0	7.1	7.2
Canada	7.6	7.6	7.2	6.8	6.3	6.0	6.1	6.3	6.2	5.9	6.3	6.3
Czech Republic	7.3	7.8	8.3	7.9	7.2	5.3	4.6	4.4	6.5	4.8	4.5	4.3
Denmark	4.5	5.3	5.5	4.8	3.9	3.7	3.3	3.7	3.7	3.3	3.4	3.9
Finland	9.1	9.0	8.9	8.4	7.7	6.9	6.3	6.0	7.6	6.9	6.2	5.9
France	7.9	8.5	8.9	8.9	8.8	7.9	7.5	7.6	8.4	7.5	7.6	7.6
Germany	8.3	9.2	9.7	10.5	9.7	8.3	7.4	7.4	9.1	7.9	7.4	7.4
Greece	9.9	9.4	10.2	9.5	8.6	8.0	7.7	7.7	..	..	..	..
Hungary	5.9	5.9	6.2	7.3	7.5	7.4	7.7	7.6	7.6	7.8	7.5	7.6
Iceland	3.3	3.4	3.1	2.6	2.9	2.3	3.4	5.7	2.5	1.9	4.3	6.6
Ireland	4.4	4.6	4.4	4.4	4.4	4.5	5.7	6.5	4.2	4.6	6.2	6.4
Italy	8.8	8.6	8.1	7.8	6.8	6.1	6.2	6.5	6.4	6.0	6.4	6.6
Japan	5.4	5.3	4.7	4.4	4.1	3.9	3.8	3.8	4.1	3.9	3.9	3.7
Korea	3.3	3.6	3.7	3.7	3.5	3.2	3.1	3.1	3.4	3.1	3.1	3.1
Luxembourg	2.9	3.7	4.2	4.7	4.4	4.4	4.5	4.9	..	..	..	..
Mexico	2.9	3.0	3.7	3.5	3.2	3.4	3.7	3.6	3.2	3.5	3.7	3.6
Netherlands	2.9	4.0	4.9	4.9	4.1	3.3	2.6	2.7	3.8	3.0	2.6	2.7
New Zealand	5.2	4.7	3.9	3.7	3.8	3.6	3.8	3.8	3.8	3.4	4.0	3.7
Norway	3.9	4.5	4.5	4.6	3.4	2.5	2.5	2.8	2.7	2.4	2.6	3.0
Poland	19.9	19.6	19.0	17.7	13.8	9.6	7.8	6.9	..	..	..	..
Portugal	5.0	6.3	6.7	7.7	7.7	8.0	7.9	7.9	8.2	7.9	8.0	7.9
Slovak Republic	18.6	17.5	18.1	16.1	13.3	11.0	10.3	9.6	12.1	10.3	10.3	9.2
Spain	11.0	11.0	10.5	9.2	8.5	8.3	9.7	10.7	8.3	8.6	10.1	11.0
Sweden	4.0	4.9	5.5	5.8	5.3	4.6	4.3	4.4	4.9	4.4	4.3	4.5
Switzerland	3.2	4.3	4.4	4.4	4.0	3.6	3.6	3.8	3.9	3.5	3.8	3.8
Turkey	10.1	10.3	10.0	10.0	9.7	9.5	10.2	10.5	..	..	..	..
United Kingdom	5.2	5.0	4.8	4.8	5.5	5.4	5.5	5.8	5.5	5.2	5.6	5.8
United States	5.8	6.0	5.5	5.1	4.6	4.6	5.4	6.1	4.4	4.8	5.8	6.1
Euro area	8.1	8.6	8.8	8.8	8.2	7.4	7.2	7.4	7.8	7.1	7.3	7.5
Total OECD	6.7	6.9	6.8	6.5	6.0	5.6	5.7	6.0	5.8	5.5	5.9	6.0

Source: OECD Economic Outlook 83 database.

Short-term interest rates

	2006	2007	2008	2009	2007 Q4	2008 Q1	Q2	Q3	Q4	2009 Q1	Q2	Q3	Q4
Australia	6.0	6.7	7.5	7.0	7.1	7.6	7.5	7.4	7.3	7.2	7.1	6.9	6.7
Canada	4.2	4.6	2.9	2.9	4.8	4.0	2.8	2.4	2.4	2.5	2.8	3.0	3.4
Czech Republic	2.3	3.1	4.2	4.2	3.8	4.0	4.2	4.2	4.2	4.2	4.2	4.2	4.2
Denmark	3.1	4.3	4.6	4.2	4.6	4.5	4.7	4.7	4.6	4.4	4.2	4.2	4.2
Hungary	6.9	7.6	8.1	7.7	7.3	7.8	8.0	8.2	8.2	8.0	7.8	7.6	7.3
Iceland	12.4	14.3	15.3	15.3	14.2	14.0	15.6	15.9	15.9	15.9	15.6	15.1	14.6
Japan	0.2	0.7	0.8	0.7	0.8	0.8	0.9	0.9	0.8	0.7	0.7	0.8	0.8
Korea	4.5	5.2	5.4	5.7	5.5	5.4	5.4	5.4	5.4	5.4	5.7	5.7	5.9
Mexico	7.3	7.4	7.3	6.8	7.5	7.5	7.4	7.3	7.1	6.8	6.8	6.8	6.8
New Zealand	7.5	8.3	8.8	8.2	8.8	8.8	8.8	8.8	8.8	8.6	8.3	8.1	7.8
Norway	3.1	5.0	6.2	6.1	5.8	6.0	6.2	6.5	6.4	6.2	6.2	6.1	6.1
Poland	4.2	4.8	6.5	7.2	5.5	5.9	6.2	6.7	7.2	7.2	7.2	7.2	7.2
Slovak Republic	4.3	4.3	4.3	4.1	4.3	4.3	4.3	4.3	4.3	4.3	4.1	4.1	4.1
Sweden	2.3	3.6	4.3	4.3	4.0	4.2	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Switzerland	1.6	2.6	2.8	2.9	2.8	2.8	2.8	2.8	2.8	2.8	3.0	3.0	3.0
Turkey	17.9	18.3	18.9	17.3	16.7	18.5	19.5	19.0	18.5	18.0	17.4	17.1	16.5
United Kingdom	4.8	6.0	5.6	4.4	6.3	5.7	5.6	5.6	5.3	4.8	4.4	4.3	4.3
United States	5.2	5.3	2.7	3.1	5.0	3.2	2.6	2.6	2.5	2.3	2.6	3.4	4.0
Euro area	3.1	4.3	4.5	4.1	4.7	4.5	4.5	4.5	4.4	4.2	4.1	4.1	4.1

Note: Individual euro area countries are not shown since their short term interest rates are equal to the euro area rate.
Source: OECD Economic Outlook 83 database.

Long-term interest rates

					2007	2008				2009			
	2006	2007	2008	2009	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Australia	5.6	6.0	6.2	6.1	6.1	6.2	6.2	6.2	6.2	6.1	6.1	6.1	6.1
Austria	3.8	4.3	4.3	4.4	4.3	4.1	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Belgium	3.8	4.3	4.3	4.4	4.4	4.2	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Canada	4.2	4.3	3.8	4.2	4.2	3.7	3.8	3.9	4.0	4.1	4.2	4.3	4.4
Czech Republic	3.8	4.3	4.8	4.8	4.6	4.6	4.8	4.8	4.8	4.8	4.8	4.8	4.8
Denmark	3.8	4.3	4.3	4.4	4.3	4.1	4.3	4.4	4.4	4.4	4.4	4.4	4.4
Finland	3.8	4.3	4.3	4.4	4.3	4.1	4.4	4.4	4.4	4.4	4.4	4.4	4.5
France	3.8	4.3	4.2	4.3	4.3	4.1	4.3	4.3	4.3	4.3	4.3	4.3	4.4
Germany	3.8	4.2	4.2	4.3	4.2	3.9	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Greece	4.1	4.5	4.5	4.5	4.5	4.4	4.6	4.5	4.5	4.5	4.5	4.5	4.5
Hungary	7.1	6.7	7.7	7.1	6.8	7.7	7.8	7.7	7.6	7.4	7.1	6.9	6.8
Iceland	9.3	9.8	11.4	10.3	10.3	10.6	11.7	11.7	11.7	11.0	10.5	10.0	9.5
Ireland	3.8	4.3	4.3	4.4	4.4	4.1	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Italy	4.0	4.5	4.5	4.6	4.5	4.3	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Japan	1.7	1.7	1.7	2.1	1.5	1.4	1.7	1.8	1.9	1.9	2.0	2.1	2.2
Korea	5.2	5.4	5.0	5.8	5.7	5.4	5.0	4.6	5.0	5.3	5.7	6.0	6.3
Luxembourg	3.3	4.4	4.1	3.9	4.6	4.6	3.9	3.9	3.9	3.9	3.9	3.9	3.9
Mexico	7.5	7.6	7.5	7.0	7.8	7.6	7.5	7.4	7.4	7.0	7.0	7.0	7.0
Netherlands	3.8	4.3	4.3	4.4	4.3	4.1	4.3	4.3	4.3	4.4	4.4	4.4	4.4
New Zealand	5.8	6.3	6.4	6.4	6.4	6.3	6.4	6.4	6.4	6.4	6.4	6.5	6.5
Norway	4.1	4.8	4.5	4.5	4.8	4.4	4.5	4.6	4.6	4.6	4.5	4.4	4.4
Portugal	3.9	4.4	4.4	4.5	4.4	4.2	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Slovak Republic	4.4	4.5	4.4	4.5	4.6	4.4	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Spain	3.8	4.3	4.2	4.3	4.3	4.1	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Sweden	3.7	4.2	4.5	4.9	4.3	4.0	4.3	4.7	4.9	4.9	4.9	4.9	4.9
Switzerland	2.5	2.9	3.0	3.3	3.0	3.0	3.0	3.0	3.0	3.1	3.3	3.4	3.4
Turkey	18.0	18.3	18.8	17.2	16.4	18.5	19.4	18.9	18.4	17.9	17.3	17.0	16.4
United Kingdom	4.5	5.0	4.7	4.8	4.8	4.5	4.7	4.7	4.7	4.8	4.8	4.9	4.9
United States	4.8	4.6	3.9	4.4	4.3	3.7	3.9	4.0	4.1	4.2	4.3	4.4	4.5
Euro area	3.8	4.3	4.3	4.4	4.3	4.1	4.4	4.4	4.4	4.4	4.4	4.4	4.4

Source: OECD Economic Outlook 83 database.

General government financial balance

Surplus (+) or deficit (-) as a percentage of nominal GDP

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Australia	2.0	0.9	-0.1	1.3	1.8	1.1	1.5	2.0	0.7	1.5	1.7
Austria	-2.4	-1.8	-0.2	-0.8	-1.5	-3.9	-1.6	-1.6	-0.7	-0.7	-0.8
Belgium	-0.5	0.1	0.5	0.0	0.0	-0.1	-2.4	0.3	-0.2	-0.3	-0.9
Canada	1.6	2.9	0.7	-0.1	-0.1	0.8	1.6	1.0	1.0	-0.2	-0.5
Czech Republic	-3.7	-3.7	-5.7	-6.8	-6.6	-2.9	-3.6	-2.6	-1.6	-1.5	-1.3
Denmark	1.4	2.3	1.2	0.2	-0.1	1.9	5.0	4.9	4.5	3.9	3.0
Finland	1.6	6.9	5.0	4.2	2.4	2.2	2.7	4.0	5.3	4.4	3.8
France	-1.8	-1.5	-1.6	-3.2	-4.1	-3.6	-3.0	-2.4	-2.7	-3.0	-2.9
Germany	-1.5	1.3	-2.8	-3.6	-4.0	-3.8	-3.4	-1.6	0.0	-0.5	-0.2
Greece	-3.1	-3.7	-4.4	-4.8	-5.7	-7.3	-5.3	-2.9	-3.1	-2.1	-2.1
Hungary	-5.3	-2.9	-4.1	-9.0	-7.1	-6.4	-7.8	-9.3	-5.5	-4.1	-3.5
Iceland	1.1	1.7	-0.7	-2.5	-2.8	0.0	4.9	6.3	5.2	2.2	-1.1
Ireland	2.6	4.7	1.0	-0.4	0.4	1.4	1.6	3.0	0.3	-1.3	-2.6
Italy	-1.8	-0.9	-3.1	-3.0	-3.5	-3.6	-4.4	-3.4	-1.9	-2.5	-2.7
Japan	-7.4	-7.6	-6.3	-8.0	-7.9	-6.2	-6.7	-1.4	-2.4	-1.4	-2.2
Korea	2.7	5.4	4.6	5.4	0.4	2.5	3.0	3.6	4.6	4.5	4.4
Luxembourg	3.4	6.0	6.1	2.1	0.5	-1.2	-0.1	1.3	3.0	1.7	1.3
Netherlands	0.4	2.0	-0.3	-2.1	-3.2	-1.8	-0.3	0.5	0.4	1.1	1.4
New Zealand	-0.2	1.6	2.1	3.2	3.8	4.3	4.5	3.9	3.8	2.5	1.8
Norway	6.0	15.4	13.3	9.2	7.3	11.1	15.1	18.5	17.3	17.9	17.1
Poland	-2.3	-3.0	-5.1	-5.0	-6.3	-5.7	-4.3	-3.8	-2.0	-2.6	-2.7
Portugal	-2.8	-3.0	-4.3	-2.9	-3.0	-3.4	-6.1	-3.9	-2.7	-2.2	-2.0
Slovak Republic	-7.1	-12.2	-6.5	-8.2	-2.7	-2.4	-2.8	-3.6	-2.2	-2.0	-1.6
Spain	-1.4	-1.0	-0.7	-0.5	-0.2	-0.4	1.0	1.8	2.2	0.7	-0.3
Sweden	1.2	3.7	1.7	-1.4	-1.2	0.6	2.0	2.2	3.4	3.1	2.7
Switzerland	-0.5	0.1	-0.1	-1.2	-1.7	-1.8	-0.7	0.7	0.8	0.5	0.1
United Kingdom	1.1	4.0	0.9	-1.7	-3.3	-3.3	-3.5	-2.8	-3.0	-3.8	-3.7
United States[1]	0.9	1.6	-0.4	-3.8	-4.8	-4.4	-3.6	-2.6	-3.0	-5.5	-5.2
Euro area	-1.4	0.0	-1.8	-2.6	-3.1	-2.9	-2.6	-1.3	-0.6	-1.1	-1.2
Total OECD	-0.8	0.2	-1.3	-3.2	-4.0	-3.4	-3.0	-1.5	-1.5	-2.5	-2.6

Note: Financial balances include one-off revenues from the sale of mobile telephone licences. Some other important one-offs have been accounted for in the past and are reported in *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. These numbers take into account public entreprises.

Source: OECD Economic Outlook 83 database.

General government cyclically-adjusted financial balance
Surplus (+) or deficit (-) as a percentage of nominal GDP

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Australia	2.0	0.7	0.1	1.5	1.9	1.0	1.4	1.9	0.3	1.1	1.6
Austria	-3.1	-3.4	-1.0	-0.8	-0.8	-2.9	-0.7	-1.2	-0.7	-1.0	-1.1
Belgium	-0.6	-1.1	-0.3	0.0	0.7	0.4	-1.8	0.6	-0.3	-0.2	-0.6
Canada	1.4	2.0	0.1	-0.5	-0.2	0.6	1.4	0.9	0.8	0.2	0.2
Czech Republic	-3.0	-3.4	-5.3	-5.8	-5.5	-2.0	-3.4	-3.0	-2.4	-2.1	-2.0
Denmark	1.3	1.5	0.5	0.4	0.8	2.7	5.3	4.1	3.3	2.6	2.1
Finland	1.5	6.3	4.6	4.3	3.1	2.7	3.1	3.8	4.6	3.9	3.5
France	-1.9	-2.3	-2.5	-3.6	-3.9	-3.3	-2.7	-2.3	-2.9	-3.3	-3.0
Germany	-1.3	-1.9	-3.6	-3.8	-3.4	-2.8	-2.1	-1.1	-0.2	-0.9	-0.5
Greece	-2.6	-3.5	-4.8	-4.6	-5.9	-7.7	-5.7	-3.3	-3.5	-2.3	-2.1
Hungary	-5.3	-3.2	-4.2	-9.1	-7.4	-6.9	-8.4	-10.0	-5.5	-3.5	-2.9
Iceland	0.9	1.5	-1.0	-2.2	-2.2	-0.3	3.6	5.3	4.5	2.7	1.0
Ireland	1.3	3.0	-0.5	-1.6	0.0	1.3	1.5	2.7	0.3	0.0	-0.7
Italy	-1.4	-2.5	-4.0	-3.4	-3.2	-3.0	-3.6	-2.7	-1.3	-1.5	-1.5
Japan	-6.7	-7.4	-5.8	-7.2	-7.0	-5.6	-6.3	-1.4	-2.6	-1.6	-2.5
Luxembourg	3.3	4.7	5.2	1.6	0.9	-0.7	0.5	1.7	3.4	2.5	2.3
Netherlands	-0.5	-0.3	-2.0	-3.0	-2.7	-0.8	0.7	1.2	0.3	0.4	0.5
New Zealand	0.2	1.7	2.3	2.9	3.4	3.5	3.9	3.8	3.5	2.7	2.0
Norway[1]	-1.1	0.9	-0.2	-2.5	-4.3	-2.3	-1.3	0.6	1.9	2.2	2.2
Poland	-2.4	-3.1	-4.3	-3.7	-5.2	-5.4	-4.1	-4.1	-2.8	-3.6	-3.7
Portugal	-4.1	-5.3	-6.1	-3.9	-2.6	-2.9	-5.1	-2.9	-1.6	-1.2	-1.0
Spain	-1.2	-1.8	-1.3	-0.6	0.0	0.0	1.1	1.8	2.1	1.2	1.0
Sweden	1.0	2.8	1.5	-1.4	-0.5	1.1	2.2	1.7	3.0	3.0	2.9
Switzerland	-1.1	-1.3	-1.4	-1.9	-1.6	-1.7	-0.7	0.4	0.2	0.0	-0.1
United Kingdom	1.1	1.3	0.5	-1.9	-3.5	-3.6	-3.5	-2.7	-3.1	-3.6	-3.1
United States	0.4	0.9	-0.6	-3.5	-4.5	-4.3	-3.7	-2.9	-3.2	-5.2	-4.4
Euro area	-1.5	-2.0	-2.6	-2.7	-2.6	-2.4	-1.9	-1.1	-0.7	-1.0	-0.8
Total OECD	-1.1	-1.1	-1.9	-3.4	-3.8	-3.4	-3.1	-1.8	-2.0	-2.8	-2.5

Note: Cyclically-adjusted balances exclude one-off revenues from the sale of mobile telephone licenses. Some other important one-offs have been accounted for in the past and are reported in *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. As a percentage of mainland potential GDP. The cyclically-adjusted balances shown exclude revenues from petroleum activities.

Source: OECD Economic Outlook 83 database.

Balance on current account
Percentage of GDP

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Australia	-5.3	-3.7	-2.0	-3.8	-5.4	-6.1	-5.8	-5.5	-6.2	-4.7	-4.6
Austria	-3.2	-2.5	-1.9	0.3	-0.2	1.7	2.1	2.8	3.1	3.5	3.2
Belgium	5.1	4.0	3.4	4.6	4.1	3.5	2.6	2.7	1.4	1.1	0.9
Canada	0.3	2.7	2.3	1.7	1.2	2.3	2.0	1.6	0.9	-0.2	-0.8
Czech Republic	-2.4	-4.8	-5.3	-5.5	-6.2	-5.2	-1.6	-3.1	-2.5	-2.6	-1.8
Denmark	1.9	1.6	2.6	2.9	3.4	2.3	4.3	2.7	1.1	0.6	0.7
Finland	6.2	8.1	8.6	8.8	5.2	6.6	3.6	4.5	4.3	3.4	2.4
France	3.1	1.7	2.0	1.3	0.9	0.5	-0.9	-1.2	-1.2	-1.8	-1.6
Germany	-1.3	-1.8	0.0	2.0	1.9	4.6	5.2	6.1	7.7	7.9	7.7
Greece	-5.6	-7.8	-7.3	-6.8	-6.6	-5.8	-7.2	-11.1	-14.1	-15.3	-15.2
Hungary	-7.6	-8.4	-6.0	-6.9	-7.9	-8.4	-6.8	-6.1	-5.0	-4.4	-4.1
Iceland	-6.7	-10.2	-4.3	1.5	-4.8	-9.8	-16.1	-25.0	-15.7	-13.3	-8.6
Ireland	0.3	-0.4	-0.6	-1.0	0.0	-0.6	-3.5	-4.2	-5.0	-5.0	-3.8
Italy	0.7	-0.5	-0.1	-0.8	-1.4	-1.1	-1.7	-2.7	-2.6	-2.4	-2.6
Japan	2.6	2.5	2.2	2.9	3.2	3.7	3.7	3.9	4.8	4.4	4.4
Korea	5.5	2.4	1.7	1.0	2.0	4.2	1.9	0.6	0.6	-0.9	-1.0
Luxembourg	8.3	13.2	8.8	10.5	8.2	11.9	11.1	10.5	9.9	9.0	9.2
Mexico	-2.9	-3.2	-2.8	-2.2	-1.3	-1.0	-0.7	-0.3	-0.8	-1.0	-2.0
Netherlands	3.8	1.9	2.4	2.5	5.5	7.5	7.2	8.3	6.5	6.1	5.9
New Zealand	-6.2	-5.1	-2.8	-3.9	-4.3	-6.4	-8.5	-8.6	-7.9	-7.7	-8.1
Norway	5.6	15.0	16.1	12.6	12.3	12.7	16.3	17.3	16.4	19.4	18.6
Poland	-7.5	-5.8	-2.8	-2.5	-2.1	-4.0	-1.2	-2.7	-3.7	-4.5	-5.6
Portugal	-8.5	-10.2	-9.9	-8.1	-6.1	-7.6	-9.5	-10.1	-9.8	-11.6	-11.6
Slovak Republic	-4.8	-3.6	-8.3	-7.9	-0.9	-3.5	-8.6	-7.0	-5.3	-4.3	-3.1
Spain	-2.9	-4.0	-3.9	-3.3	-3.5	-5.3	-7.4	-8.6	-10.1	-10.1	-9.8
Sweden	4.2	3.8	3.8	4.0	7.1	6.7	6.8	8.5	8.3	8.6	8.4
Switzerland	10.8	12.0	7.7	8.3	12.9	12.9	13.7	14.7	16.9	9.9	11.0
Turkey	-0.8	-3.7	1.8	-0.7	-2.7	-4.0	-4.7	-6.1	-5.8	-5.4	-5.3
United Kingdom	-2.4	-2.6	-2.2	-1.6	-1.3	-1.6	-2.5	-3.9	-4.2	-3.3	-3.1
United States	-3.3	-4.3	-3.8	-4.4	-4.8	-5.5	-6.1	-6.2	-5.3	-5.0	-4.4
Euro area	0.3	-0.6	0.1	0.6	0.5	1.2	0.4	0.2	0.2	0.1	0.0
Total OECD	-0.7	-1.3	-1.1	-1.1	-1.0	-1.0	-1.5	-1.7	-1.4	-1.3	-1.1

Source: OECD Economic Outlook 83 database.

Balance on current account

$ billion

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Australia	-14.7	-7.4	-15.8	-28.6	-38.9	-41.0	-41.5	-56.7	-52.6	-55.5
Austria	-5.0	-3.7	0.7	-0.5	5.0	6.4	8.9	11.7	15.4	14.9
Belgium	9.4	7.9	11.7	12.9	12.6	9.9	10.8	6.1	5.8	5.2
Canada	19.7	16.3	12.6	10.6	22.3	23.3	20.7	12.5	-3.5	-13.2
Czech Republic	-2.7	-3.3	-4.2	-5.8	-5.7	-2.0	-4.5	-4.3	-6.4	-4.8
Denmark	2.5	4.2	5.0	7.3	5.7	11.1	7.4	3.5	2.2	2.7
Finland	9.9	10.8	12.0	8.5	12.4	7.1	9.4	10.5	9.8	7.3
France	22.2	26.3	19.2	15.6	9.5	-19.9	-28.0	-31.0	-56.3	-49.5
Germany	-33.8	0.4	41.1	48.0	126.3	145.0	178.5	255.7	307.1	310.4
Greece	-9.9	-9.5	-10.1	-12.8	-13.3	-17.8	-29.7	-44.4	-58.2	-62.2
Hungary	-4.0	-3.2	-4.7	-6.7	-8.6	-7.5	-6.8	-6.9	-7.3	-7.4
Iceland	-0.9	-0.4	0.1	-0.5	-1.3	-2.6	-4.2	-3.2	-2.6	-1.6
Ireland	-0.3	-0.7	-1.2	0.0	-1.1	-7.0	-9.2	-12.8	-14.6	-11.8
Italy	-5.7	-0.7	-9.7	-20.9	-19.4	-30.3	-50.0	-54.1	-59.5	-65.7
Japan	118.7	88.4	112.3	136.4	170.9	166.6	172.0	212.2	217.2	224.2
Korea	12.3	8.0	5.4	11.9	28.2	15.0	5.4	6.0	-8.1	-9.8
Luxembourg	2.7	1.8	2.3	2.4	4.1	4.1	4.5	4.9	5.2	5.7
Mexico	-18.7	-17.7	-14.1	-8.6	-6.6	-5.2	-2.2	-7.4	-10.3	-21.4
Netherlands	7.2	9.8	11.1	29.9	46.0	45.6	56.0	50.3	54.6	55.7
New Zealand	-2.7	-1.4	-2.3	-3.4	-6.3	-9.3	-9.1	-10.1	-10.9	-11.9
Norway	25.1	27.5	24.2	27.7	32.9	49.2	58.5	64.5	96.7	97.2
Poland	-10.0	-5.4	-5.0	-4.6	-10.0	-3.6	-9.2	-15.8	-26.3	-37.6
Portugal	-11.6	-11.5	-10.3	-9.6	-13.6	-17.6	-19.7	-22.0	-30.2	-31.7
Slovak Republic	-0.7	-1.7	-1.9	-0.3	-1.4	-4.1	-3.9	-4.0	-4.2	-3.4
Spain	-23.0	-24.0	-22.5	-31.1	-54.9	-83.1	-106.6	-146.2	-170.8	-173.2
Sweden	9.4	8.5	9.8	22.3	24.0	24.8	33.3	38.1	45.5	47.2
Switzerland	30.1	19.7	23.6	42.0	46.9	51.0	57.2	71.4	49.6	57.2
Turkey	-9.8	3.4	-1.5	-8.0	-15.5	-22.6	-32.3	-38.6	-42.5	-46.1
United Kingdom	-37.4	-31.5	-24.7	-24.5	-35.3	-55.8	-93.7	-115.4	-92.4	-89.9
United States	-417.4	-384.7	-459.6	-522.1	-640.2	-754.8	-811.5	-738.6	-716.7	- 648.2
Euro area	-37.8	6.8	44.2	42.3	113.5	42.4	24.9	28.9	8.1	5.0
Total OECD	-339.1	-273.8	-296.6	-312.6	-325.4	-525.1	-639.2	-563.9	-564.6	-517.4
Memorandum items										
China	20.5	17.4	35.4	45.9	68.7	160.8	249.9	354.7	390.2	435.8
Dynamic Asian Economies[1]	50.2	57.5	69.6	94.6	76.6	79.2	125.7	166.6	161.2	152.3
Other Asia	-5.4	2.8	10.6	10.5	-1.9	-12.1	-16.2	-21.5	-48.4	-57.7
Total Non-OECD Asia	65.3	77.7	115.6	151.0	143.4	227.9	359.3	499.8	502.9	530.5
Latin America	-28.6	-34.4	0.0	17.7	27.5	41.5	49.8	31.4	1.1	-23.4
Africa and Middle-East	83.4	37.6	22.2	64.3	108.2	215.9	250.3	211.6	315.7	267.7
Central and Eastern Europe	42.5	26.5	22.8	23.8	44.6	64.1	63.3	15.0	44.2	7.7
Total of non-OECD countries	162.6	107.4	160.7	256.8	323.7	549.4	722.7	757.8	863.8	782.5
World (discrepancy)	-176.5	-166.4	-136.0	-55.8	-1.8	24.3	83.5	193.9	299.3	265.1

1. Indonesia, Malaysia, Chinese Taipei, Philippines, Singapore, Thailand and Hong-Kong, China.

Source: OECD Economic Outlook 83 database.

Quarterly demand and output projections

Percentage changes from previous period, seasonally adjusted at annual rates, volume

	2007	2008	2009	2008 Q2	2008 Q3	2008 Q4	2009 Q1	2009 Q2	2009 Q3	2009 Q4	Fourth quarter[1] 2007	Fourth quarter[1] 2008	Fourth quarter[1] 2009
Private consumption													
Canada	4.7	4.3	3.0	3.0	2.8	2.7	2.8	3.0	3.5	4.0	5.4	3.0	3.3
France	2.5	1.6	1.7	1.6	1.2	1.2	1.5	2.2	2.4	2.4	2.8	1.2	2.1
Germany	-0.5	0.9	1.7	1.4	1.6	1.6	1.7	1.7	1.8	1.8	-1.5	1.8	1.8
Italy	1.5	0.7	1.2	1.3	0.9	0.8	1.0	1.4	1.6	1.6	1.0	1.2	1.4
Japan	1.5	1.6	1.2	1.0	1.0	1.2	1.2	1.3	1.4	1.5	1.1	1.6	1.4
United Kingdom	3.1	1.9	0.6	-0.4	-0.3	-0.1	0.6	1.1	1.6	2.0	2.4	1.2	1.3
United States	2.9	1.2	0.4	0.1	1.2	-1.0	0.2	0.6	1.2	2.0	2.6	0.3	1.0
Euro area	1.6	1.3	1.6	1.4	1.3	1.4	1.5	1.8	1.9	1.9	1.2	1.4	1.8
Total OECD	2.6	1.8	1.4	1.1	1.5	0.8	1.3	1.6	1.9	2.3	2.4	1.4	1.8
Public consumption													
Canada	3.6	3.4	2.3	1.3	1.6	1.8	2.3	3.0	3.0	3.0	5.0	1.7	2.8
France	1.4	1.0	0.7	0.9	1.1	1.0	0.8	0.4	0.4	0.4	1.3	0.9	0.5
Germany	2.1	1.6	1.8	2.6	2.4	2.4	1.6	1.4	1.4	1.4	1.7	2.7	1.5
Italy	1.3	1.0	1.0	1.2	1.2	1.0	1.0	0.8	0.8	0.8	0.9	1.1	0.8
Japan	0.8	0.3	1.1	1.1	1.1	1.0	1.0	1.1	1.1	1.1	1.5	0.0	1.1
United Kingdom	1.9	2.3	2.2	3.2	3.0	2.8	2.0	1.8	1.6	1.2	1.3	3.3	1.7
United States	1.9	2.3	1.5	1.6	1.3	1.3	1.7	1.3	1.7	1.7	2.1	1.8	1.6
Euro area	2.3	1.7	1.7	2.1	2.1	2.0	1.7	1.4	1.4	1.4	2.1	2.0	1.5
Total OECD	2.1	2.0	1.8	1.8	2.0	1.7	1.9	1.6	1.6	1.6	2.3	1.8	1.7
Business investment													
Canada	4.4	2.9	2.3	1.5	1.0	1.0	2.0	3.0	4.0	5.0	3.7	1.1	3.5
France	6.8	4.4	1.8	2.4	1.6	1.2	0.8	2.4	2.8	3.0	5.5	3.1	2.3
Germany	7.3	4.7	0.0	-16.7	1.3	1.3	1.5	1.2	1.1	1.1	6.2	1.7	1.2
Italy	0.0	0.5	0.7	0.5	0.2	0.2	0.7	1.0	1.0	1.0	-0.7	0.3	0.9
Japan	2.2	-1.0	1.4	-3.0	0.0	1.0	1.8	2.6	2.6	3.0	0.1	-1.4	2.5
United Kingdom	7.9	1.4	0.9	-0.5	0.0	0.0	0.0	1.6	2.8	4.1	5.3	-1.5	2.1
United States	4.7	0.8	-0.5	-4.9	-4.8	-4.3	-0.2	1.5	5.0	6.5	7.1	-3.8	3.2
Euro area	5.7	3.4	1.3	-3.1	1.2	1.2	1.4	2.0	2.0	2.2	4.5	1.9	1.9
Total OECD	5.1	1.7	0.8	-2.8	-1.2	-0.9	1.0	2.1	3.6	4.4	5.2	-0.8	2.7
Total investment													
Canada	4.1	2.8	1.8	1.2	0.8	0.8	1.3	2.5	3.2	3.9	4.7	1.1	2.7
France	4.9	3.1	1.4	1.6	1.2	1.1	0.9	1.8	2.2	2.4	3.9	2.0	1.8
Germany	5.1	2.7	0.5	-11.5	1.3	1.3	1.5	1.4	1.3	1.3	2.4	1.5	1.4
Italy	0.7	0.5	0.4	0.8	0.0	0.0	0.4	0.6	0.6	0.6	-0.3	0.4	0.6
Japan	-0.5	-1.2	1.3	0.2	0.9	1.0	1.2	1.6	1.6	1.8	-3.6	0.8	1.6
United Kingdom	6.2	0.5	0.9	-0.3	0.1	0.5	0.5	1.3	2.3	3.1	4.1	-1.5	1.8
United States	-2.0	-5.2	-1.7	-9.6	-6.9	-4.4	-0.8	0.7	3.3	4.5	-0.7	-7.2	1.9
Euro area	4.3	2.0	0.8	-2.3	0.5	0.6	0.8	1.3	1.5	1.6	2.9	1.1	1.3
Total OECD	1.9	-0.5	0.7	-3.3	-1.5	-0.5	1.0	1.8	2.9	3.4	1.7	-1.6	2.3

Note: These numbers are working-day adjusted and hence may differ from the basis used for official projections.

1. Year-on -year growth rates in per cent.

Source: OECD Economic Outlook 83 database.

(cont'd) Quarterly demand and output projections

Percentage changes from previous period, seasonally adjusted at annual rates, volume

	2007	2008	2009	2008			2009				Fourth quarter[1]		
				Q2	Q3	Q4	Q1	Q2	Q3	Q4	2007	2008	2009
Total domestic demand													
Canada	4.3	3.6	2.6	2.3	2.1	2.1	2.3	2.9	3.3	3.8	6.4	1.6	3.1
France	2.9	1.5	1.4	1.4	1.2	1.1	1.2	1.7	1.9	2.0	2.6	1.3	1.7
Germany	1.1	1.7	1.4	-2.0	1.7	1.7	1.7	1.6	1.6	1.6	1.0	2.3	1.6
Italy	1.2	0.5	1.0	1.1	0.8	1.1	0.9	1.1	1.3	1.3	0.1	1.2	1.1
Japan	1.0	0.7	1.2	0.9	1.0	1.1	1.2	1.3	1.4	1.5	0.1	1.1	1.4
United Kingdom	3.7	1.5	1.0	0.3	0.4	0.6	0.9	1.3	1.7	2.0	3.7	0.5	1.5
United States	1.5	0.1	0.2	-1.5	-0.4	-1.0	0.3	0.7	1.6	2.3	1.6	-0.7	1.2
Euro area	2.3	1.5	1.4	0.5	1.3	1.4	1.4	1.6	1.7	1.7	1.8	1.7	1.6
Total OECD	2.4	1.4	1.3	0.3	1.0	0.8	1.3	1.6	2.0	2.4	2.3	0.9	1.8
Export of goods and services													
Canada	0.9	-2.6	1.8	-1.0	0.0	0.0	2.0	3.0	4.0	4.5	-1.2	-1.3	3.4
France	3.2	4.5	3.0	0.4	2.2	2.7	3.4	3.6	3.7	3.8	3.4	4.5	3.6
Germany	8.0	6.3	5.1	4.9	4.5	4.5	4.9	5.7	5.9	5.9	4.3	5.5	5.6
Italy	4.5	1.8	3.1	3.2	3.0	2.8	2.8	3.2	3.4	3.4	0.7	3.1	3.2
Japan	8.6	10.3	5.3	5.0	4.3	4.8	5.6	5.9	5.8	5.5	10.4	8.2	5.7
United Kingdom	-5.3	1.8	4.6	2.8	3.2	4.6	4.7	5.3	5.3	5.7	0.6	2.7	5.3
United States	8.1	7.4	7.0	7.3	7.2	7.1	6.8	6.9	7.2	7.3	8.4	6.1	7.0
Total OECD[2]	6.6	6.2	5.6	4.9	5.0	5.2	5.6	6.0	6.2	6.3	6.7	5.2	6.0
Import of goods and services													
Canada	5.7	4.4	3.6	3.3	3.3	3.3	3.3	3.6	4.0	5.0	9.2	1.1	4.0
France	5.9	3.4	2.7	2.4	2.4	2.4	2.4	3.0	3.2	3.4	4.8	3.8	3.0
Germany	5.0	6.5	6.6	6.5	6.6	6.6	6.7	6.7	6.7	6.7	3.0	8.0	6.7
Italy	4.0	2.0	3.5	3.7	3.6	3.6	3.0	3.6	3.6	3.6	0.8	3.7	3.4
Japan	1.8	4.7	4.3	4.7	4.9	4.0	3.6	4.4	4.6	4.8	2.4	5.5	4.4
United Kingdom	-2.9	0.7	2.8	0.0	0.8	2.0	2.9	3.9	4.3	5.1	3.1	0.1	4.0
United States	1.9	-0.9	0.4	-1.0	-1.2	-1.8	0.9	1.4	2.3	2.5	1.0	-1.5	1.8
Total OECD[2]	4.0	2.9	3.2	2.3	2.4	2.2	3.3	3.8	4.3	4.5	4.0	2.4	4.0
GDP													
Canada	2.7	1.2	2.0	0.8	1.0	1.0	1.9	2.7	3.3	3.6	2.9	0.8	2.9
France	2.1	1.8	1.5	0.9	1.1	1.2	1.4	1.8	2.0	2.0	2.2	1.4	1.8
Germany	2.6	1.9	1.1	-2.1	1.1	1.1	1.2	1.5	1.6	1.6	1.8	1.5	1.5
Italy	1.4	0.5	0.9	0.9	0.6	0.9	0.8	1.0	1.2	1.2	0.1	1.0	1.1
Japan	2.1	1.7	1.5	1.1	1.0	1.3	1.6	1.6	1.7	1.7	1.5	1.7	1.6
United Kingdom	3.0	1.8	1.4	1.1	1.1	1.2	1.3	1.6	1.9	2.1	2.8	1.2	1.7
United States	2.2	1.2	1.1	-0.5	0.7	0.2	1.0	1.4	2.2	3.0	2.5	0.3	1.9
Euro area	2.6	1.7	1.4	0.2	1.1	1.2	1.4	1.7	1.8	1.9	2.1	1.4	1.7
Total OECD	2.7	1.8	1.7	0.5	1.2	1.2	1.7	2.0	2.4	2.7	2.6	1.3	2.2

Note: These numbers are working-day adjusted and hence may differ from the basis used for official projections.

1. Year-on -year growth rates in per cent.
2. Includes intra-regional trade.

Source: OECD Economic Outlook 83 database.

Quarterly price, cost and unemployment projections

Percentage changes from previous period, seasonally adjusted at annual rates, volume

	2007	2008	2009	2008			2009				Fourth quarter[1]		
				Q2	Q3	Q4	Q1	Q2	Q3	Q4	2007	2008	2009
Consumer price index													
Canada	2.1	1.3	1.3	1.7	1.7	1.5	1.1	1.2	1.2	1.3	2.4	1.5	1.2
France	1.6	3.5	2.4	3.6	2.8	2.4	2.3	2.2	2.1	2.0	2.5	3.3	2.2
Germany	2.3	2.9	2.1	2.4	2.0	1.9	2.1	2.1	2.1	2.1	3.1	2.4	2.1
Italy	2.0	3.6	2.1	3.9	2.7	2.4	1.7	1.7	1.6	1.7	2.6	3.4	1.7
Japan	0.1	0.9	0.4	0.6	0.3	0.3	0.3	0.4	0.5	0.6	0.5	0.6	0.5
United Kingdom	2.3	3.0	2.5	3.6	3.2	3.0	2.4	2.0	2.0	1.8	2.1	3.3	2.1
United States	2.9	3.9	2.2	4.0	2.7	2.2	2.0	1.9	1.8	1.8	4.0	3.3	1.8
Euro area	2.1	3.4	2.4	3.3	2.6	2.4	2.3	2.2	2.1	2.0	2.9	3.1	2.1
Private consumption deflator													
Canada	1.5	1.1	1.1	1.3	1.2	1.1	1.0	1.0	1.0	1.0	1.7	1.1	1.0
France	2.0	3.0	2.2	3.2	2.2	2.2	2.2	2.1	2.1	2.1	2.6	2.8	2.1
Germany	1.7	2.2	1.7	1.9	1.7	1.6	1.6	1.7	1.7	1.7	2.1	2.0	1.7
Italy	2.2	3.5	2.0	3.6	2.7	2.4	1.7	1.6	1.4	1.2	2.8	3.3	1.5
Japan	-0.5	0.3	0.3	0.2	0.2	0.2	0.3	0.4	0.4	0.5	-0.2	0.3	0.4
United Kingdom	2.6	3.2	2.9	4.1	4.1	3.6	2.8	2.1	1.9	1.8	2.8	3.7	2.2
United States	2.5	3.2	2.0	3.6	2.4	2.0	1.8	1.7	1.6	1.6	3.4	2.9	1.6
Euro area	2.1	3.1	2.2	3.0	2.5	2.3	2.1	2.0	1.9	1.9	2.7	2.8	2.0
Total OECD	2.2	3.0	2.1	3.2	2.5	2.3	2.0	1.9	1.8	1.8	2.8	2.8	1.9
GDP deflator													
Canada	3.1	2.8	1.5	4.4	2.2	1.1	1.2	1.0	1.3	1.3	3.8	2.5	1.2
France	2.5	2.7	2.4	3.0	2.7	2.5	2.3	2.2	2.2	2.3	2.3	2.8	2.2
Germany	1.8	2.1	1.8	2.7	2.5	2.3	1.5	1.5	1.3	1.2	1.9	2.6	1.4
Italy	2.3	2.3	2.4	3.2	2.8	2.3	2.3	2.3	2.2	2.0	2.7	2.6	2.2
Japan	-0.8	-1.1	0.2	0.0	0.1	0.1	0.2	0.3	0.3	0.4	-1.3	-0.4	0.3
United Kingdom	3.1	2.6	2.3	3.8	2.7	2.7	2.2	2.0	1.9	1.8	3.0	2.7	2.0
United States	2.7	1.9	1.7	0.7	1.9	1.8	1.8	1.8	1.7	1.8	2.6	1.8	1.8
Euro area	2.2	2.4	2.2	2.8	2.6	2.4	2.0	2.0	1.9	1.8	2.2	2.6	1.9
Total OECD	2.3	2.2	2.0	2.2	2.3	2.1	1.9	1.9	1.8	1.8	2.3	2.3	1.9
Unit labour cost (total economy)													
Canada	3.3	4.3	2.3	4.5	3.3	2.3	1.6	2.1	1.7	2.4	3.2	4.3	2.0
France	2.2	1.8	2.2	2.8	2.6	2.5	2.3	1.8	1.4	1.5	1.6	2.2	1.8
Germany	0.1	1.5	1.9	6.4	2.6	2.6	1.3	1.0	0.9	1.0	0.7	2.9	1.1
Italy	2.0	4.5	2.3	4.3	4.1	2.3	2.0	1.6	1.4	1.4	5.2	3.6	1.6
Japan	-1.8	-0.2	-0.2	1.3	1.1	0.2	-0.6	-0.8	-0.8	-0.6	-1.5	0.3	-0.7
United Kingdom	1.3	2.9	2.1	2.9	2.7	2.5	1.6	1.9	1.7	1.8	1.6	3.0	1.8
United States	3.3	2.6	2.4	3.4	2.2	2.8	2.2	2.2	2.0	2.0	2.2	3.2	2.1
Euro area	1.7	2.6	2.3	4.2	3.1	2.6	2.2	1.8	1.6	1.6	2.3	2.9	1.8
Total OECD	2.2	2.6	2.2	3.8	2.5	2.4	2.0	2.2	1.6	1.6	2.0	3.0	1.8
	Per cent of labour force												
Unemployment													
Canada	6.0	6.1	6.3	6.1	6.2	6.3	6.4	6.4	6.3	6.3	5.9	6.3	6.3
France	7.9	7.5	7.6	7.5	7.5	7.6	7.6	7.6	7.6	7.6	7.5	7.6	7.6
Germany	8.3	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.9	7.4	7.4
Italy	6.1	6.2	6.5	6.2	6.3	6.4	6.4	6.5	6.5	6.6	6.0	6.4	6.6
Japan	3.9	3.8	3.8	3.8	3.8	3.9	3.9	3.8	3.7	3.7	3.9	3.9	3.7
United Kingdom	5.4	5.5	5.8	5.4	5.6	5.6	5.7	5.7	5.8	5.8	5.2	5.6	5.8
United States	4.6	5.4	6.1	5.2	5.5	5.8	6.0	6.2	6.2	6.1	4.8	5.8	6.1
Euro area	7.4	7.2	7.4	7.2	7.2	7.3	7.4	7.4	7.5	7.5	7.1	7.3	7.5
Total OECD	5.6	5.7	6.0	5.7	5.7	5.9	6.0	6.0	6.0	6.0	5.5	5.9	6.0

Note: These numbers are working-day adjusted and hence may differ from the basis used for official projections.

1. Year-on -year growth rates in per cent.

Source: OECD Economic Outlook 83 database.

CHAPTER 2

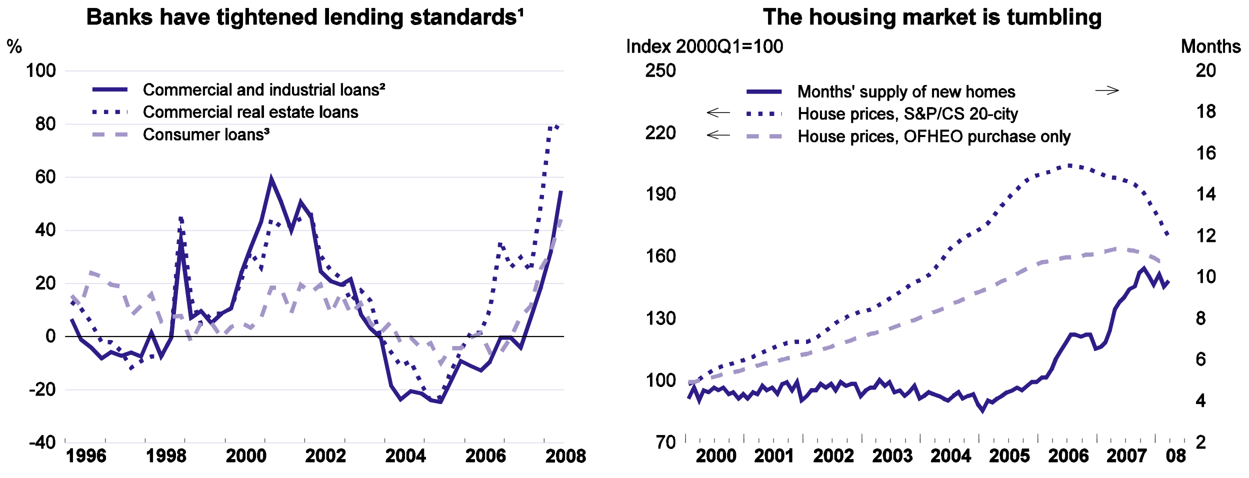
DEVELOPMENTS IN INDIVIDUAL OECD COUNTRIES AND SELECTED NON-MEMBER ECONOMIES

UNITED STATES

The economy is facing strong headwinds, which are exerting a sizeable drag on activity. The financial crisis is resulting in a credit squeeze, declining house prices are putting pressure on household wealth and the sharp increase in commodity prices is eroding workers' disposable incomes. The response of macroeconomic policy will help to moderate these effects, as will a dynamic external sector which will continue to benefit from the growth of world trade and the weakening of the dollar. After stalling this year, real GDP growth should gradually return to potential next year. The opening of a substantial output gap and higher unemployment, together with stabilisation of commodity prices, should ease inflationary pressures.

Monetary policy should be maintained at the current accommodative stance until the recovery has taken hold, but interest rates should be raised promptly when conditions normalise. Financial market regulation will need to be revised, including by reducing banks' scope for regulatory arbitrage through developing their activities through off-balance sheet vehicles and by subjecting financial institutions judged to be too inter-connected to be allowed to fail to the same capital adequacy requirements as banks.

United States



1. Net percentage of banks reporting that they tightened their lending standards over the past three months.
2. Loans to large and middle market firms.
3. Non-credit-card consumer loans.

Source: Federal Reserve's Senior Loan Officer Opinion Survey; S&P/Case-Shiller; Office of Federal Housing Enterprise Oversight.

United States: **Employment, income and inflation**

Percentage changes from previous period

	2005	2006	2007	2008	2009
Employment[1]	1.6	1.8	0.9	-0.1	0.0
Unemployment rate[2]	5.1	4.6	4.6	5.4	6.1
Employment cost index	3.1	2.9	3.1	3.0	2.9
Compensation per employee[3]	3.4	4.0	4.5	3.5	3.3
Labour productivity[3]	1.6	1.2	1.4	1.4	1.1
Unit labour cost[3]	2.2	3.0	3.3	2.6	2.4
GDP deflator	3.2	3.2	2.7	1.9	1.7
Consumer price index	3.4	3.2	2.9	3.9	2.2
Core PCE deflator[4]	2.2	2.2	2.1	2.2	1.9
Private consumption deflator	2.9	2.8	2.5	3.2	2.0
Real household disposable income	1.7	3.1	3.1	2.8	-0.2

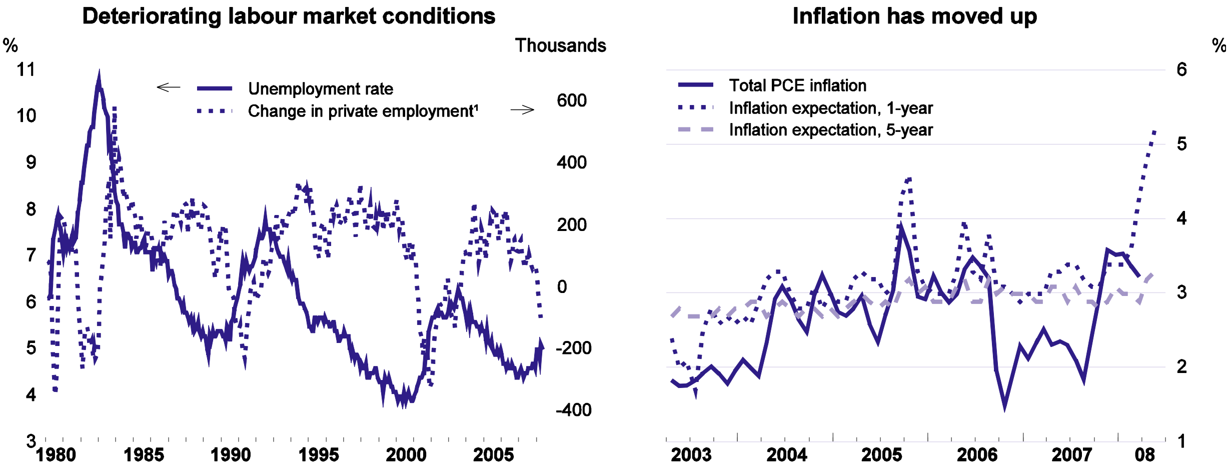
1. Whole economy, for further details see *OECD Economic Outlook* Sources and Methods, *(http://www.oecd.org/eco/sources-and-methods).*
2. As a percentage of labour force.
3. In the private sector.
4. Price index for personal consumption expenditure excluding food and energy.

Source: OECD Economic Outlook 83 database.

The financial crisis exerts a drag on economic activity

The US economy is at the epicentre of a financial crisis, which is causing considerable disruption to real activity. The trigger for the crisis was a sharp rise in delinquencies on subprime mortgages, which led to large losses on the securities backed by these mortgages. As investors came to realise that mortgage- and asset-based securities were much riskier than supposed, demand for and trading of such products dried up, resulting in further losses on a variety of credit-based securities. Banking institutions linked to these leveraged products incurred large losses, necessitating

United States



1. Three-month moving average of one-month actual change of total private employment.

Source: Bureau of Labor Statistics; Bureau of Economic Analysis; Reuters/University of Michigan Surveys of Consumers.

measures to restore their financial health. This involves a drawn-out process of raising equity capital, shrinking balance sheets, retaining earnings and lengthening the maturity of funding. Hence, the tightening of lending conditions evident since late 2007 and the slowdown of commercial bank loans in the early months of 2008 are likely to persist for some time.

United States: **Financial indicators**

	2005	2006	2007	2008	2009
Household saving ratio[1]	0.5	0.4	0.4	1.8	1.2
General government financial balance[2]	-3.6	-2.6	-3.0	-5.5	-5.2
Current account balance[2]	-6.1	-6.2	-5.3	-5.0	-4.4
Short-term interest rate[3]	3.5	5.2	5.3	2.7	3.1
Long-term interest rate[4]	4.3	4.8	4.6	3.9	4.4

1. As a percentage of disposable income.
2. As a percentage of GDP.
3. 3-month euro-dollar.
4. 10-year government bonds.

Source: OECD Economic Outlook 83 database.

Furthermore, housing continues to falter…

The credit squeeze has reinforced the decline in house prices. While residential construction has fallen dramatically, inventories of unsold houses have nevertheless increased to unsustainably high levels, putting further downward pressure on the real estate market. Falling house prices are contributing to the rise in home foreclosures, exerting in turn additional

United States: **Demand and output**

	2004	2005	2006	2007	2008	2009
	Current prices $ billion	Percentage changes, volume (2000 prices)				
Private consumption	8 195.9	3.2	3.1	2.9	1.2	0.4
Government consumption	1 844.1	0.8	1.4	1.9	2.3	1.5
Gross fixed investment	2 202.8	5.8	2.6	-2.0	-5.2	-1.7
Public	372.8	0.6	3.7	2.4	0.9	1.2
Residential	675.5	6.6	-4.6	-17.0	-23.6	-8.5
Non-residential	1 154.5	7.1	6.6	4.7	0.8	-0.5
Final domestic demand	12 242.7	3.3	2.7	1.8	0.3	0.2
Stockbuilding[1]	58.6	-0.2	0.1	-0.3	-0.1	0.0
Total domestic demand	12 301.3	3.1	2.8	1.5	0.1	0.2
Exports of goods and services	1 182.4	6.9	8.4	8.1	7.4	7.0
Imports of goods and services	1 797.8	5.9	5.9	1.9	-0.9	0.4
Net exports[1]	- 615.4	-0.2	-0.1	0.6	1.0	0.9
GDP at market prices	11 685.9	3.1	2.9	2.2	1.2	1.1

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

Source: OECD Economic Outlook 83 database.

pressure on prices. In combination with declining equity prices, this means that household wealth -- a key influence on private consumption -- is decreasing for the first time since 2002.

… and commodity prices have moved up sharply

Amplified by dollar depreciation, energy prices have soared to new record highs recently and food prices have risen more rapidly than for nearly two decades, further weighing on economic prospects. Headline inflation, as measured by the price index for personal consumption expenditures, remained high, near 3¼ per cent over the twelve months to March, lowering consumers' purchasing power. Indeed, for many workers, increases in real wage rates over 2007 were very modest, once again falling short of the rise in labour productivity. While core inflation has remained relatively well contained, some indicators point to rising inflation expectations.

United States: **External indicators**

	2005	2006	2007	2008	2009
			$ billion		
Goods and services exports	1 309.4	1 467.6	1 643.0	1 862	2 038
Goods and services imports	2 024.0	2 229.6	2 351.0	2 585	2 670
Foreign balance	- 714.6	- 762.0	- 708.0	- 723	- 633
Invisibles, net	- 40.3	- 49.5	- 30.7	6	- 16
Current account balance	- 754.8	- 811.5	- 738.6	- 717	- 648
			Percentage changes		
Goods and services export volumes	6.9	8.4	8.1	7.4	7.0
Goods and services import volumes	5.9	5.9	1.9	- 0.9	0.4
Export performance[1]	- 1.9	- 0.7	0.5	0.2	0.1
Terms of trade	- 2.5	- 0.6	0.1	- 4.9	- 0.6

1. Ratio between export volume and export market of total goods and services.
Source: OECD Economic Outlook 83 database.

Deteriorating labour market conditions…

Recent labour market developments should further curtail real disposable income. Private sector employment has fallen for five consecutive months, a trend that in the past has coincided with the onset of recessions. Furthermore, the loss of jobs has spread from the construction sector to manufacturing and several service-producing industries, while the unemployment rate has risen to 5%.

… have led to weakness in consumer spending

In the face of these adverse shocks, the economy grew at a sluggish pace in the first quarter of 2008. Consumer spending, which had held up reasonably well in the second half of 2007, was restrained by an only moderate increase in real disposable income.

Investment weakened but net exports have kept the economy moving

The first-quarter figures indicate that the crisis has spread from residential investment, which contracted at a record rate, to non-residential investment, which contracted after posting solid gains over the previous few quarters. Foreign trade has thus become the main engine of growth, with exports continuing to benefit from the weakening of the dollar and solid growth abroad.

Aggressive easing of monetary policy…

In addition to cutting its policy rate dramatically, the Federal Reserve took decisive steps to improve the functioning of the short-term funding market, to re-liquefy the market for mortgage-backed securities and to assist with the rescue of Bear Stearns. Since the onset of the financial crisis in August 2007, it committed more than half of its nearly $1 trillion balance sheet to lend Treasury securities in exchange for lesser grade securities, mostly backed by mortgages. The federal funds rate has been sharply lowered but, with the spread between the policy rate and short-term market rates remaining elevated, part of this easing should be viewed as a recalibration of policy to partially offset tighter financial conditions. The current accommodative stance should be maintained until such time as the economy is projected to be firmly recovering, and then the policy rate should be swiftly brought back towards neutral to keep inflation expectations under control.

… and the fiscal stimulus package are supporting the economy

About $115 billion in tax rebates are being sent to households, while firms were offered a bonus depreciation scheme worth $50 billion to foster investment. The fiscal stimulus package together with the projected slowdown in activity will considerably curb growth in government revenues over this year and next. Hence, public deficits should increase noticeably both at the federal and at the local levels. Given the already high level of the general government budget deficit and looming long-term budget challenges of funding the entitlement programmes, there does not appear to be much room to provide further support to economic activity.

Consumer spending will be weak…

Tighter credit conditions, together with stagnating real disposable incomes and reduced confidence, will likely weigh considerably on household spending. Furthermore, assuming that house prices (as measured by the Office of Federal Housing Enterprises Oversight index) will fall 10% over the course of this year and next, declines in household wealth should lead to a 1 percentage point rise in the saving rate by 2009, holding back private consumption. The rebate cheques are likely to provide a considerable, but temporary, boost to household spending in the second and especially the third quarters of 2008, but also result in an uneven growth profile for private consumption as real disposable income is then projected to drop in the fourth quarter.

… and private investment should contract

The credit squeeze, together with weak sales prospects, will also likely lead to a sizeable contraction in non-residential investment, with capital spending plans already pointing to some reduction. In particular, the non-residential construction component should slow down noticeably from the rapid pace posted last year, in part in response to a lower supply of bank loans. Furthermore, housing activity is projected to continue declining in the face of weaker demand amid a reduction in the availability of mortgage lending.

GDP is set to be flat in 2008 and to pick up through 2009

GDP is projected to nearly stall over the remainder of 2008, despite a continued positive contribution from net exports. Next year, economic activity should gradually recover, led by a pickup in equipment and software investment. With the opening of a substantial output gap and the unemployment rate climbing above 6% inflationary pressures should eventually ease, assuming that commodity prices flatten out.

Risks have widened

There is considerable uncertainty about the eventual scale of financial institutions' losses and the extent to which they restore their capital ratios by raising new capital as opposed to shrinking their balance sheets. These risks could go either way, speeding the recovery or delaying it. In addition, potential growth may have been significantly reduced by the financial crisis and the rise in commodity prices, resulting in higher-than-projected inflation.

JAPAN

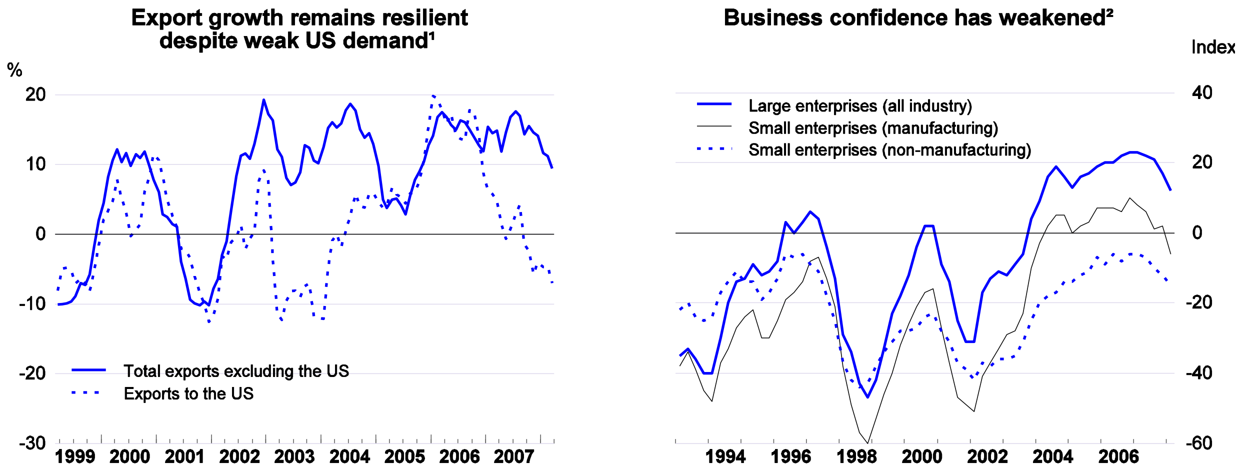
Although output growth is slowing somewhat, wage gains and a rebound in housing investment should help sustain the expansion in 2008, and growth is projected to pick up during 2009. While headline inflation has risen to about 1% as a result of soaring import prices, underlying inflation is around zero and is expected to pick up only slowly.

The Bank of Japan should not raise the short-term policy interest rate while underlying inflation remains close to zero. It is essential to cut spending and implement a comprehensive tax reform to achieve a primary budget surplus by fiscal year 2011, as a first step in reducing the public debt-to-GDP ratio. Structural reforms are needed to boost productivity, particularly in the service sector, which would help maintain improvements in living standards despite a shrinking working-age population.

The expansion has slowed but remains on track, led by exports…

The current expansion -- the longest in Japan's post-war history -- has been led by exports and business investment, which together have accounted for three-quarters of output gains since 2002. Export volumes continued to expand at a double-digit rate in the first quarter of 2008 despite yen appreciation and declining shipments to the United States. The resilience of export growth reflects the decline in the US share of Japanese exports from 30% in 2000 to 20% in 2007, while the share of other

Japan



1. Yea-on-year growth rates of a moving average of export values over three quarters.
2. Diffusion index of "favourable" minus "unfavourable" business conditions in the Tankan Survey. There is a discontinuity between the third and fourth quarters of 2003 due to data revisions.

Source: Ministry of Finance; Bank of Japan.

Japan: **Employment, income and inflation**

Percentage changes from previous period

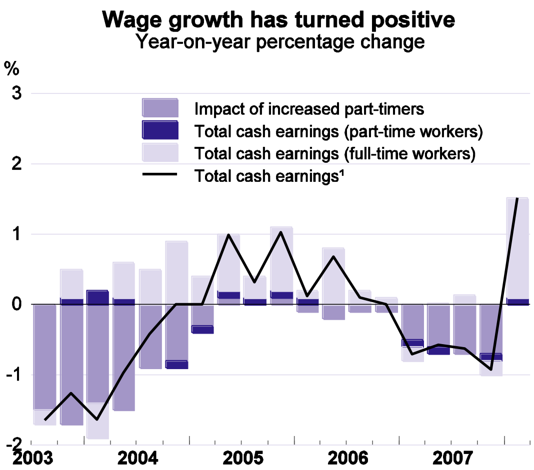
	2005	2006	2007	2008	2009
Employment	0.4	0.4	0.5	-0.1	0.0
Unemployment rate[1]	4.4	4.1	3.9	3.8	3.8
Compensation of employees	0.8	1.6	0.3	1.5	1.3
Unit labour cost	-1.1	-0.8	-1.8	-0.2	-0.2
Household disposable income	0.9	1.0	1.1	1.3	1.6
GDP deflator	-1.2	-1.0	-0.8	-1.1	0.2
Consumer price index[2]	-0.6	0.2	0.1	0.9	0.4
Core consumer price index[3]	-0.4	-0.4	-0.2	0.1	0.3
Private consumption deflator	-0.8	-0.3	-0.5	0.3	0.3

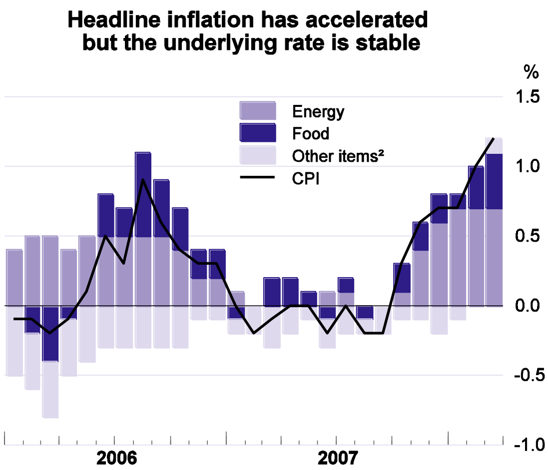
1. As a percentage of labour force.
2. Calculated as the sum of the seasonally adjusted quarterly indices for each year. In the Japanese official statistics, annual growth rates are based on the non-seasonally adjusted series, giving -0.3% in 2005 and 0.3% in 2006.
3. Consumer price index excluding food and energy.

Source: OECD Economic Outlook 83 database.

Asian countries has risen to one-half. However, the appreciation of the yen, by 9% in trade-weighted terms since mid-2007, contributed to a decline in corporate profits in the fourth quarter of 2007, the first since 2002. The sharp rise in prices for oil and raw materials has also lowered profitability, as firms have had difficulty to fully pass along their higher costs. Meanwhile, international financial market turbulence and the prospects of a slowing world economy reduced business confidence to a four-year low in early 2008. Falling profits and confidence resulted in a decline in capital good shipments for domestic use in the first quarter of 2008 and weaker loan demand from the corporate sector.

Japan





1. Total cash earnings of all workers, including bonuses.
2. Corresponds to the OECD measure of core inflation.

Source: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

Japan: **Financial indicators**

	2005	2006	2007	2008	2009
Household saving ratio[1]	3.9	3.3	3.1	2.6	2.6
General government financial balance[2]	-6.7	-1.4	-2.4	-1.4	-2.2
Current account balance[2]	3.7	3.9	4.8	4.4	4.4
Short-term interest rate[3]	0.0	0.2	0.7	0.8	0.7
Long-term interest rate[4]	1.4	1.7	1.7	1.7	2.1

1. As a percentage of disposable income.
2. As a percentage of GDP.
3. 3-month CDs.
4. 10-year government bonds.

Source: OECD Economic Outlook 83 database.

… and a rebound in housing investment and wage gains

The weakness in business capital spending in the first half of 2008 is offset by a rebound in housing investment, which had fallen by 27% in the second half of 2007 (seasonally-adjusted annual rate), reducing GDP growth by a full percentage point. The sharp decline was caused by the revision of the Building Standards Law in June 2007. Following improvements in regulatory procedures, housing starts rose by 36% (in terms of area) between the third quarter of 2007 and the first quarter of 2008. Another positive factor is the reversal of the wage decline recorded in 2007. The rise in wages in the first quarter of 2008 reflects higher compensation for full-time workers and an end of the shift to lower-paid part-time workers, thus removing a significant drag on wage gains.

Japan: **Demand and output**

	2004	2005	2006	2007	2008	2009
	Current prices ¥ trillion	Percentage changes, volume (2000 prices)				
Private consumption	284.4	1.3	2.0	1.5	1.6	1.2
Government consumption	89.5	1.6	-0.4	0.8	0.3	1.1
Gross fixed investment	113.2	3.1	1.3	-0.5	-1.2	1.3
Public[1]	25.2	-10.1	-8.1	-2.5	-1.7	-3.4
Residential	18.4	-1.5	0.9	-9.5	-1.8	6.0
Non-residential	69.6	9.2	4.3	2.2	-1.0	1.4
Final domestic demand	487.1	1.8	1.4	0.9	0.7	1.2
Stockbuilding[2]	1.6	-0.1	0.2	0.1	0.0	0.0
Total domestic demand	488.7	1.7	1.6	1.0	0.7	1.2
Exports of goods and services	66.3	7.0	9.7	8.6	10.3	5.3
Imports of goods and services	56.7	5.8	4.2	1.8	4.7	4.3
Net exports[2]	9.6	0.3	0.8	1.1	1.1	0.2
GDP at market prices	498.3	1.9	2.4	2.1	1.7	1.5

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Including public corporations.
2. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

Source: OECD Economic Outlook 83 database.

Japan: **External indicators**

	2005	2006	2007	2008	2009
			$ billion		
Goods and services exports	652.8	702.6	772.1	905	949
Goods and services imports	589.4	648.1	698.9	842	878
Foreign balance	63.4	54.5	73.3	63	71
Invisibles, net	103.3	117.5	138.9	154	153
Current account balance	166.6	172.0	212.2	217	224
			Percentage changes		
Goods and services export volumes	7.0	9.7	8.6	10.3	5.3
Goods and services import volumes	5.8	4.2	1.8	4.7	4.3
Export performance[1]	- 1.8	0.4	1.2	3.5	- 2.1
Terms of trade	- 6.4	- 6.9	- 4.5	- 7.6	- 0.4

1. Ratio between export volume and export market of total goods and services.
Source: OECD Economic Outlook 83 database.

However, consumers' purchasing power has been squeezed by rising energy and food prices. Indeed, headline inflation accelerated from 0.1% in 2007 to more than 1% in the first quarter of 2008, with energy accounting for two-thirds of the increase and food the remaining one-third.

The Bank of Japan has left the short-term policy interest rate unchanged

Despite the rise in headline inflation, the core consumer price index (excluding energy and food) remained flat during the first quarter of 2008, while unit labour costs continued to decline. Given weak inflationary pressures and turbulence in international financial markets, the Bank of Japan has left its policy interest rate unchanged at 0.5% since February 2007. Japan has largely avoided disruptions in its own financial market, with interest rate spreads on bank loans remaining steady. With the growth outlook weakening, long-term interest rates have fluctuated around 1½ per cent thus far in 2008. Meanwhile, residential land prices, which stabilised in 2007 after 15 consecutive years of decline, rose by 1% nationwide in the annual survey in January 2008. Inflationary pressures are set to remain weak and there is a need to ensure an adequate buffer against deflation by allowing underlying inflation to rise until it is firmly positive. Therefore, the OECD's projection assumes that the policy interest rate remains unchanged through mid-2009, when underlying inflation is projected to approach ½ per cent. With expectations of inflation rising further, it may then be possible to initiate a sequence of policy rate hikes.

Additional measures are needed to achieve the fiscal targets

Japan has reduced its budget deficit from 8% of GDP in 2002 to around 3% in 2007 (excluding one-off factors), reflecting spending cuts, primarily in public investment, and increased revenues. The government maintains its commitment to achieving a primary budget surplus for the combined central and local governments by financial year (FY) 2011, as a first step toward reducing the gross public-debt-to-GDP ratio -- which currently exceeds 170%, the highest ever recorded in the OECD area -- from the mid-2010s. On a general government basis, the primary deficit, excluding one-off factors, was about 2¼ per cent of GDP in 2007. Under current policies, the primary deficit is projected to fall by around ¼ per cent of GDP in both 2008 and 2009. This implies that achieving the FY 2011 target will require further measures to cut expenditures and raise revenues.

Economic growth is projected to pick up during 2009…

Economic growth is projected to decelerate to about 1¼ per cent for the remainder of 2008 and then rise during 2009 to just above the potential rate of 1½ per cent. While exports are likely to decelerate as a result of slower world growth and past yen appreciation, domestic demand has sufficient momentum to avoid a recession. *First*, the rebound in residential investment is projected to add nearly ½ percentage point to GDP growth in 2008, even assuming that housing starts converge only gradually to the long-term trend. *Second*, the corporate sector is more resilient to external shocks given the improvement in its profitability and balance sheets since the post-bubble period, while the banking system is adequately capitalised. With strong underlying profitability, growth in business investment is projected to resume in 2009. *Third*, the return to positive wage growth in early 2008 is projected to continue through the end of 2009, thus supporting private consumption. Indeed, the unemployment rate is set to remain below 4% and the structural factors putting downward pressure on wages are likely to weaken further. In addition to the stabilisation of the share of non-regular workers, the retirement of the baby boom generation -- which has been putting downward pressure on wages as high-paid workers leave the labour force -- peaked in the first quarter of 2008. Even so, with the effect of higher energy and raw material prices fading and the impact of the stronger yen, inflation is projected to increase only very gradually during 2009.

… though external and domestic risks are mostly on the downside

There are a number of risks to the outlook, including a sharper-than-expected decline in overseas demand and further yen appreciation in the context of a current account surplus exceeding 4% of GDP. On the domestic side, the key risk is that the upward trend in wages may falter. In addition, the extent and pace of the recovery in housing starts, following last year’s regulatory change, is uncertain.

EURO AREA

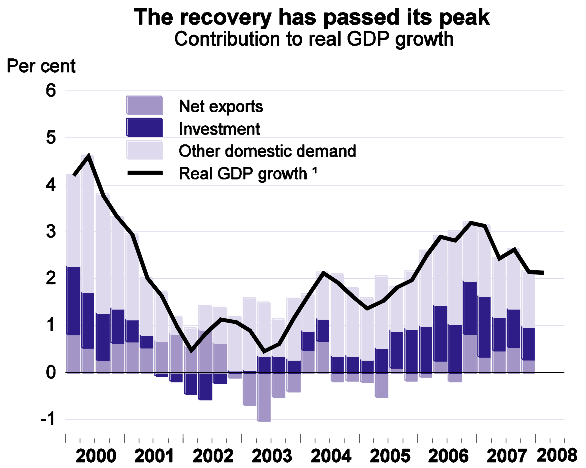
The economic expansion is likely to moderate during 2008, with a trough in the second quarter. Output growth is being slowed by tighter financial conditions, higher inflation and weaker housing market activity. Growth is expected to drop below potential this year, before picking-up slowly through 2009 as financial headwinds dissipate and the external environment improves. Domestic demand should be underpinned by continued job creation and a modest pick-up in wage growth. Inflation has risen markedly, but is projected to decelerate towards 2% as demand eases and energy and food price effects drop out of the headline measure.

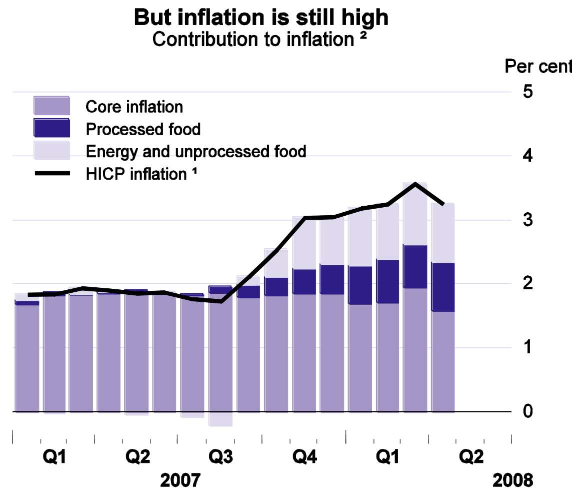
Monetary policy is finely balanced, with upside risks to inflation from second-round effects on wages and prices, but downside risks to activity. At present it appears appropriate to maintain interest rates at their current level. Fiscal measures that would raise the structural budget deficit are not needed and priority should be given to medium-term consolidation. Growth prospects would be enhanced by further structural reforms to strengthen labour and product market outcomes.

Economic growth has begun to slow

Economic activity is set to moderate, with the pick-up in output growth in the first quarter of 2008 expected to prove only temporary. Business investment and net exports have been the main contributors to growth over the past year, with household consumption remaining subdued as household real incomes were squeezed. The housing investment cycle has turned, led by declines in construction in Spain and Ireland. Recent data

Euro area





1. Year-on-year percentage change.

2. Represented by the harmonised consumer price index (HICP).

Source: OECD, Economic Outlook 83 database.

show that industrial production growth remained robust in the early part of 2008, but retail sales barely grew at all. Survey data for the first four months of 2008 point towards a period of below-trend growth, with service sector sentiment and consumer confidence having declined consistently since mid-2007 to below their long-term average levels. Industrial confidence has been comparatively resilient, but has also declined.

Euro area: **Employment, income and inflation**

Percentage changes from previous period

	2005	2006	2007	2008	2009
Employment	1.1	1.6	1.8	1.0	0.4
Unemployment rate[1]	8.8	8.2	7.4	7.2	7.4
Compensation per employee[2]	1.2	2.1	2.2	2.9	3.2
Labour productivity	0.6	1.3	0.8	0.7	1.0
Unit labour cost	1.1	1.1	1.7	2.6	2.3
Household disposable income	3.2	3.8	3.6	4.5	3.6
GDP deflator	1.9	1.9	2.2	2.4	2.2
Harmonised index of consumer prices	2.2	2.2	2.1	3.4	2.4
Core harmonised index of consumer prices[3]	1.5	1.5	1.9	2.0	2.2
Private consumption deflator	2.1	2.2	2.1	3.1	2.2

Note: The euro area aggregates cover the euro area countries that are members of the OECD.
1. As a percentage of labour force.
2. In the private sector.
3. Harmonised index of consumer prices excluding energy, food, drink and tobacco.

Source: OECD Economic Outlook 83 database.

Financial conditions have tightened

International financial market turmoil, and the associated re-pricing of risk, has contributed to tighter financial conditions in the euro area. Bank lending standards have tightened, financial market sentiment has declined and money-market spreads have widened. Spreads between the average interest rates charged for new long-term loans to the private sector and government bond rates have risen by more than 50 basis points since the onset of the financial crisis, pushing up the effective cost of borrowing. Credit growth to households is slowing, but bank lending to companies

Euro area: **Financial indicators**

	2005	2006	2007	2008	2009
Household saving ratio[1]	9.8	9.4	9.3	9.3	9.2
General government financial balance[2]	-2.6	-1.3	-0.6	-1.1	-1.2
Current account balance[2]	0.4	0.2	0.2	0.1	0.0
Short-term interest rate[3]	2.2	3.1	4.3	4.5	4.1
Long-term interest rate[4]	3.4	3.8	4.3	4.3	4.4

Note: The euro area aggregates cover the euro area countries that are members of the OECD.
1. As a percentage of disposable income.
2. As a percentage of GDP.
3. 3-month interbank rate.
4. 10-year government bonds.

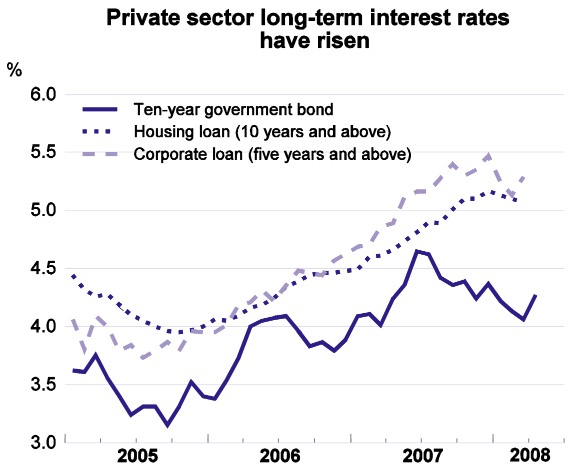
Source: OECD Economic Outlook 83 database.

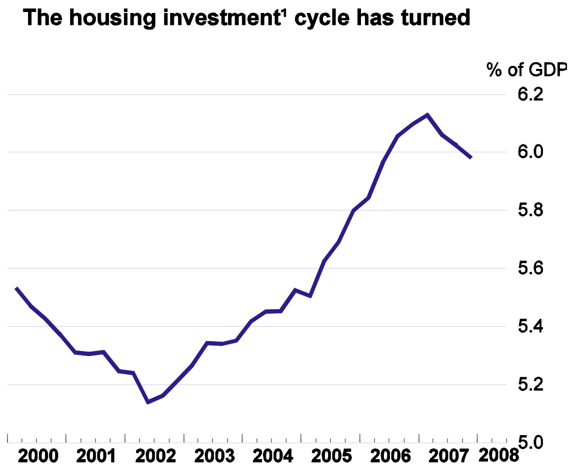
remains strong, supported by financial re-intermediation and other portfolio adjustments. Other forms of corporate financing, such as equity and debt securities, are, however, rising much less rapidly. The appreciation of the euro, and declines in equity and house prices also add to financial pressures, imparting negative wealth effects on private sector spending and depressing net exports. In effective terms, the euro appreciated by 7¾ per cent in the year to mid-May.

Improvements in the labour market are moderating

The rate of job creation and the decline in the unemployment rate have both begun to slow. In the first three months of 2008, the unemployment rate remained unchanged at just over 7%. Cost pressures have begun to pick-up, with unit labour costs now increasing at about 2% per annum as productivity growth has slipped. With moderate economic growth, and labour costs rising, the unemployment rate is likely to edge up over the course of this year and next.

Euro area





1. Residential investment.

Source: OECD Economic Outlook 83 database and European Central Bank.

Monetary policy decisions are finely balanced

Headline inflation reached 3.6% in March, pushed up primarily by rising food and energy prices, before edging down to 3.3% in April. The commodity-related effects should fade away in the early part of 2009 as past price increases drop out of the annual comparison. Core inflation, excluding food, drink, tobacco and energy, remains under 2%, but other measures of inflation, such as the GDP deflator, are running at a faster pace. Domestic cost pressures are expected to rise further this year, although these could be absorbed in profit margins to some extent. The gradual emergence of a negative output gap and weaker import price pressures should help to moderate underlying consumer price inflation in 2009. Both headline and core inflation are projected to be close to the medium-term objective of the European Central Bank by the end of the forecast horizon. Although the policy rate is unchanged since the summer of 2007, the effective tightening of financial conditions is helping to damp underlying inflationary pressures. This policy stance remains appropriate, but is finely balanced between important risks in both directions. On the upside, sustained increases in energy and food prices raise the risks of second-round effects on wages, prices and medium-term inflation expectations. But if financial conditions were to deteriorate further, or remain impaired for longer, with activity slowing more rapidly than projected, inflationary pressures could diminish quite sharply.

Euro area: **Demand and output**

	2004	2005	2006	2007	2008	2009
	Current prices € billion	Percentage changes, volume (2001 prices)				
Private consumption	4 452.0	1.7	1.9	1.6	1.3	1.6
Government consumption	1 586.1	1.5	2.0	2.3	1.7	1.7
Gross fixed investment	1 572.5	3.3	5.5	4.3	2.0	0.8
Public	197.6	2.6	1.5	2.9	3.5	3.4
Residential	424.5	3.0	6.0	1.5	-2.2	-2.0
Non-residential	950.5	3.5	6.1	5.7	3.4	1.3
Final domestic demand	7 610.7	2.0	2.7	2.3	1.5	1.4
Stockbuilding[1]	7.0	0.0	0.0	0.0	0.0	0.0
Total domestic demand	7 617.7	2.0	2.7	2.3	1.5	1.4
Net exports[1]	148.4	-0.2	0.2	0.4	0.2	0.0
GDP at market prices	7 766.1	1.7	2.9	2.6	1.7	1.4

Note: The euro area aggregates cover the euro area countries that are members of the OECD.
1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
Source: OECD Economic Outlook 83 database.

The automatic fiscal stabilisers should be allowed to work

Fiscal outcomes have improved markedly over the economic upturn, with the structural budget deficit declining by 1½ per cent of GDP over the period 2005-07. In a cyclical downturn, actual budget balances are likely to deteriorate as the automatic stabilisers cushion demand. But the case for discretionary relaxation is limited given the strength of the automatic stabilisers and existing inflationary pressures. The likely fading of the revenue gains from strong asset price growth and the continued need for structural measures to reduce debt levels point to a need for additional fiscal consolidation in the medium term. Looking ahead, support to growth should be provided primarily by well-targeted measures to improve the quality of the public finances.

Euro area: **External indicators**

	2005	2006	2007	2008	2009
	$ billion				
Foreign balance	135.7	116.5	179.5	194	209
Invisibles, net	- 93.3	- 91.6	- 150.6	- 186	- 204
Current account balance	42.4	24.9	28.9	8	5

Note: The euro area aggregates cover the euro area countries that are members of the OECD.
Source: OECD Economic Outlook 83 database.

Prospects for growth depend on the resilience of domestic demand

The prospects for growth over the projection period depend on the resilience of domestic demand. Tighter financial conditions and high inflation should damp consumption and business investment, but ongoing job creation, a modest pick-up in wage growth, the automatic fiscal stabilisers and an eventual unwinding of financial market tensions should support continued, but subdued growth. Residential investment will be a drag on activity as house-building declines, although this will begin to fade through 2009. Output growth is projected to be well below trend rates in the latter half of 2008 and the early part of 2009, before returning to trend by the year-end. The positive contribution to growth from net exports is expected to dissipate this year, with export volumes hit by the weaker external environment and the strength of the euro. These effects are projected to fade in 2009, with export growth turning up through the course of the year. Import growth should remain subdued this year, but is likely to pick-up somewhat as demand growth recovers through 2009.

There is probably more risk on the downside

A key risk is that euro area activity could be affected more sharply than projected by the slowdown in the external environment, with international trade and financial market linkages having deepened over time. More generally, the negative impact of domestic financial market strains and, for some countries, housing market downturns, could be steeper and more protracted than projected. That said, financial market pressures could abate more quickly than expected, while the exchange rate risk goes in both directions.

GERMANY

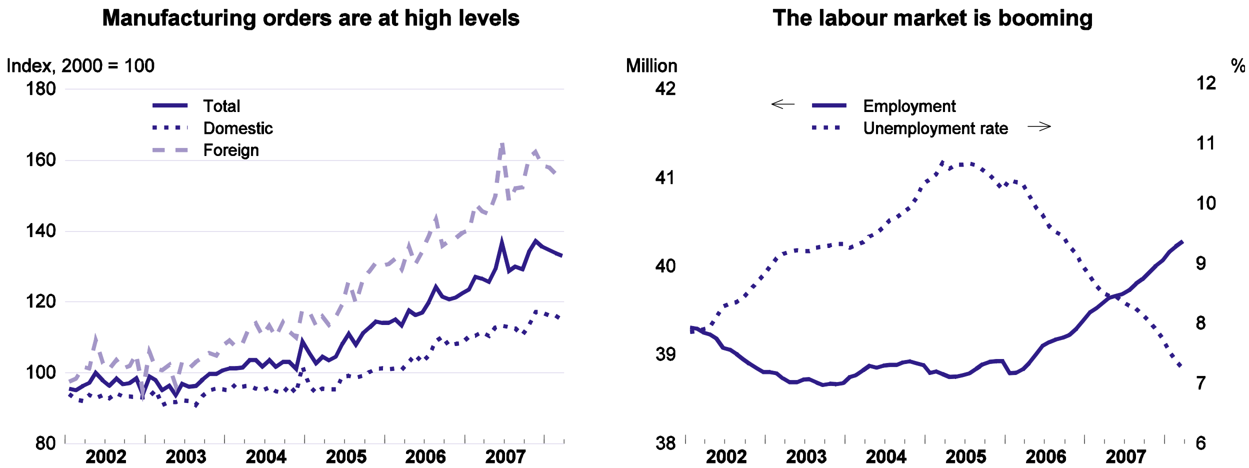
Following weaker activity at the end of 2007, growth picked up strongly at the beginning of the current year. So far, there is little evidence of significant adverse effects on the real economy coming from the financial turmoil, the strong euro or high commodity prices. However, growth is expected to ease over the remainder of this year, mostly on account of slower export growth, before returning to trend in the course of next year. Private consumption is projected to pick up, reflecting the significant growth in disposable income. As the labour market is getting tight, the period of wage moderation is coming to an end.

Fiscal policy will turn expansionary this year due to a decrease in corporate tax rates and a further lowering of social security contributions. Further easing should be avoided in view of capacity pressure and in order not to jeopardize past consolidation efforts. Instead, the relative resilience of the economy should be used to implement structural reforms, notably on the labour market, to enhance potential growth.

Growth picked up at the beginning of the year…

Economic growth picked up significantly at the beginning of the year following a slowdown in the fourth quarter. This primarily reflects investment spending which remained an engine of growth after having been boosted at the end of last year by the expiration of generous depreciation allowances. In particular fixed investment in machinery and equipment remained strong, as firms expanded production capacities. Non-residential construction has been buoyant in the first quarter, also reflecting mild weather conditions. Export growth is holding up well as a slowing of shipments to the United States is compensated by still strong demand from

Germany



Note: Employment is the domestic concept of the national accounts.

Source: Deutsche Bundesbank; German Federal Statistics Office.

European countries as well as by significant re-spending of oil revenues by oil exporting countries. Past gains in competitiveness and a product mix that is less price-sensitive have helped German exporters to deal with the exchange rate appreciation so far.

Germany: **Employment, income and inflation**

Percentage changes from previous period

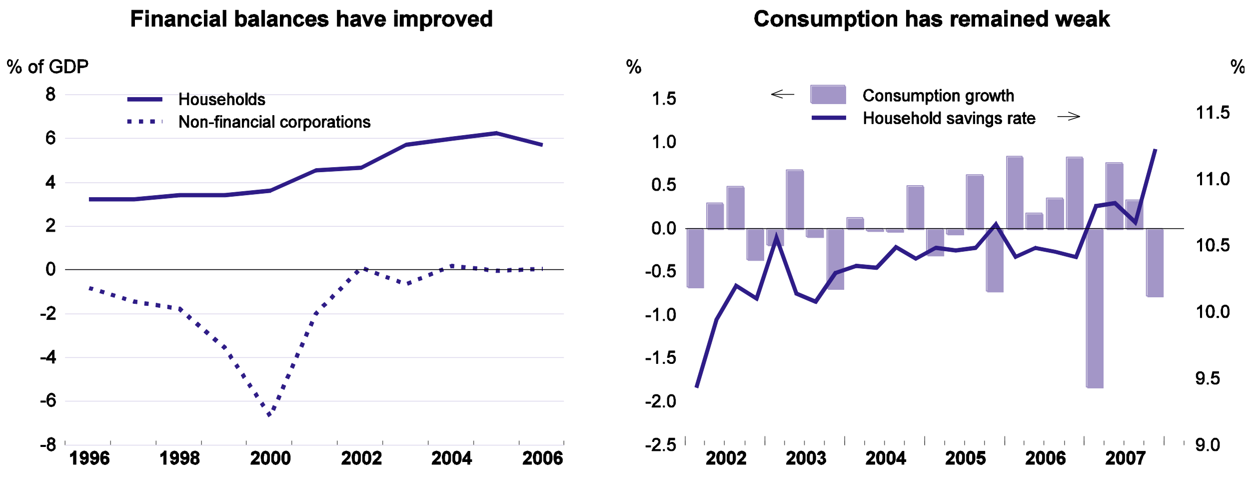
	2005	2006	2007	2008	2009
Employment	-0.1	0.6	1.7	1.1	0.2
Unemployment rate[1]	10.5	9.7	8.3	7.4	7.4
Compensation of employees	-0.6	1.7	2.7	3.5	3.0
Unit labour cost	-1.6	-1.4	0.1	1.5	1.9
Household disposable income	1.7	1.9	1.6	3.4	2.7
GDP deflator	0.7	0.6	1.8	2.1	1.8
Harmonised index of consumer prices	1.9	1.8	2.3	2.9	2.1
Core harmonised index of consumer prices[2]	0.6	0.7	1.9	1.6	2.0
Private consumption deflator	1.5	1.4	1.7	2.2	1.7

1. As a percentage of labour force, based on national accounts.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 83 database.

… but private consumption continues to lag

Private consumption continued to grow more slowly than in previous upswings. One explanatory factor has been the hike in the value-added tax rate which led to a strong decline in consumption at the beginning of 2007. However, the ensuing pick-up was weaker than could be expected given the favourable labour market developments. The increase in inflation on the back of higher food and energy prices is likely to have dented consumer spending towards the end of last year. However, households also increased their savings rate by almost one percentage point over the course of 2007 and, at over 11%, the rate is at its highest level since the mid-1990s.

Germany



Note: Financial balances are net lending(+)/net borrowing(-). Household sector includes non-profit institutions serving households. Private consumption growth is quarter-on-quarter.

Source: Deutsche Bundesbank (July 2007), Financial Accounts 1991 to 2006; OECD Economic Outlook 83 database.

Germany: **Financial indicators**

	2005	2006	2007	2008	2009
Household saving ratio[1]	10.5	10.5	10.9	10.9	10.6
General government financial balance[2]	-3.4	-1.6	0.0	-0.5	-0.2
Current account balance[2]	5.2	6.1	7.7	7.9	7.7
Short-term interest rate[3]	2.2	3.1	4.3	4.5	4.1
Long-term interest rate[4]	3.4	3.8	4.2	4.2	4.3

1. As a percentage of disposable income.
2. As a percentage of GDP.
3. 3-month interbank rate.
4. 10-year government bonds.

Source: OECD Economic Outlook 83 database.

Shocks will hit the economy with a lag

So far the economy has weathered fairly well the shocks emanating from the financial turmoil (tighter credit standards and higher costs of capital for most companies), high commodity prices and exchange rate appreciation. To some extent this reflects the solid aggregate profit situation of non-financial companies, leaving them less dependent on external financing, and allowing exporters to price their products to market to maintain market shares as the costs of such a policy are reflected in margin compression. In addition, some of the exchange rate exposure of

Germany: **Demand and output**

	2004	2005	2006	2007	2008	2009
	Current prices € billion	Percentage changes, volume (2000 prices)				
Private consumption	1 304.1	0.1	1.1	-0.5	0.9	1.7
Government consumption	415.6	0.5	0.9	2.1	1.6	1.8
Gross fixed investment	384.5	1.3	7.0	5.1	2.7	0.5
Public	31.6	-2.8	5.2	5.8	2.6	3.8
Residential	119.7	-3.8	5.4	0.5	-1.4	0.6
Non-residential	233.3	4.4	8.0	7.3	4.7	0.0
Final domestic demand	2 104.2	0.4	2.1	1.1	1.4	1.5
Stockbuilding[1]	- 10.7	0.1	-0.1	0.0	0.2	-0.1
Total domestic demand	2 093.5	0.5	2.1	1.1	1.7	1.4
Exports of goods and services	843.5	7.4	12.9	8.0	6.3	5.1
Imports of goods and services	733.5	6.9	11.5	5.0	6.5	6.6
Net exports[1]	110.0	0.5	1.1	1.6	0.4	-0.3
GDP at market prices	2 203.5	1.0	3.1	2.6	1.9	1.1
Memorandum items						
GDP without working day adjustments	2 211.3	0.8	2.9	2.5	2.3	1.0
Investment in machinery and equipmen	177.9	6.2	8.7	8.3	5.1	0.6
Construction investment	206.7	-3.0	5.4	2.2	0.4	0.4

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

Source: OECD Economic Outlook 83 database.

exporters has been hedged. In contrast to some other countries, Germany is also less exposed to a downturn in the global house price cycle as prices had not followed the previous global upswing. Notwithstanding the relative resilience of the economy, however, some of the adverse shocks are likely to affect the economy with a lag, notably through the external sector. A future slowdown in activity is also indicated by the decrease in business confidence over the past six months, which is driven by the expectations component. In addition, it is important to note that the business cycle is gradually entering a mature stage and some slowdown would have been expected even in absence of the shocks.

Germany: **External indicators**

	2005	2006	2007	2008	2009
			$ billion		
Goods and services exports	1 137.9	1 316.1	1 558.1	1 880	2 010
Goods and services imports	997.1	1 156.7	1 322.4	1 592	1 718
Foreign balance	140.8	159.4	235.7	288	292
Invisibles, net	4.2	19.0	20.0	19	18
Current account balance	145.0	178.5	255.7	307	310
			Percentage changes		
Goods and services export volumes	7.4	12.9	8.0	6.3	5.1
Goods and services import volumes	6.9	11.5	5.0	6.5	6.6
Export performance[1]	- 0.3	3.5	0.9	0.0	- 1.0
Terms of trade	- 1.3	- 1.5	0.7	0.4	0.5

1. Ratio between export volume and export market of total goods and services.
Source: OECD Economic Outlook 83 database.

Fiscal policy turns expansionary

Some support to counter the slowdown will come from tax relief in 2008. A further decrease in the unemployment insurance contribution rate by 0.9 percentage point at the beginning of the year and the significant lowering of corporate tax rates, which is only partly financed by base-broadening measures, will push the general government budget back into deficit. In addition to the revenue shortfalls due to the corporate tax reform, corporate tax receipts may suffer from lower profits, not least due to a worsening of the business situation in the financial sector. Besides lower tax receipts, the government budget will be adversely affected from the spending side. Public expenditure will increase significantly more than in past years as the restraining influence from spending on unemployment insurance benefits due to the labour market improvements is diminished while outlays are boosted by higher wages and employment in the public sector. In addition, a discretionary increase in pension payments will burden the budget.

Growth to slow down in the course of 2008

The expansion is expected to slow down in the remainder of this year, with the second quarter being particularly weak as extraordinary factors boosting first quarter activity unwind, before gradually returning towards trend growth rates during 2009. This temporary slowdown is projected to be driven mainly by weaker export growth due to lower demand from trading partners and lagged effects of the euro appreciation. Growth in business investment is projected to ease throughout the projection horizon, reflecting growth trends as well as the tightening of financial conditions. The slowdown in exports and investment may be countered partly by a pick-up in private consumption, not least because of an increase in household disposable income as wages are expected to increase significantly. With the labour market getting tight, the era of wage moderation in both the private and public sector is coming to an end. Despite the uncertainties with regard to the financial turmoil, the rapidly improving labour market situation should also reduce income uncertainty for households at least to some extent and as a consequence they may choose to lower their propensity to save, further supporting consumption. This would reverse some of the past increases in the savings rate which have to some extent been motivated by precautionary savings by households. The unemployment rate has already fallen below its estimated natural rate of around 8¼ per cent and the expected slowing of economic activity may limit further declines in unemployment. With a positive output gap, underlying price pressures will rise and core inflation is expected to increase to just above 2% over the projection horizon.

Lower consumption is the main risk

Overall, annual growth in 2008 is projected to be 1.9% (adjusted for the higher number of working days; without this adjustment the growth rate is 2.3%) and 1.1% (1.0% without adjustment for the number of working days) in 2009. These annual growth rates nevertheless conceal the underlying profile of the projection, which shows some pick-up in economic activity through 2009. The main risk to the projection remains consumption, which may not be as strong as envisaged. In addition, growth could be weaker if the financial turmoil turns out to be deeper and longer lasting than assumed or in case of a further pronounced appreciation of the euro, but in both cases the risk could also go in the opposite direction.

FRANCE

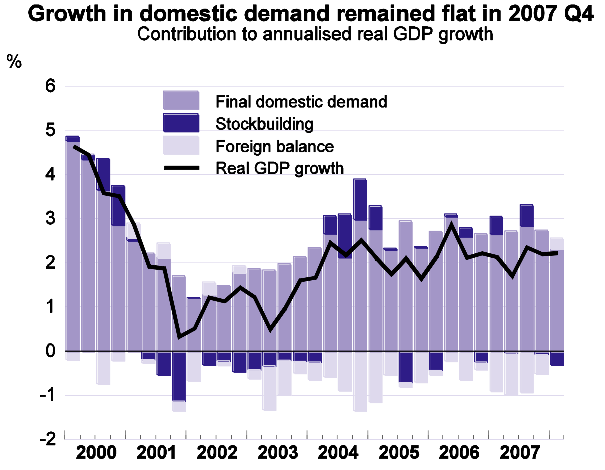
After picking up in the first quarter, activity is thought to be softening already in the second quarter and is projected to remain weak in the rest of 2008 and early 2009. The slowdown should help limit further increases in wages and prices, in the face of recent food and energy shocks. The shortfall in the general government financial balance may widen in 2008, before stabilising in 2009.

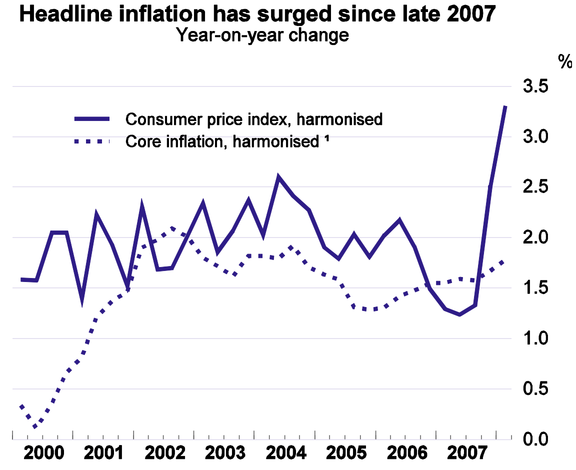
After stimulating demand in 2008 through tax cuts, fiscal policy is set to tighten in 2009. However, a significant and sustainable decline of the budget deficit will require far more substantial reductions in public spending than those announced to date. In the longer term, a vigorous pursuit of the structural reform agenda would also help in that regard.

Growth has softened but activity shows some resilience

After slowing in the fourth quarter of 2007, GDP grew by 2.6% in the first quarter of 2008 (annual rate), according to preliminary estimates. A strong pick-up in exports and, to a lesser extent, in business investment was partly offset by relatively weak household consumption and residential investment. Even though import volumes also grew vigorously, the contribution from net exports remained positive for a second consecutive quarter. The most recent additional information provides a mixed picture. On the one hand, manufacturing order books have been filling up and, following the significant fourth-quarter decline, stocks are still viewed as somewhat below normal. In addition, bank lending to enterprises

France





1. Harmonised inflation excluding energy, food, alcohol and tobacco.

Source: OECD Economic Outlook 83 database.

has thus far shown surprising resilience. On the other hand, recent indicators point to a deterioration in the business climate in manufacturing, which could foreshadow a slowdown in private investment later in the year.

France: **Employment, income and inflation**

Percentage changes from previous period

	2005	2006	2007	2008	2009
Employment	0.7	0.6	1.9	1.1	0.3
Unemployment rate[1]	8.9	8.8	7.9	7.5	7.6
Compensation of employees	3.7	4.2	4.3	3.6	3.7
Unit labour cost	1.7	1.8	2.2	1.8	2.2
Household disposable income	3.4	4.9	5.5	4.3	4.0
GDP deflator	2.0	2.5	2.5	2.7	2.4
Harmonised index of consumer prices	1.9	1.9	1.6	3.5	2.4
Core harmonised index of consumer prices[2]	1.5	1.5	1.6	2.1	2.3
Private consumption deflator	1.8	2.2	2.0	3.0	2.2

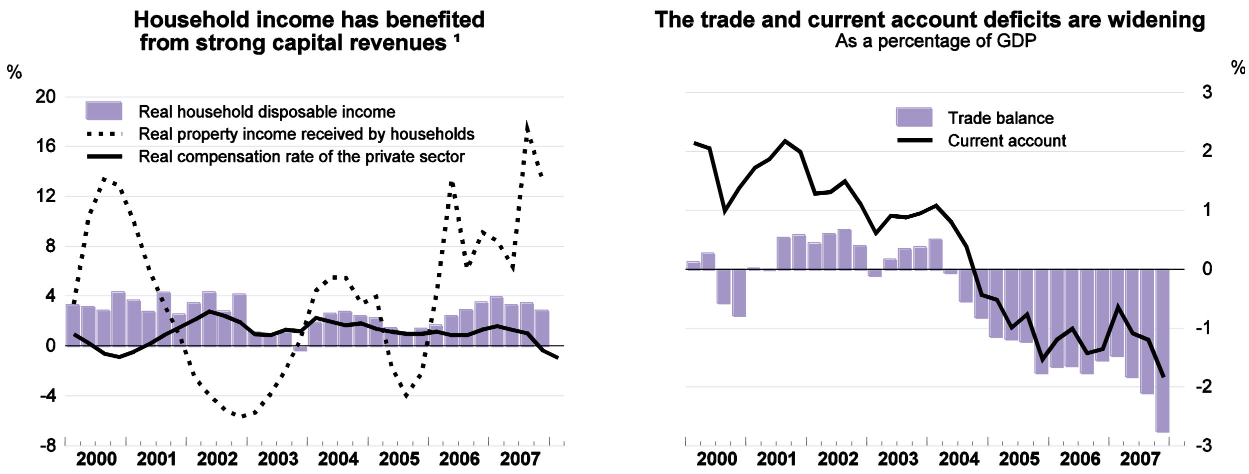
1. As a percentage of labour force.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.

Source: OECD Economic Outlook 83 database.

Unemployment may have bottomed out but wage pressures persist

Job creation was relatively strong throughout 2007, although it decelerated somewhat in the final quarter and in early 2008. As a result, the unemployment rate continued to decline, reaching 7.4% in the first quarter which may represent the bottom of the current cycle. Employment growth has been particularly high in service sectors. After slowing through most of 2007, nominal wages have picked up, driven mainly by the tightening

France



1. Year-on-year percentage change, private consumption price used as deflator.

Source: OECD Economic Outlook 83 database.

labour market and the sharp rise in food and energy prices, which led to a surge in headline inflation and an automatic increase in the minimum wage in May. With wages rising faster than productivity, higher unit labour costs may have in turn contributed to the upward pressures on core inflation. The recent upswing in export prices may indicate that the capacity of (non-commodity) exporting firms to absorb the impact of the euro appreciation in order to limit potential losses of foreign market shares may be reaching its limit. After deteriorating throughout 2007, the terms of trade improved slightly in the first quarter of 2008, which helped to limit the trend widening of the external trade and current account deficits.

France: **Financial indicators**

	2005	2006	2007	2008	2009
Household saving ratio[1]	11.8	11.9	12.7	12.3	12.3
General government financial balance[2]	-3.0	-2.4	-2.7	-3.0	-2.9
Current account balance[2]	-0.9	-1.2	-1.2	-1.8	-1.6
Short-term interest rate[3]	2.2	3.1	4.3	4.5	4.1
Long-term interest rate[4]	3.4	3.8	4.3	4.2	4.3

1. As a percentage of disposable income.
2. As a percentage of GDP.
3. 3-month interbank rate.
4. 10-year benchmark government bonds.

Source: OECD Economic Outlook 83 database.

Tighter financial conditions and higher inflation play key roles

Looking ahead, a number of factors will contribute to further weaken GDP growth, especially in the second half of 2008 and early 2009. *First*, even though financial market turbulence has not had a major impact so far on household and business credit, the expected tightening of bank lending conditions, the higher cost of financing on securities markets and the flattening of real estate prices should cause housing investment to stagnate and business investment to slow significantly later this year. *Second*, the euro appreciation, combined with the economic slowdown projected in major foreign markets will bear down on the external trade performance. *Third*, the surge in consumer price inflation will severely limit the gains in household real disposable income in 2008, in spite of the slight acceleration in nominal wages and the tax reductions introduced as part of the fiscal package voted in 2007. This will in turn curb private consumption, even if households are likely to cushion the shortfall in disposable income by partly reversing the earlier substantial increase in their saving rate.

A slowdown and then a delayed recovery in 2009 are in store

A decline in GDP growth is thus expected in 2008, which will ease excess demand pressures. While the trough in growth will most likely be reached in the middle of 2008, no significant pick-up is projected before the spring of 2009, after the international economic environment has begun to improve. With food and other commodity prices flattening, headline inflation should gradually ease during the remainder of 2008, France: **Demand and output**

	2004	2005	2006	2007	2008	2009
	Current prices € billion	Percentage changes, volume (2000 prices)				
Private consumption	939.4	2.5	2.5	2.5	1.6	1.7
Government consumption	393.5	1.3	1.4	1.4	1.0	0.7
Gross fixed investment	319.7	4.5	5.0	4.9	3.1	1.4
Public	51.5	7.0	-2.1	1.7	2.6	2.4
Residential	87.6	5.8	6.9	2.9	0.6	0.3
Non-residential	180.6	3.1	6.3	6.8	4.4	1.8
Final domestic demand	1 652.5	2.6	2.7	2.7	1.8	1.4
Stockbuilding[1]	4.8	0.0	-0.1	0.2	-0.3	0.0
Total domestic demand	1 657.3	2.6	2.6	2.9	1.5	1.4
Exports of goods and services	424.6	3.6	5.6	3.2	4.5	3.0
Imports of goods and services	424.1	6.0	6.5	5.9	3.4	2.7
Net exports[1]	0.4	-0.6	-0.3	-0.8	0.2	0.0
GDP at market prices	1 657.7	1.9	2.4	2.1	1.8	1.5

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

Source: OECD Economic Outlook 83 database.

stabilising thereafter at around 2%. Meanwhile, second-round effects from the food and energy shocks on wages and prices -- albeit moderate -- will push core inflation gradually higher until it converges with headline inflation in early 2009. Given the weakening of demand and rising wages, the pace of job creation is likely to decelerate further. Hence, unemployment is projected to edge up in the rest of 2008 and to remain largely unchanged in 2009. After acting as a slight drag on growth in the first half of 2008, the contribution of net exports will most likely be nearly neutral thereafter, with only a moderate rebound in foreign sales.

The budget deficit will rise again in 2008

The combination of tax cuts and lower cyclical revenues -- in particular from the corporate sector -- will cause the general government deficit to widen further in 2008 to 3% of GDP. The slow recovery in 2009 will again put pressures on the budget shortfall. These should be offset, however, by the announced measures to contain public spending, with little net change in the balance. Both revenues and expenditures may continue to decline as a ratio of GDP throughout the projection period. According to the Maastricht definition, debt is likely to rise to 67% of GDP by 2009.

Uncertainties are mainly related to developments abroad

The main risks to the projection remain focused on external developments. In particular, a longer-lasting downturn in the United States, accompanied by further dollar depreciation, could lead to more significant retrenchment of domestic consumption and investment. Also, the profile of

France: **External indicators**

	2005	2006	2007	2008	2009
	$ billion				
Goods and services exports	558.1	609.1	689.0	822	868
Goods and services imports	576.1	636.9	738.9	883	924
Foreign balance	- 18.0	- 27.8	- 50.0	- 61	- 56
Invisibles, net	- 1.9	- 0.3	19.0	5	7
Current account balance	- 19.9	- 28.0	- 31.0	- 56	- 49
	Percentage changes				
Goods and services export volumes	3.6	5.6	3.2	4.5	3.0
Goods and services import volumes	6.0	6.5	5.9	3.4	2.7
Export performance[1]	- 4.0	- 3.4	- 3.1	- 1.9	- 3.1
Terms of trade	- 1.0	- 0.5	0.1	- 1.3	0.6

1. Ratio between export volume and export market of total goods and services.
Source: OECD Economic Outlook 83 database.

inflation over the projection period is based on a stabilisation of oil and food prices over the coming quarters, whereas they could continue to rise. In both cases, however, the outcome could also turn out to be more favourable than projected, with positive spill-over effects on French activity. On the domestic side, a flattening of house prices is having only a limited impact on consumption via the wealth channel. Nonetheless, a large decline in such prices could have more significant effects on private consumption and housing investment.

ITALY

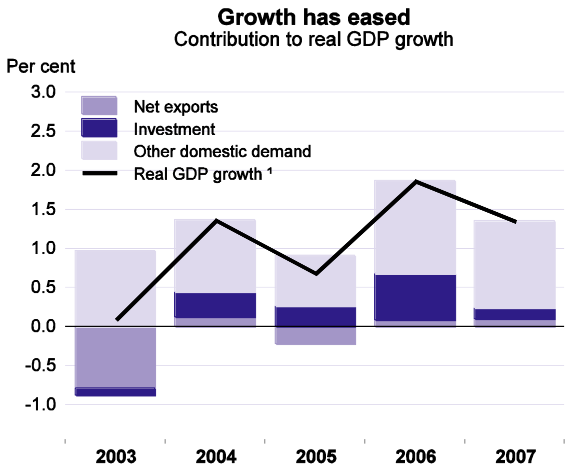
Economic activity seems to have stalled since the first half of 2007. The weakening external environment and knock-on effects from tighter credit conditions will constrain growth to below its potential rate of around 1¼ per cent this year, while unemployment may rise again. The recent surge in consumer price inflation should fade towards the end of 2008.

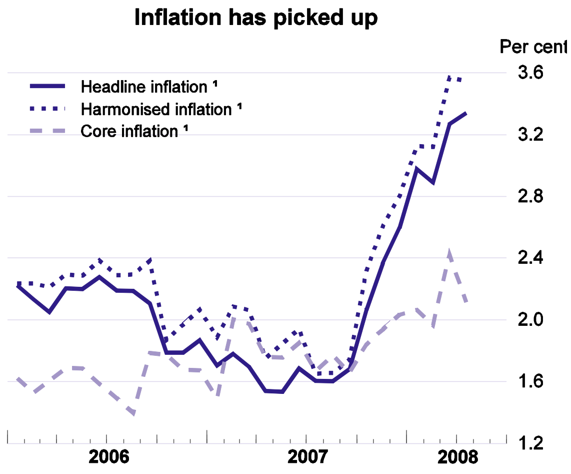
The fiscal improvement continued in 2007, thanks mainly to measures on the revenue side. As activity slows, the government should keep control of expenditure and beware of doing anything more than allowing automatic stabilisers to work: public debt is so high that additional relaxation is unlikely to have a sustained positive effect on demand. Further delays to full implementation of the pension reform should be avoided and medium-term plans to reduce the deficit and debt must be maintained, not least because of the increases in age-related spending to come.

Stagnant activity for much of 2007

For 2007 as a whole, the economy grew by 1½ per cent, but performance has been poor since spring 2007. GDP barely grew up to the third quarter and fell in the fourth quarter, partly as a result of transportation strikes in December. The unwinding of these effects accounts for part of the rebound in the first quarter of 2008. The purchasing managers index (PMI) in the manufacturing sector fell in March and April, indicating sluggish activity. The business confidence index also fell in

Italy





1. Year-on-year percentage change.

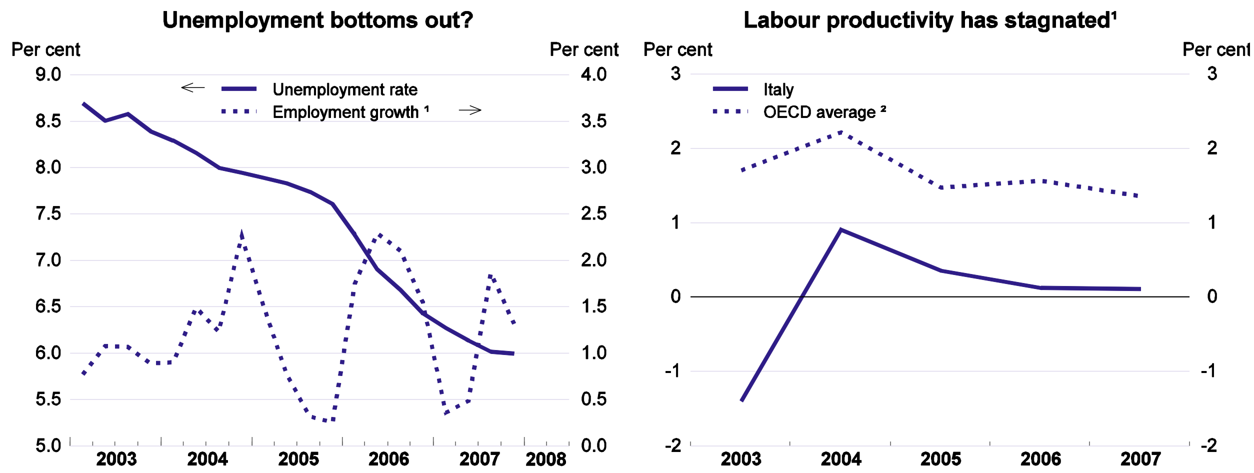
Source: OECD, Economic Outlook 83 database.

March and April and, in the services sector, indicators of activity and forward-looking expectations give little hope for an early return to any substantial growth.

Limited direct effects of financial turmoil

Interest rate spreads widened in Italy as elsewhere, under the influence of the turmoil in financial markets, and indicators suggest that credit is more difficult to obtain for firms, though conditions for households may have eased. The stagnation in real activity last year seems to have occurred independently of this turmoil, though its consequences nevertheless depress prospects for resumed growth. Despite reported credit tightening, domestic bank lending to companies continued to grow at about 12% through to February 2008, much as it did through 2007, though lending to households has slowed. According to the Bank of Italy, Italian banks have been able to access funds available in the Eurosystem refinancing facility on relatively favourable terms. Household indebtedness, although it has increased rapidly, is much lower than in many countries where the housing boom has been stronger and where "subprime" loans have financed a larger share of the expansion. Consumption growth over the past two years has nevertheless been at the expense of a decline in the household saving rate, which is now expected to broadly stabilise.

Italy



1. Year-on-year percentage change.

2. Weighted by 2000 GDP at purchasing power parity exchange rates.

Source: OECD, Economic Outlook 83 database.

The labour market is softening

Unemployment has fallen fairly consistently since 2002, but late 2007 saw a pause, as unemployment reached 6% in the third quarter and stayed there in the next. The level of employment grew by slightly over 1% in the past year, which implied a slight acceleration of productivity compared to the previous year. The weakening of activity in the first half of 2008 is likely to have exerted a negative effect on job creation and may have pushed up the number of job seekers.

Italy: Employment, income and inflation

Percentage changes from previous period

	2005	2006	2007	2008	2009
Employment[1]	0.3	1.7	1.2	0.4	0.4
Unemployment rate[2]	7.8	6.8	6.1	6.2	6.5
Compensation of employees	4.6	4.6	3.4	5.0	3.2
Unit labour cost	3.9	2.7	2.0	4.5	2.3
Household disposable income	2.4	2.8	2.1	4.4	3.2
GDP deflator	2.1	1.8	2.3	2.3	2.4
Harmonised index of consumer prices	2.2	2.2	2.0	3.6	2.1
Core harmonised index of consumer prices[3]	1.9	1.6	1.8	2.4	2.0
Private consumption deflator	2.2	2.7	2.2	3.5	2.0

1. Data for whole economy employment are from the national accounts. These data include an estimate made by Istat for employment in the underground economy. Total employment according to the national accounts is approximately 2 million, about 10%, higher than employment according to the labour force survey. Following national practice, the unemployment rate is calculated relative to labour force survey data.
2. As a percentage of labour force.
3. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.

Source: OECD Economic Outlook 83 database.

Price inflation has picked up

Low productivity growth for several years has meant that even relatively low wage increases have not prevented unit labour costs from rising. Nevertheless, inflation remained moderate, benefitting from sluggish import prices, and perhaps also from some deregulation in the retail sector, until late 2007. Since October food and energy prices have caused the annual headline rate of inflation to climb quite steeply, in common with other European countries, reaching 3.6% on a harmonised definition in April. Core inflation has increased by less, though still rising quite noticeably.

Italy: Financial indicators

	2005	2006	2007	2008	2009
Household saving ratio[1]	10.0	8.7	6.8	6.8	6.8
General government financial balance[2,3,4]	-4.4	-3.4	-1.9	-2.5	-2.7
Current account balance[2]	-1.7	-2.7	-2.6	-2.4	-2.6
Short-term interest rate[5]	2.2	3.1	4.3	4.5	4.1
Long-term interest rate[6]	3.6	4.0	4.5	4.5	4.6

1. As a percentage of disposable income.
2. As a percentage of GDP.
3. The 2006 general government financial balance was revised from -4.4% to -3.4% of GDP following a decision by Eurostat to record VAT reimbursements on company cars in the years when the claims are validated, rather than in 2006 as originally planned.
4. In 2006 includes certain one-off revenues and a railways debt forgiveness operation amounting to 0.9% of GDP. Excluding these extraordinary items, the general government financial balance in 2006 was - 3.0% of GDP.
5. 3-month interbank rate.
6. 10-year government bonds.

Source: OECD Economic Outlook 83 database.

The budget deficit has improved significantly…

Relatively low expenditure growth, coupled with a significant increase in the ratio of tax revenue to GDP, produced another improvement in the budget deficit in 2007. The revenue improvement in 2007 was due in part to ongoing measures to reduce tax evasion, but also to a change in arrangements for contributions to the severance pay scheme, TFR, worth about 0.4% of GDP on current revenue but adding to future liabilities. Looking through annual changes, there has been a significant reduction in the structural deficit over the past two years.

Italy: **Demand and output**

	2004	2005	2006	2007	2008	2009
	Current prices € billion	Percentage changes, volume (2000 prices)				
Private consumption[1]	815.2	0.9	1.1	1.5	0.7	1.2
Government consumption	276.2	1.9	0.9	1.3	1.0	1.0
Gross fixed investment	284.5	1.3	2.8	0.7	0.5	0.4
Machinery and equipment	152.1	1.7	3.9	-0.5	0.4	0.8
Construction	132.4	0.8	1.7	2.0	0.7	-0.1
Residential	55.3	5.5	4.1	3.1	-0.7	-0.9
Non-residential	77.1	-2.6	-0.3	1.2	1.9	0.6
Final domestic demand	1 375.9	1.2	1.4	1.2	0.7	1.0
Stockbuilding[2]	2.8	-0.3	0.4	0.0	-0.2	0.1
Total domestic demand	1 378.6	0.9	1.8	1.2	0.5	1.0
Exports of goods and services	351.7	1.8	6.5	4.5	1.8	3.1
Imports of goods and services	341.4	2.7	6.1	4.0	2.0	3.5
Net exports[2]	10.3	-0.2	0.1	0.1	-0.1	-0.1
GDP at market prices	1 388.9	0.7	1.9	1.4	0.5	0.9

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Final consumption in the domestic market by households.
2. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

Source: OECD Economic Outlook 83 database.

… but will widen in 2008

The fiscal position is expected to deteriorate in 2008 reflecting slower growth, as well as the effects of deficit-increasing measures in the budget. This includes the cuts in property tax and the regional tax on productive activities (IRAP). On the expenditure side, social transfers and public investments are expected to increase. The reductions in taxation that were part of the supplementary budget may be regretted if recent improvements in tax collection and the consequent widening of the tax base are not sustained. Overall, there is no further improvement in the structural primary budget surplus expected to occur over the two years of the projection. Despite the somewhat higher nominal public deficit, the reduction in Italy's considerable debt-to-GDP ratio should continue, but at a slower pace.

2008 will see morose growth but there is hope for a pick-up in 2009

With rather pessimistic forward-looking indicators, and the expectation that the effects of the financial market turmoil will spread further to countries not directly affected, prospects are for continued slow growth this year. Growth in construction and investment will remain low this year as activity slows from the peak reached in 2007, and the household saving rate is likely to be broadly unchanged in today's uncertain conditions. However, inflation is expected to decline and export markets will still grow at a reasonable rate, if more slowly than in 2006-07, so a turn in the investment cycle should start to bring growth back towards potential during 2009. Renewal of certain longer-term contracts will push up public sector wage growth this year, though this influence should then fade in 2009. Inflation, after some further impulse to come from energy prices in the next few months, is expected to decline from autumn 2008 onwards.

Italy: **External indicators**

	2005	2006	2007	2008	2009
			$ billion		
Goods and services exports	459.3	516.8	610.7	719	765
Goods and services imports	462.3	534.2	620.2	729	771
Foreign balance	- 3.0	- 17.4	- 9.5	- 10	- 7
Invisibles, net	- 27.3	- 32.5	- 44.7	- 49	- 59
Current account balance	- 30.3	- 50.0	- 54.1	- 60	- 66
			Percentage changes		
Goods and services export volumes	1.8	6.5	4.5	1.8	3.1
Goods and services import volumes	2.7	6.1	4.0	2.0	3.5
Export performance[1]	- 6.1	- 3.3	- 3.0	- 5.2	- 3.6
Terms of trade	- 2.0	- 2.9	1.3	0.3	0.9

1. Ratio between export volume and export market of total goods and services.
Source: OECD Economic Outlook 83 database.

Risks to growth are symmetric

These projections incorporate an ongoing but indirect impact from financial market developments; although there may still be unpleasant surprises in store, the likelihood that Italy is vulnerable to domestic financial risk seems less than it did a few months ago. Growth could turn out to be lower than projected here, but a stronger pickup in 2009, perhaps as investment recovers faster, is also possible.

UNITED KINGDOM

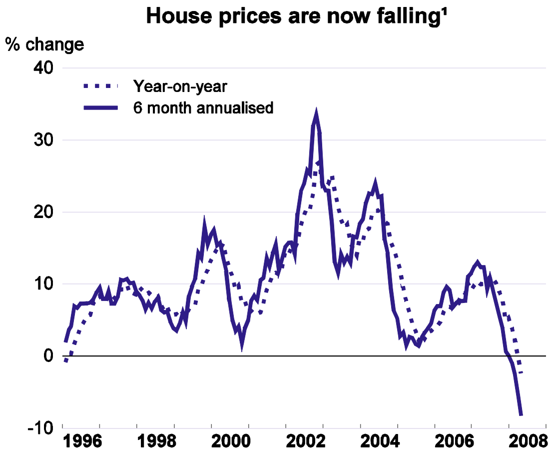
GDP growth slowed gradually from an above-trend pace throughout 2007 to an annualised rate of 1.5% in the first quarter of 2008. A further slowing is expected over coming quarters, as both investment and consumer demand are damped by tight credit conditions and housing market weakness. Consumer price inflation has accelerated in recent months and is expected to rise further to above 3½ per cent later this year before falling back to close to the inflation target during 2009.

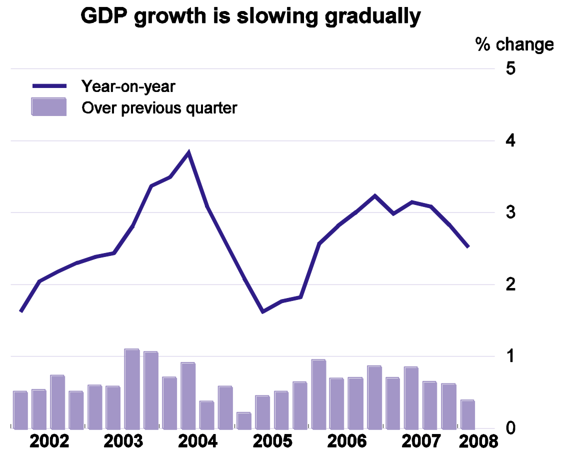
Given the extent to which inflation is expected to exceed the target, the Bank of England should leave policy interest rates on hold in the short term, in order to ensure that high inflation expectations do not become embedded. However, some further easing in policy rates is likely to be required further ahead, to avoid a significant undershooting of the target in the medium term as the economy slows. The slowing economy is also likely to limit tax revenues, and the government deficit now seems likely to move significantly above 3% of GDP, putting the fiscal rules at risk. Potential growth should be boosted by improving planning regulations and reconsidering the green-belt boundaries in fast-growing areas, as recommended by the Barker review.

Economic growth is slowing

Given the deterioration in financial sector health and considerable weakness in survey indicators, many real economy indicators were surprisingly resilient over the first few months of 2008. For example, both private consumption expenditure and employment growth were strong, with unemployment falling to 5.2%, its lowest level in many years. In addition, public spending and net exports have continued to underpin demand. As a result, GDP growth has slowed only moderately to date, from an

United Kingdom





1. Average of the Halifax and Nationwide house price indices.

Source: OECD Economic Outlook 83 database, Nationwide and HBOS plc.

United Kingdom: **Employment, income and inflation**

Percentage changes from previous period

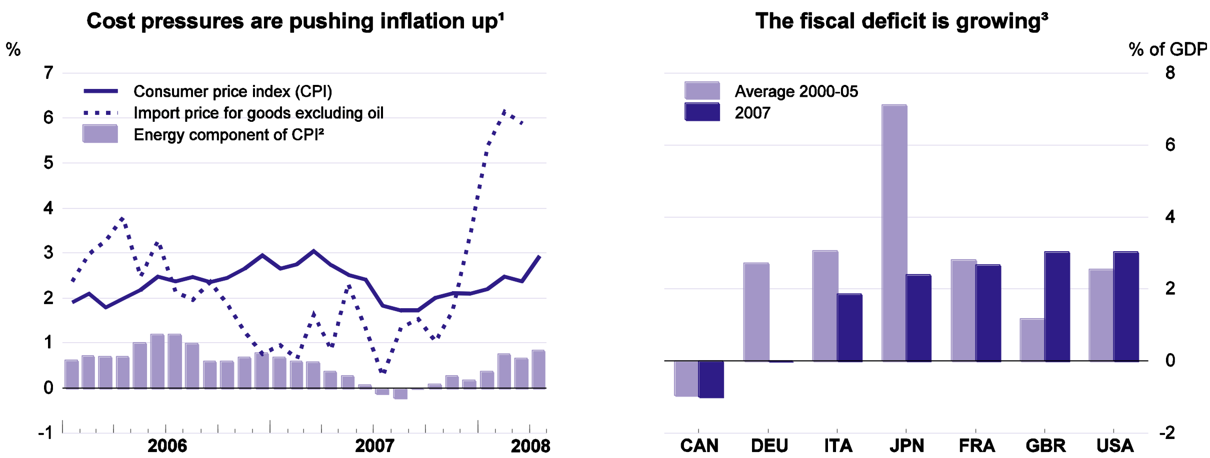
	2005	2006	2007	2008	2009
Employment	1.0	0.9	0.7	0.8	0.1
Unemployment rate[1]	4.8	5.5	5.4	5.5	5.8
Compensation of employees	5.8	5.3	4.3	4.7	3.5
Unit labour cost	3.9	2.3	1.3	2.9	2.1
Household disposable income	5.5	3.3	3.8	5.1	3.0
GDP deflator	2.3	2.7	3.1	2.6	2.3
Harmonised index of consumer prices[2]	2.0	2.3	2.3	3.0	2.5
Core harmonised index of consumer prices[3]	1.4	1.3	1.6	1.7	2.2
Private consumption deflator	2.5	2.4	2.6	3.2	2.9

1. As a percentage of labour force.
2. The HICP is known as the Consumer Price Index in the United Kingdom.
3. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.

Source: OECD Economic Outlook 83 database.

above-trend rate in early 2007 to an annualised rate of 1.5% in the first quarter of 2008. At the same time, housing market activity has continued to weaken, with house price inflation moving into negative territory. Forward-looking housing-sector indicators continue to show significant weakness, and these projections assume that nominal house prices will fall by around 10% by the end of 2009. Meanwhile, bank lending conditions have tightened significantly, especially for the most risky borrowers, and are expected to remain tight, even after the Bank of England's recent steps to improve liquidity conditions of money markets by permitting banks and building societies to temporarily swap their higher quality mortgage-backed and other securities for UK Treasury Bills.

United Kingdom



1. Year-on-year percentage change.
2. Difference between the growth of total CPI and CPI excluding energy.
3. Government net lending in per cent of GDP.

Source:OECD Economic Outlook 83 database and National Statistics.

But consumer price inflation is accelerating

After dropping back from an early 2007 spike to around the target of 2%, consumer price inflation re-accelerated to 3% in April, boosted by high energy and food prices. Meanwhile, inflation expectations are at levels that are high by the standards of the past decade, creating concern for the monetary authority, especially considering the near-term outlook for even higher inflation. The risks to this outlook are exacerbated by the 10% fall in the effective exchange rate since mid-2007 and very tight profit margins in the retail sector; retailers may be forced to pass on rising input costs to consumers, despite weakening demand. On the other hand, wage inflation has remained moderate, despite strong employment growth.

Policy interest rates should be gradually cut

In response to tightening credit conditions and indicators suggesting a slowing in output growth, the Bank of England cut the policy rate by 25 basis points in December, January and April, taking the rate to 5.0%. Despite this, some mortgage rates on new lending have been raised, particularly for the riskiest borrowers, while the supply of some of the riskier lending products has disappeared. On the other hand, the significant depreciation of the pound is providing a short-run stimulus to demand and inflation. The Bank now faces an important challenge in getting the balance right between preventing a significant undershoot of the inflation target in the medium term, without risking a further drift up in inflation expectations as inflation continues to rise in the near term. All things considered, the Bank should delay further easing of policy rates until the risks of provoking additional inflationary pressures have receded and excess capacity in the economy has begun to emerge. These projections have factored in three further 25 basis point cuts in the policy rate in the first half of 2009.

United Kingdom: **Financial indicators**

	2005	2006	2007	2008	2009
Household saving ratio[1]	5.6	4.8	2.9	2.5	2.5
General government financial balance[2]	-3.5	-2.8	-3.0	-3.8	-3.7
Current account balance[2]	-2.5	-3.9	-4.2	-3.3	-3.1
Short-term interest rate[3]	4.7	4.8	6.0	5.6	4.4
Long-term interest rate[4]	4.4	4.5	5.0	4.7	4.8

1. As a percentage of disposable income.
2. As a percentage of GDP.
3. 3-month interbank rate.
4. 10-year government bonds.

Source: OECD Economic Outlook 83 database.

The fiscal rules are at risk

The contractionary fiscal stance for 2008 that the government projected in the Pre-Budget Report was postponed in the Budget in response to the weaker economic outlook. These projections assume that nominal current spending evolves roughly in line with the government's budget projections over 2008 and 2009, with adjustments for the OECD's weaker growth projections. Th e more marked slowdown in GDP growth relative to the Treasury projections also implies a more substantial slowing in corporate and personal income tax revenues. Finally, these projections also take into account the government's recently announced fiscal stimulus for the 2008/09 tax year, which takes the form of a temporary tax cut for those on lower incomes. Combining these factors, the deficit is projected to expand to over 3½ per cent of GDP. These figures suggest that the sustainable investment rule could be breached in 2009, as the measure of net debt monitored by the government rises towards the 40% ceiling (excluding the additional Northern Rock-related liabilities). The ongoing cycle dating uncertainty makes it more difficult to evaluate progress on the golden rule, which states that over the cycle the government will borrow only to invest and not to fund current spending. The government has tentatively stated that the economic cycle that started in 1997 may have ended towards the end of 2006 (over which period the golden rule was met). However, it is clear that much tighter fiscal policy will be required in the future if the rule is still to be respected. While ongoing economic weakness in 2009 would argue against fiscal restraint, the government's options have been limited by excessively loose fiscal policy in past years when economic growth was strong.

United Kingdom: **Demand and output**

	2004	2005	2006	2007	2008	2009
	Current prices £ billion	Percentage changes, volume (2003 prices)				
Private consumption	761.5	1.5	2.0	3.1	1.9	0.6
Government consumption	250.7	2.7	1.7	1.9	2.3	2.2
Gross fixed investment	202.3	1.5	7.6	6.2	0.5	0.9
Public[1]	21.0	-68.4	271.3	4.2	6.5	3.7
Residential	61.7	-3.9	8.5	3.3	-4.0	-0.2
Non-residential	119.6	15.7	-4.6	7.9	1.4	0.9
Final domestic demand	1 214.5	1.8	2.9	3.4	1.7	1.0
Stockbuilding[2]	4.8	-0.1	0.0	0.4	-0.2	0.0
Total domestic demand	1 219.3	1.6	2.8	3.7	1.5	1.0
Exports of goods and services	298.7	8.2	10.7	-5.3	1.8	4.6
Imports of goods and services	333.7	7.1	9.8	-2.9	0.7	2.8
Net exports[2]	- 35.0	0.0	0.0	-0.6	0.3	0.4
GDP at market prices	1 184.3	1.8	2.9	3.0	1.8	1.4

1. Including nationalised industries and public corporations.
2. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

Source: OECD Economic Outlook 83 database.

A significant downswing in growth is expected

Looking forward, much tighter credit conditions and moderately falling house prices are expected to lead to a dissipation of the house value collateral and wealth effects, and a significant slowing in consumption growth and residential investment. Business investment is also likely to slow, due to less readily available credit, increased uncertainty and weaker domestic demand. However, overall output is expected to be supported by public spending and a small contribution from net exports. GDP growth is projected to slow to a trough of around 1%, on an annualised quarterly basis, later this year before rebounding through 2009, and the unemployment rate is projected to rise to 5.8%. Inflation is expected to accelerate further over the next few months, boosted by higher prices of food, oil, and imported goods. However, weakening domestic demand should have a damping impact on profit margins and keep wage increases at a moderate level. Overall, consumer price inflation is likely to rise to above 3½ per cent on a 12-month basis later this year, but should move back towards the 2% target during 2009. The Governor of the Bank of England has already indicated that he is likely to be required to write a number of open letters to the Chancellor explaining why inflation has deviated by more than 1 percentage point from the target.

United Kingdom: **External indicators**

	2005	2006	2007	2008	2009
			$ billion		
Goods and services exports	593.8	682.2	719.4	767	813
Goods and services imports	674.0	767.9	818.0	872	921
Foreign balance	- 80.2	- 85.7	- 98.6	- 105	- 108
Invisibles, net	24.4	- 8.0	- 16.8	13	18
Current account balance	- 55.8	- 93.7	- 115.4	- 92	- 90
			Percentage changes		
Goods and services export volumes	8.2	10.7	- 5.3	1.8	4.6
Goods and services import volumes	7.1	9.8	- 2.9	0.7	2.8
Export performance[1]	0.2	2.0	- 11.3	- 3.9	- 1.0
Terms of trade	- 2.5	0.0	1.4	- 1.0	- 1.4

1. Ratio between export volume and export market of total goods and services.
Source: OECD Economic Outlook 83 database.

But there are downside risks to growth and upside risks to inflation

GDP growth is weakening while inflation rises, and there is a risk that they drift even further apart than projected. For example, GDP growth could slow more markedly if financial sector health continues to deteriorate or if the housing market falls into a more significant slump, while high inflation expectations pose upside risks to inflation.

CANADA

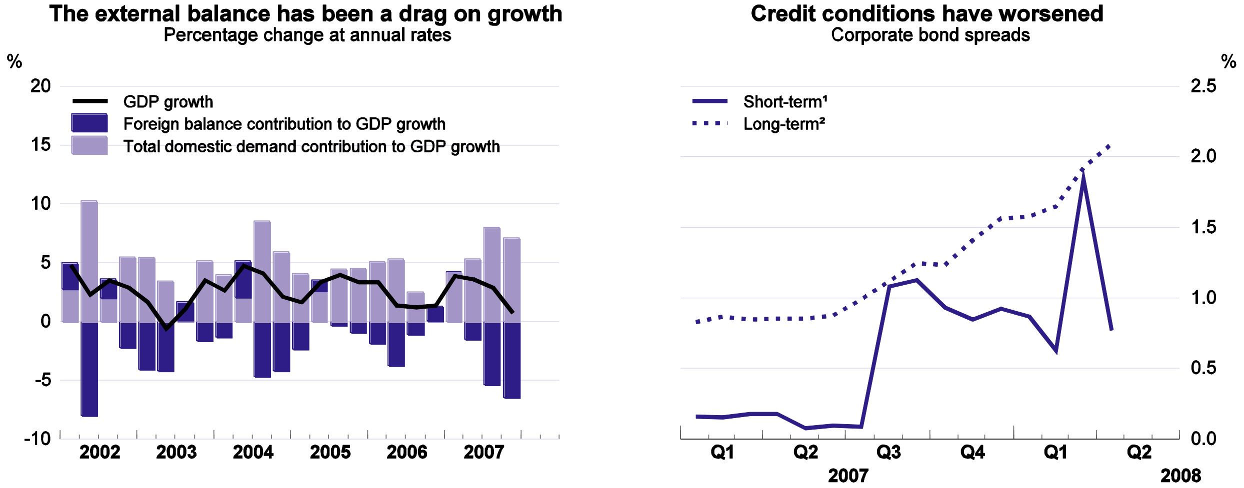
Economic growth decelerated sharply late in 2007 mainly because of faltering exports and manufacturing output. Growth is projected to remain weak until spring 2009 as US demand stagnates, but no recession is expected. The current account may dip deeper into deficit, and the general government fiscal balance may show a small deficit as well, as both tax cuts and the business cycle eat into government revenues. Economic growth is expected to bounce back in 2009 when credit market difficulties are worked out and the US economy recovers.

The monetary policy easing that started in late 2007 needs to continue in order to offset the likely protracted slowdown in the US economy, the impact of the currency appreciation as well as the consequences of financial-sector stresses on the real economy. Meanwhile, governments will need to hold the line on spending to keep their budgets close to balance.

Canada has entered the slowdown from a strong position

Canada has entered the current period of weakening global growth from an enviable position. *First*, both employment and final domestic demand were buoyant in 2007, helping to offset a substantial drag from net exports, and they have remained fairly strong thus far in 2008. Strong income growth has been related primarily to a surge in Canada's terms of trade, led by sharply higher commodity prices. *Second*, the housing sector is in relatively good shape and mortgage delinquencies remain low. With

Canada



1. Yield on three-month prime corporate paper minus yield on three-month treasury bill.

2. Merrill Lynch composite yield for 10-15 year corporate bonds minus yield on 10-year government bond.

Source: Statistics Canada; Bank of Canada; Thomson Financial; OECD, Main Economic Indicators database; and OECD Economic Outlook 83 database.

no large bubble in residential construction and prices, the correction ahead should be relatively mild. *Third*, there are no imbalances to unwind. The current account surplus was 0.9% of GDP in 2007, and the general government was still in moderate surplus as well. And, *fourth*, despite not having been completely immune to the global credit contraction that started in mid-2007, Canadian banks are well capitalised, and asset write downs related to US mortgages have been relatively modest.

Canada: **Employment, income and inflation**

Percentage changes from previous period

	2005	2006	2007	2008	2009
Employment	1.4	1.9	2.3	1.6	0.8
Unemployment rate[1]	6.8	6.3	6.0	6.1	6.3
Compensation of employees	6.0	6.2	6.1	5.5	4.3
Unit labour cost	2.8	3.4	3.3	4.3	2.3
Household disposable income	4.3	6.4	5.6	4.9	4.3
GDP deflator	3.4	2.4	3.1	2.8	1.5
Consumer price index	2.2	2.0	2.1	1.3	1.3
Core consumer price index[2]	1.6	1.9	2.1	1.2	1.2
Private consumption deflator	1.7	1.4	1.5	1.1	1.1

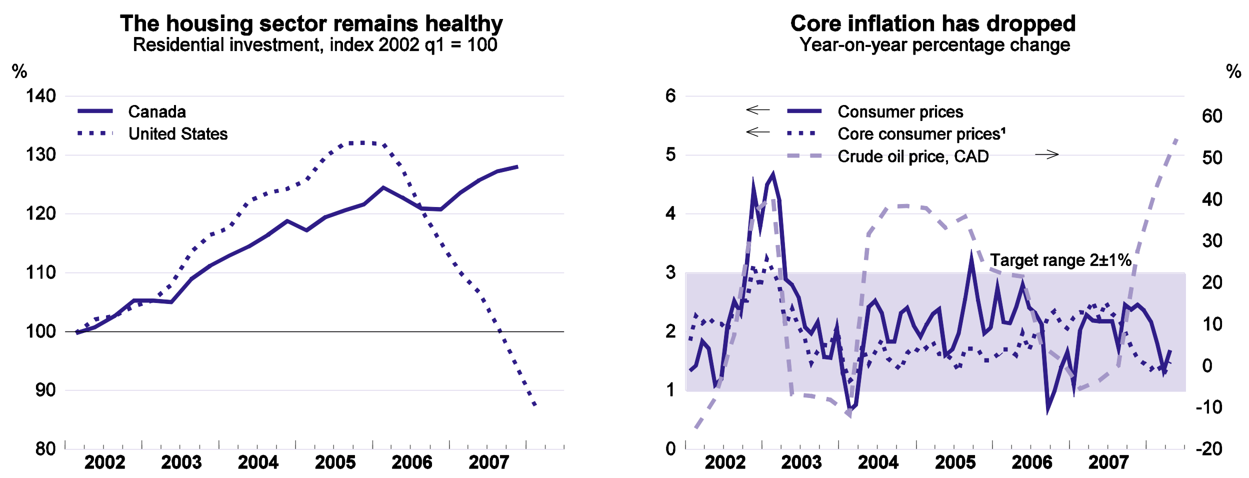
1. As a percentage of labour force.
2. Consumer price index excluding the eight more volatile items.

Source: OECD Economic Outlook 83 database.

The slowdown began through exports

Despite its robust starting position, Canada's economy is not sheltered from the global economic slowdown originating from the deflating US housing-market bubble and the associated global credit market contraction. Economic expansion almost stopped in the final quarter

Canada



1. Bank of Canada definition.

Source: Statistics Canada; OECD, Main Economic Indicators database and OECD Economic Outlook 83 database.

of 2007, led by an abrupt drop in exports, and monthly GDP and other indicators point to a similar outcome in the first quarter of this year. The external balance had already been putting a damper on output growth for some time, as a rising exchange rate curbed exports and boosted imports. Export weakness looks set to persist, as growth slows to a crawl in the United States. For their part, imports continue to be encouraged by the pass-through of the appreciation -- the Canadian dollar having now stabilised around parity with its US counterpart -- into import and ultimately consumer prices. As a result, these projections show a small current account deficit in 2008 that widens in 2009.

Domestic demand and employment will probably follow

The latest three-month growth rate of overall employment remains 2% on an annualised basis, still much stronger than the pace of real GDP growth, and labour productivity has been falling. Wage growth has also remained high, showing a 4.3% year-over-year gain in April 2008. Both employment and wages are lagging indicators, however, and their growth is expected to slow later in 2008. The unemployment rate, which inched up from its recent 33-year low of 5.8%, is expected to continue edging up over the next few quarters, reaching 6.4% by mid-2009.

Canada: **Financial indicators**

	2005	2006	2007	2008	2009
Household saving ratio[1]	1.6	2.3	1.5	1.0	1.1
General government financial balance[2]	1.6	1.0	1.0	-0.2	-0.5
Current account balance[2]	2.0	1.6	0.9	-0.2	-0.8
Short-term interest rate[3]	2.8	4.2	4.6	2.9	2.9
Long-term interest rate[4]	4.1	4.2	4.3	3.8	4.2

1. As a percentage of disposable income.
2. As a percentage of GDP.
3. 3-month deposit rate.
4. 10-year government bonds.

Source: OECD Economic Outlook 83 database.

Domestic demand is projected to decelerate. Recent survey evidence points to falling consumer and business confidence. Falling job creation and high mortgage spreads should drag down growth in residential construction, and consumer expenditures, resilient so far, should also soften. Business investment will likewise suffer from the higher cost of capital as well as from weaker export prospects.

The Bank of Canada has room to manoeuvre

Inflation pressures related to capacity constraints, which as recently as July 2007 forced the Bank of Canada to increase its official rate, have now largely abated. Headline and core inflation, which were both running at over 2% year-over-year through much of 2007, have fallen to 1.7% and 1.5% in April, respectively. A cooling economy and the continued pass-through of the currency appreciation should help maintain a benign inflation environment, leaving the Bank with room to cushion the economic slowdown. It has already shifted to an easing stance, cutting its target for the overnight rate by 150 basis points since December 2007. Further easing of monetary policy will be required to give a needed boost to the economy in 2009 and at the same time avoid putting additional upward pressure on the currency. More expansionary monetary policy should also help ease the strains in corporate bond markets, where spreads over government bonds have recently surged again. Because monetary policy is forward-looking and the length of the economic downturn is uncertain, it will be tricky for the Bank to decide exactly when to start raising the target rate again, but it is expected to have to do so in the first half of 2009.

Canada: **Demand and output**

	2004	2005	2006	2007	2008	2009
	Current prices CAD billion	Percentage changes, volume (2002 prices)				
Private consumption	720.4	3.8	4.2	4.7	4.3	3.0
Government consumption	248.9	2.2	3.3	3.6	3.4	2.3
Gross fixed investment	261.5	8.5	7.2	4.1	2.8	1.8
Public[1]	31.7	11.0	8.2	4.5	4.5	2.4
Residential	83.3	3.5	2.1	3.2	1.8	0.7
Non-residential	146.5	10.8	9.9	4.4	2.9	2.3
Final domestic demand	1 230.8	4.5	4.7	4.3	3.8	2.6
Stockbuilding[2]	5.4	0.4	-0.2	0.0	-0.2	0.0
Total domestic demand	1 236.2	4.9	4.4	4.3	3.6	2.6
Exports of goods and services	495.3	2.2	0.7	0.9	-2.6	1.8
Imports of goods and services	440.7	7.5	5.0	5.7	4.4	3.6
Net exports[2]	54.6	-1.7	-1.4	-1.6	-2.3	-0.6
GDP at market prices	1 290.8	3.1	2.8	2.7	1.2	2.0

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Excluding nationalised industries and public corporations.
2. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

Source: OECD Economic Outlook 83 database.

Governments need to hold the line on spending

Following a string of personal and business income tax cuts by the federal and many provincial governments in recent years, government revenues as a percentage of GDP are projected to fall in 2008 and 2009, a situation amplified by a slowing economy. As a result, the general government is projected to show small deficits for both years, and governments will have to stick to their spending plans closely to avoid dipping into the red on a more sustained basis than projected.

The economy should bounce back in 2009

Given the relatively healthy state of the economy as it entered the slowdown, the impulse of tax cuts and the aggressive monetary policy easing built into the baseline projection, a recession is likely to be avoided. Economic growth is nevertheless expected to be weak through 2008, with GDP expanding 1.2% overall over 2007, before bouncing back in 2009 as credit market stresses begin to recede and lower interest rates work their way into the economy. Economic expansion is expected to gather pace through 2009, reaching a growth rate of around 3½ per cent by year-end. The output gap should start to close around mid-2009 and inflation to inch back up toward the 2% target. Just as recent nationwide economic indicators hide sharp disparities across regions, these projections also hide unequal economic performance going forward, with the west continuing to benefit from high commodity prices and manufacturing-based central Canada being on the losing end of the slowdown. Ontario, notably, will almost certainly register a recession in 2008.

Canada: **External indicators**

	2005	2006	2007	2008	2009
	$ billion				
Goods and services exports	430.0	462.6	499.0	530	552
Goods and services imports	386.7	430.0	470.5	512	543
Foreign balance	43.3	32.6	28.5	18	9
Invisibles, net	- 20.0	- 11.9	- 16.0	- 22	- 22
Current account balance	23.3	20.7	12.5	- 3	- 13
	Percentage changes				
Goods and services export volumes	2.2	0.7	0.9	- 2.6	1.8
Goods and services import volumes	7.5	5.0	5.7	4.4	3.6
Export performance[1]	- 4.0	- 5.6	- 2.0	- 3.4	- 0.1
Terms of trade	4.0	0.9	3.4	4.5	- 0.1

1. Ratio between export volume and export market of total goods and services.
Source: OECD Economic Outlook 83 database.

Risks are mainly to the downside

The immediate risks to the outlook are for the credit crisis and adjustment in the US housing market to be either sharper/longer, or shallower/shorter, than currently expected (through to spring 2009), signifying respectively prolonged weakness in the Canadian economy or speedier-than-anticipated recovery. Longer term, however, risks are tilted to the downside and mainly result from the lofty Canadian dollar and the resulting shrinkage in the external balance, though the exchange rate itself could obviously also change.

AUSTRALIA

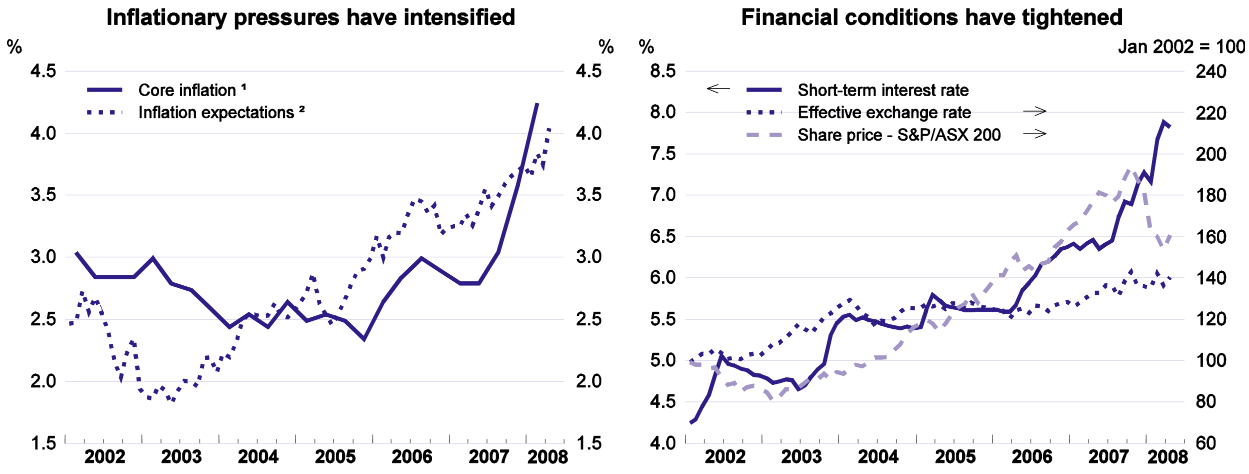
After reaching 4% in 2007, economic activity is likely to slow to below 3% in 2008 and 2009 because of tighter financial conditions and the worsening external environment. This should ease pressures on the labour market and bring inflation down to under 3% by the end of 2009.

To avoid rising inflation expectations causing strong wage growth, monetary conditions need to be kept tight until domestic demand and price pressures have moderated sufficiently. In this context, the stabilising role that fiscal policy should play is welcome. Efforts to harmonise the regulations segmenting product markets between States should benefit productivity growth.

Domestic demand is moderating

Underpinned by the increase in incomes resulting from the rise in the terms of trade, growth of domestic demand remained very brisk up until the fourth quarter of 2007, at a rate close to 6% year-on-year. GDP growth, which reached 4% during this period, was curbed though by the lack of spare capacity. Imports rose sharply, while the increase in exports remained modest because of the Australian dollar's appreciation and the supply-side constraints caused by drought and persisting infrastructure bottlenecks. Demand has, however, moderated since early 2008. Consumer confidence has slumped, while growth in retail sales and mortgage lending have slowed. The business climate, too, has become gloomier. But firms' investment plans remain ambitious. The capacity utilisation rate is high and

Australia



1. Average of the weighted median and trimmed mean measures of consumer price inflation.

2. Difference between the ten-year and indexed Australian government bond yields.

Source: Reserve Bank of Australia.

the still comfortable level of profits should rise, reflecting further terms of trade gains except in the near term. Employment growth has remained solid and the unemployment rate fell to 4.1% in the first quarter of 2008, the lowest level for 33 years. Wage increases were contained, but inflation picked up under the pressure of demand and the surge in commodity prices, reaching 4¼ per cent year-on-year in early 2008 on the basis of both the overall price index and the Reserve Bank of Australia's underlying inflation indicator.

Australia: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices AUD billion	Percentage changes, volume (2005/2006 prices)				
Private consumption	509.2	3.0	2.9	4.5	3.7	2.9
Government consumption	156.1	3.0	3.8	3.0	2.8	2.0
Gross fixed capital formation	221.6	8.0	4.9	8.1	6.2	5.0
Final domestic demand	886.9	4.3	3.6	5.2	4.2	3.3
Stockbuilding[1]	6.2	0.2	-0.8	0.9	0.0	0.0
Total domestic demand	893.1	4.4	2.8	6.0	4.2	3.3
Exports of goods and services	157.2	2.4	3.3	3.3	3.3	6.6
Imports of goods and services	181.0	8.5	7.3	11.2	9.3	8.1
Net exports[1]	- 23.8	-1.3	-0.9	-1.8	-1.4	-0.3
GDP at market prices	869.3	3.0	2.6	4.1	2.9	2.7
GDP deflator	_	4.3	4.8	3.8	6.4	4.1
Memorandum items						
Consumer price index	_	2.7	3.5	2.3	4.1	3.1
Private consumption deflator	_	1.7	2.8	2.4	3.8	3.1
Unemployment rate	_	5.0	4.8	4.4	4.2	4.7
Household saving ratio[2]	_	-1.1	-0.2	1.8	2.0	2.5
General government financial balance[3]	_	1.5	2.0	0.7	1.5	1.7
Current account balance[3]	_	-5.8	-5.5	-6.2	-4.7	-4.6

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of disposable income.
3. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Financial conditions have tightened

In order to stem inflationary pressures, the Reserve Bank raised its official interest rate by 1 percentage point between August 2007 and March 2008, to 7.25%. The monetary policy tightening was accentuated by the increased cost of bank borrowing caused by the international credit crunch, with the result that the three-month interbank rate rose by 1.5 percentage points. The Australian dollar appreciated over the period by 4% in effective terms and the stock market fell.

Fiscal policy is slightly restrictive

In 2007/08, the federal fiscal surplus could reach 1.8% of GDP and slightly exceed the initial objective due to somewhat higher revenues. According to the 2008/09 budget, the surplus should edge up to 1.9% of GDP. The budget incorporates a reduction in revenues of about 1% of GDP, including a personal income tax cut, and a set of measures of a similar magnitude slowing spending growth. A shift in expenditure, placing a stronger focus on infrastructure, climate change, education and health is also planned. This strategy should ease demand pressures to some extent.

A soft landing of the economy is the most likely outcome

The tightening of macroeconomic policy is expected to slow GDP growth to respectively 3% and 2¾ per cent in 2008 and 2009, somewhat below potential growth. Tighter financial conditions and mounting uncertainty is expected to check household demand and stimulate saving. The slowdown in corporate investment should be moderate, especially in the mining sector which benefits from the improved terms of trade. The impact of the appreciation of the currency on foreign trade and the weakening economic situation in the OECD area should be cushioned in Australia’s case by the persisting strength of the Chinese economy. Moreover, a return to normal weather conditions should prompt an upturn in agricultural exports. As economic activity moderates, the unemployment rate will probably rise a little and the output gap should narrow. Inflation is expected to slow gradually to below 3% by the end of 2009. However, a steeper than forecast rise in the terms of trade, which cannot be ruled out, would increase inflationary pressures. But a less favourable external situation due to a fall in the terms of trade constitutes a significant negative risk.

AUSTRIA

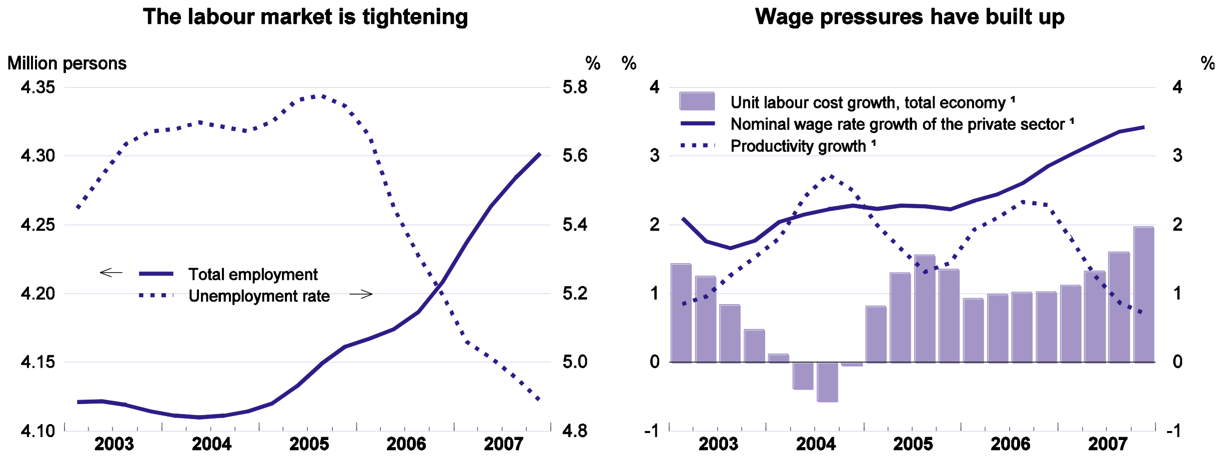
GDP growth is likely to decelerate in 2008 -- mostly reflecting the lagged effects of a weakening global economic environment and euro appreciation -- before picking up at the end of the year as the world economy recovers. Headline inflation is projected to remain above 2% for most of the projection period, reflecting the pass-through effects of high energy and food prices.

The government should continue to aim at balancing the general government budget by 2010, and resist implementing tax cuts in the absence of concrete and fully offsetting measures to reduce public expenditures.

GDP growth decelerated slightly through 2007 before picking up in 2008Q1

Austria experienced a second year of strong growth in 2007, even though quarter-on-quarter growth rates slowed down during the year. The banking system has so far been only marginally affected by recent developments in global financial markets. Slowing export market growth and the appreciation of the euro negatively affected exports of goods and services in 2007, which in turn slowed down investment growth, while private consumption continued to be weak. However, net exports picked up strongly in the first quarter of 2008, more than offsetting a further deceleration in total domestic demand.

Austria



1. Year-on-year percentage change

Source: OECD Economic Outlook 83 database.

The labour market is tightening

Unemployment continued to decline steadily in 2007, despite a 1.6% increase in the labour force. This reflected strong employment growth, with total employment growing by 2.1%. There continue to be diverging trends in unit labour costs in different sectors of the economy -- these have been falling in the manufacturing sector since mid-2005 but rising in the rest of the economy. The government plans to alleviate a growing shortage of skilled workers by improving job-training schemes, and there will be a partial opening up of the labour market this year in specific industries for workers from new EU member states.

Austria: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices € billion	Percentage changes, volume (2000 prices)				
Private consumption	132.2	2.3	2.0	1.5	1.1	1.5
Government consumption	42.9	1.7	2.0	2.6	2.6	2.9
Gross fixed capital formation	48.6	1.5	3.1	4.0	2.0	1.8
Final domestic demand	223.8	2.0	2.2	2.3	1.6	1.8
Stockbuilding[1]	2.1	-0.1	-0.1	-0.2	0.0	0.0
Total domestic demand	225.9	1.9	1.5	1.5	0.4	1.9
Exports of goods and services	120.3	6.8	7.7	8.6	6.5	6.2
Imports of goods and services	110.5	6.1	4.7	6.2	4.8	7.1
Net exports[1]	9.8	0.6	1.8	1.7	1.3	0.0
GDP at market prices	235.7	2.3	3.3	3.3	2.3	1.7
GDP deflator	_	1.7	1.9	2.3	2.4	1.7
Memorandum items						
Harmonised index of consumer prices	_	2.1	1.7	2.2	3.1	2.2
Private consumption deflator	_	1.6	1.9	2.1	3.1	2.3
Unemployment rate[2]	_	5.7	5.4	5.0	4.8	4.8
Household saving ratio[3]	_	9.3	9.7	10.1	10.0	9.8
General government financial balance[4]	_	-1.6	-1.6	-0.7	-0.7	-0.8
Current account balance[4]	_	2.1	2.8	3.1	3.5	3.2

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. See data annex for details.
3. As a percentage of disposable income.
4. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Short-term inflationary pressures are strong

Harmonised consumer price inflation picked up sharply in the fourth quarter of 2007, to 3.2%, accelerating further to 3.3% in the first quarter of 2008. This was in line with the average for the euro area and was driven by hikes in imported energy and food prices. Nominal wage settlements in autumn 2007 were some ¾ percentage points higher than those of the previous year. However, net of taxes and adjusted for inflation, real wages are likely to increase only marginally in 2008. It is expected that Austria will continue to contain wage pressures, in line with its past experience of strong cooperation between employers and trade unions. Immigration from central and eastern Europe, and the possibility of relocating production to lower-cost countries, should also help to contain the growth of labour costs in Austria.

Fiscal policy needs to be monitored closely

Austria's fiscal deficit in 2007 amounted to 0.7% of GDP -- lower than the targets agreed upon in the coalition accord in January 2007 (1.1% of GDP) and passed by Parliament in May (0.9% of GDP). This improvement in the fiscal situation stemmed primarily from higher tax revenues, with particularly large increases in corporate tax receipts and in revenues from withholding taxes on investment and on interest. However, on current policies the government is unlikely to meet its target of balancing the general government budget by 2010, as the deficit is expected to rise slightly over the projection period. In this context the government should avoid committing to any significant tax cuts until it comes up with specific offsetting measures to cut public expenditures. Financial transactions between the government and public enterprises should be treated transparently and in line with EU norms.

Growth is likely to pick up, and inflation to fall, in 2009

Despite the unexpected upturn in activity in the first quarter of 2008, overall the economy is expected to slow down in 2008 - even with the anticipated boost to tourism from Austria's co-hosting of the European football championship in the second quarter of 2008. However, economic activity is expected to pick up from the end of the year. Headline and core inflation should both decline to below 2% by the end of the projection period. The main downside risks to growth stem from a greater-than-anticipated fallout from the US slowdown and continuing turmoil in international financial markets on the economies of Austria's major trading partners in Europe and elsewhere. The main upside risk continues to be a stronger-than-anticipated rebound in private consumption. On inflation the main uncertainties relate to developments in food and energy prices in world markets and to wage pressures in the domestic labour market.

BELGIUM

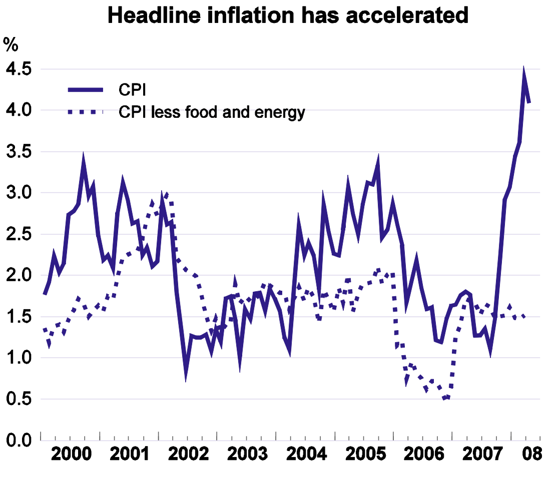
The economy is projected to remain sluggish through most of 2008, before regaining some speed next year. As a result, the output gap will widen in the near term and employment prospects will weaken. Headline inflation should come down as the effects of recent energy and food price increases dissipate. On the other hand, core inflation will increase as a result of the automatic indexation of wages.

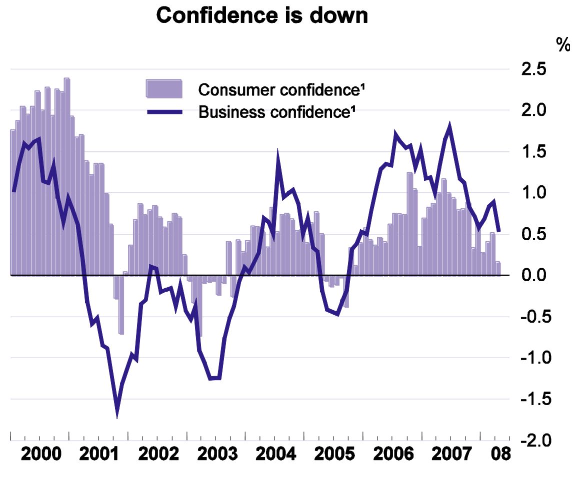
The general government financial balance is expected to remain in deficit in 2008, despite the mildly restrictive fiscal stance at the federal level, reflecting the operation of automatic stabilizers in a period of slower economic growth. Even with a pickup of growth in the following year, the deficit is expected to widen further. By then, the overall fiscal position will be more than a percentage point of GDP below the medium-term budgetary trajectory towards fiscal sustainability as presented in the recent Stability Programme, pointing to the need for expenditure restraint at all levels of government.

Economic growth has fallen below its potential rate

After dynamic growth during 2007, output weakened in early 2008. However, household spending softened earlier, reflecting deteriorating consumer confidence and more sluggish real income growth. As in other countries, house prices softened and residential investment lost some of its momentum. Meanwhile, exports remained relatively strong in most of 2007

Belgium





1. The series have been normalised at the average for the period and are presented in units of standard deviation.

Source: OECD Economic Outlook 83 database and OECD, Main Economic Indicators.

as exporters managed to reduce their market share losses, although exporters were hit by the sharp slowdown in world trade towards the end of the year, contributing to a sharp increase in stock-building. Less rapid expansion of employment combined with higher labour market participation meant that the standardised unemployment rate remained at around 7% in early 2008.

Belgium: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices € billion	Percentage changes, volume (2005 prices)				
Private consumption	152.4	1.4	2.2	2.4	1.2	1.7
Government consumption	66.1	-0.2	0.0	2.1	2.2	1.8
Gross fixed capital formation	56.9	6.7	4.2	5.7	3.9	3.5
Final domestic demand	275.5	2.1	2.1	3.0	2.0	2.1
Stockbuilding[1]	1.1	0.0	1.1	0.3	0.3	0.0
Total domestic demand	276.5	2.1	3.2	3.3	2.4	2.1
Exports of goods and services	242.3	4.1	2.6	3.8	3.2	4.3
Imports of goods and services	229.9	4.7	2.8	4.6	4.2	4.7
Net exports[1]	12.4	-0.2	-0.1	-0.6	-0.8	-0.3
GDP at market prices	289.0	2.0	2.9	2.8	1.7	1.7
GDP deflator	_	2.5	2.0	1.6	2.1	2.0
Memorandum items						
Harmonised index of consumer prices	_	2.5	2.3	1.8	3.7	2.0
Private consumption deflator	_	2.9	2.4	1.9	3.6	2.0
Unemployment rate	_	8.5	8.2	7.5	7.0	7.2
Household saving ratio[2]	_	9.6	9.9	10.4	10.5	10.8
General government financial balance[3]	_	-2.4	0.3	-0.2	-0.3	-0.9
Current account balance[3]	_	2.6	2.7	1.4	1.1	0.9

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of disposable income.
3. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Headline inflation has increased

Headline consumer price inflation has increased sharply since the start of the year, peaking at nearly 4½ per cent in March 2008, more than in most other euro area countries, before easing somewhat. At the same time, core inflation has remained stable at around 1½ per cent during 2007 and into the first quarter of 2008. While the effects of hikes in energy and food prices are expected to dissipate, core inflation is projected to increase following the triggering of the automatic wage indexation mechanism. Under this impact, hourly wage growth should accelerate to above 4% for the year, which is higher than stipulated in the wage agreement. The wage agreements for the next two years are set to be negotiated among the social partners; this is assumed to lead to outcomes that continue to observe the reference value laid down in the wage norm, thus keeping wage developments in line with expected hourly labour costs trends in the three main trading partners.

Fiscal adjustment is needed to return towards a sustainable path

The general government financial balance is expected to show another small deficit this year, reflecting the effects of automatic stabilisers, despite some fiscal restraint at the federal level. There are no new one-off fiscal measures, unlike in earlier budgets, although the budget will be affected negatively by some earlier self-reversing measures. The current federal budget was presented in Spring 2008 by the interim government, but was only passed recently. The current government is committed to return public finances to a path that heads towards fiscal sustainability. However, despite the acceleration of growth the deficit is expected to widen further in 2009, mostly reflecting higher social spending in the wake of higher unemployment. This would leave a shortfall of more than one percentage point of GDP from the planned trajectory towards fiscal sustainability stipulated in this year's Stability Programme. Rectifying this situation over the medium term requires that expenditure restraint is secured at all levels of government. This is particularly important in the context of the government's plans for further devolution of economic powers to sub-central levels of governments by mid-2008.

Slow near-term growth will give way to a reacceleration

After sluggish growth through most of 2008, economic activity is set to regain momentum during next year. As a result the output gap is expected to widen during 2008 and then stabilise. The main risk to this projection is related to greater persistence in inflation developments arising from the automatic wage indexation mechanism. On the upside, household savings may fall further than projected, allowing for a faster recovery.

CZECH REPUBLIC

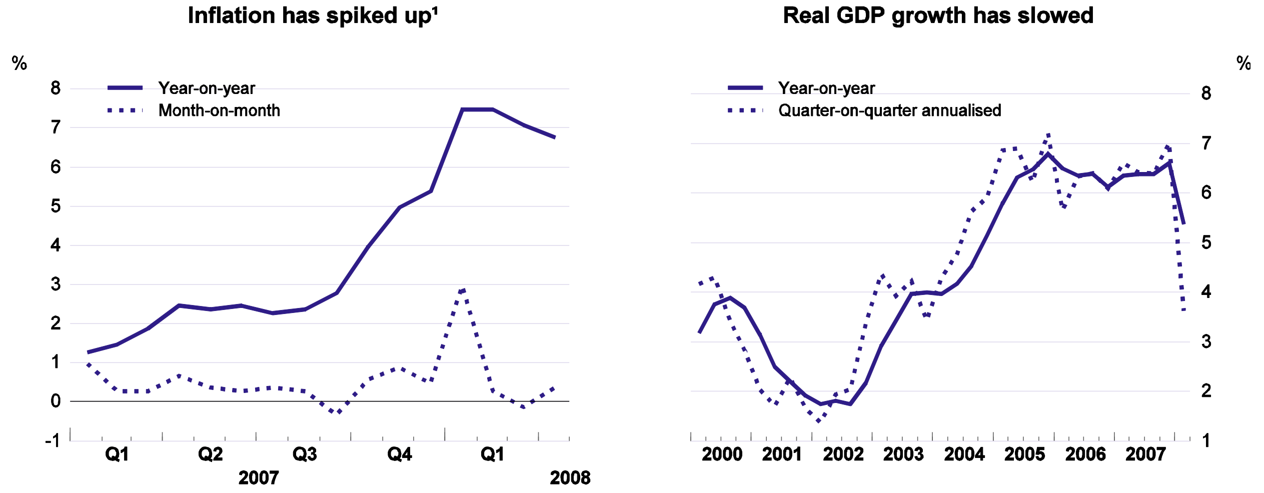
Following three years of growth in excess of 6%, real GDP is expected to decelerate to around 4½ per cent for 2008 before picking up again in 2009. Most of the slowdown is due to a spike in inflation that has squeezed real household disposable incomes.

The inflation spike reflects to a considerable extent several measures that formed part of a fiscal package passed late last year. The government is pushing ahead with further reform but its weak political mandate means progress is slow. The key challenges are to ensure fiscal sustainability in the light of upcoming population pressures and to expand the labour supply and improve education systems so as to prevent employment and skills shortages from constraining growth potential.

Growth slowed significantly in the first quarter

Real aggregate demand growth slowed significantly in the first quarter of this year, largely due to increasing consumer prices. Market developments in food and oil prices had already been pushing headline inflation up in the second half of 2007, despite the strong appreciation of the Czech koruna. Then, in January an increase in the lower rate of value-added tax (VAT) and other policy driven price hikes increased inflation further. In February and March, month-on-month growth in the consumer price index was close to zero, notably with slight falls in the food component of the index. Despite this, inflation was 7.5% year-on-year in the first quarter. Inflation developments have significantly slowed real household consumption spending and are likely to have a lagged impact on consumption looking forward. As regards other components of aggregate

Czech Republic



1. Inflation is measured by the consumer price index.

Source: Czech Statistical Office and OECD Economic Outlook database.

demand, export volume growth notably turned out at 14.5% in 2007. Typical of recent years, this increase was a good margin above estimates of export market growth. The recent slowdown in growth has not had a significant impact on the labour market; the unemployment rate remains low following the large falls due to the strong economic growth in recent years.

Czech Republic: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices CZK billion	Percentage changes, volume (2000 prices)				
Private consumption	1 416.5	2.4	5.5	5.6	2.8	4.0
Government consumption	621.6	2.2	0.0	0.9	0.0	0.1
Gross fixed capital formation	727.2	2.3	5.5	6.1	8.6	7.8
Final domestic demand	2 765.3	2.3	4.2	4.7	3.7	4.2
Stockbuilding[1]	48.2	-0.7	1.4	1.0	0.0	0.0
Total domestic demand	2 813.5	1.6	5.6	5.6	3.6	4.0
Exports of goods and services	1 968.6	12.0	15.0	14.5	11.9	11.4
Imports of goods and services	1 967.7	5.1	14.4	13.6	11.1	10.8
Net exports[1]	0.9	4.8	0.9	1.1	1.1	1.0
GDP at market prices	2 814.4	6.4	6.4	6.5	4.5	4.8
GDP deflator	_	-0.2	1.7	3.4	7.0	2.5
Memorandum items						
Consumer price index	_	1.9	2.6	3.0	6.8	2.9
Private consumption deflator	_	0.9	2.3	2.9	7.1	2.9
Unemployment rate	_	7.9	7.2	5.3	4.6	4.4
General government financial balance[2]	_	-3.6	-2.6	-1.6	-1.5	-1.3
Current account balance[2]	_	-1.6	-3.1	-2.5	-2.6	-1.8

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Monetary policy rates have increased in recent months

The global financial turbulence has, so far, not had significant effects on the Czech financial sector and has therefore not prompted special measures by the Central Bank. The spike in inflation will probably not significantly affect underlying inflation but it is presenting challenges in the Bank's communication to markets and the public. Communication is further complicated by an upcoming reduction in the inflation target. As of January 2010, the inflation target, expressed as annual consumer price inflation, will be lowered by 1 percentage point to 2% with the same ±1 percentage point tolerance band.

The government deficit outturn for 2007 was lower than expected

The general government deficit for 2007 was 1.6% as a share of GDP, which is much lower than expected. For 2008, reforms are bringing some uncertainty in revenues and spending. The increases in the lower rate of VAT and other indirect taxes are part of a package which simultaneously lowered direct taxation through a move to a single rate of personal income tax and a schedule of reductions in the corporate tax rate. There have also been various measures on the spending side.

Growth is expected to pick up

Annual real GDP growth is projected to ease to 4.5% in 2008, due primarily to the squeeze on real household consumption. But in addition, a slight easing in export growth is expected up to the final quarter of 2008, reflecting developments in demand elsewhere in Europe. By 2009, any lagged effects of the inflation spike on consumption are likely to have largely worn off. This, combined with some increase in export growth, is expected to drive annual growth for 2009 up to 4.8%, and by the final quarter it will have reached a little over 5% year-on-year. Inflation is projected to drop off significantly between the first and second quarters of this year and to decline slowly thereafter. Nevertheless, annual inflation is projected to turn out at 6.8% for 2008; however, it will be much lower in 2009 at 2.9% and by the final quarter it is expected to be down to 2.6%, year-on-year. Small reductions in the general government deficit are expected with outturns of 1.5% and 1.3% of GDP in 2008 and 2009, respectively.

Risk factors are mainly on the downside

Risks are predominantly, but not exclusively, on the downside. Second-round effects on inflationary expectations from the spike in inflation may be more significant than expected. Also, future price developments in food and energy markets are particularly uncertain, but could nevertheless moderate more than projected. Although Czech financial markets do not appear to have strong direct linkages with the global financial turmoil, any further negative effects on the global economy could feed through to the domestic economy, principally through export demand.

DENMARK

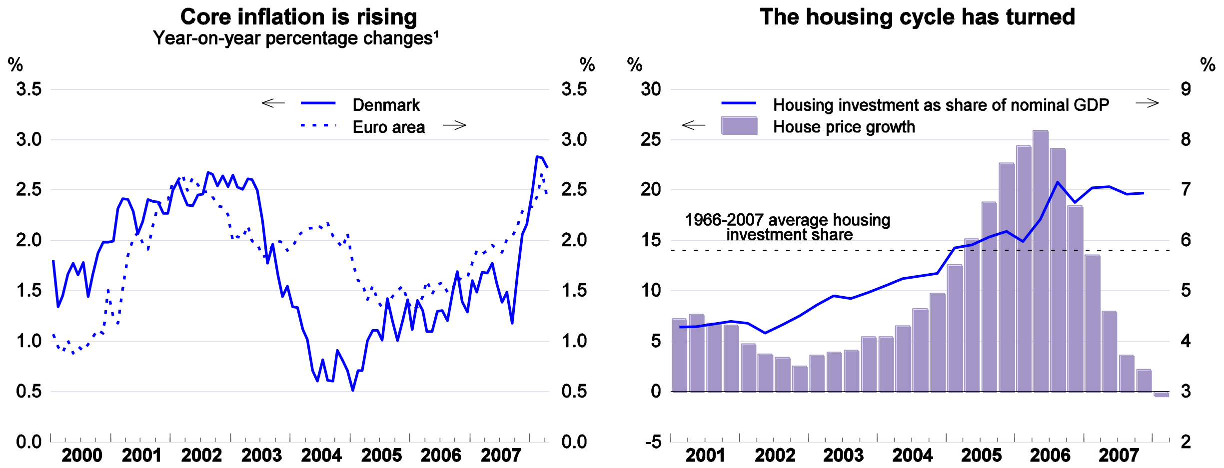
Following a marked slowdown, the economy has expanded at a rate close to potential and the pronounced labour and capacity shortages are easing only gradually. Going forward, construction activity is projected to contract and to drag down growth. Export demand is set to weaken, and households are likely to become more cautious when spending.

With wage and price inflation pressures, fiscal stimulus should be avoided. Rather, policies should continue to focus on expanding labour supply, *via* clearer incentives for benefit recipients to seek employment and financed reductions in marginal income tax rates.

Capacity pressures remain despite slower growth

Growth has slowed to around its potential rate of 1½ to 2%, leaving the positive output gap previously built up in place. Private consumption expanded rapidly late last year, along with business investment, but much of the additional demand was met by imports. Sentiment about the state of the economy weakened sharply in early 2008, but consumers are more optimistic about their own situation. Business profits are weighed down by rising raw material and labour costs, and sales expectations are weakening. Meanwhile, unemployment has continued to decline, and many firms indicate that they plan to continue hiring. For the private sector as a whole, hourly wage rises have gone up by 1½ percentage points to an annual rate of 4.6% in the final quarter of 2007, and similar rises have been agreed for most of the public sector for 2008-10. With private-sector productivity

Denmark



1. Core inflation excluding unprocessed food and energy.

Source: Eurostat database; OECD Economic Outlook 83 database and Association of Danish Mortgage Banks.

growth averaging 1½ per cent over the past fifteen years, these wage rises are indicative of some overheating, with a gradual erosion of competitiveness. Consumer price inflation was below 2% in most of 2007, but rose to well above 3% in early 2008, in tandem with the euro area.

Denmark: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices DKK billion	Percentage changes, volume (2000 prices)				
Private consumption	707.2	5.2	3.8	2.5	2.9	1.0
Government consumption	389.0	0.9	2.0	1.7	1.9	1.3
Gross fixed capital formation	282.9	6.2	14.0	6.1	2.2	-1.9
Final domestic demand	1 379.2	4.2	5.4	3.1	2.5	0.4
Stockbuilding[1]	15.6	-0.7	0.6	-0.3	-0.4	0.0
Total domestic demand	1 394.8	3.4	6.0	2.7	2.2	0.4
Exports of goods and services	665.6	8.2	9.0	3.7	3.6	3.6
Imports of goods and services	594.1	11.2	14.1	5.6	5.6	3.2
Net exports[1]	71.4	-0.8	-1.8	-0.8	-1.0	0.2
GDP at market prices	1 466.2	2.5	3.9	1.8	1.2	0.6
GDP deflator	_	3.1	2.0	1.5	3.3	2.4
Memorandum items						
Consumer price index	_	1.8	1.9	1.7	3.3	2.6
Private consumption deflator	_	2.1	2.1	1.9	2.9	2.6
Unemployment rate[2]	_	4.8	3.9	3.7	3.3	3.7
Household saving ratio[3]	_	-4.0	-3.1	-2.7	-3.2	-2.6
General government financial balance[4]	_	5.0	4.9	4.5	3.9	3.0
Current account balance[4]	_	4.3	2.7	1.1	0.6	0.7

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. Based on the Labour Force Survey, being ½-1 percentage point above the registered unemployment rate.
3. As a percentage of disposable income, net of household consumption of fixed capital.
4. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Financial turmoil or not, residential construction is set to contract

Following the spectacular house prices increases and high mortgage debt levels built up over recent years, Denmark would at first glance seem vulnerable to financial turmoil. Yet, so far, none of the major banks has reported significant losses related to bad loans. Mortgage lending standards have tightened and forced sales are becoming more frequent, but the latter still run at only a fifth of the rate observed on average in the 1980s. How much financial stress may yet surface is hard to predict, but in any case construction activity is projected to contract markedly. On the back of rising housing demand, residential investment has accounted for 7% of GDP since 2006, over one percentage point above its 40-year average. The granting of new permits halved during 2006, but with a backlog of dwellings under construction, completions have remained high until now. Residential investment is projected to ease to its historical average by the end of next year, implying a double-digit fall in the volume of residential construction.

With rising inflation fiscal stimulus is undesirable

Unlike many OECD economies, Denmark entered 2008 with a sizeable positive output gap, estimated at 2% of GDP. On top of higher energy and food prices, domestic inflationary pressures will therefore remain strong, even if the Danish economy slows further. A soft landing would require a gradual increase of unemployment towards equilibrium levels which would be conducive to wage moderation and slow the erosion of cost competitiveness. Fiscal stimulus should be avoided in 2009, with the automatic stabilisers providing enough of a cushion. Public spending should be firmly controlled to avoid a repetition of the 2006-07 overruns, during which time public consumption rose by 2.0% and 1.7%, well above the 0.5% and 1.0% expected by government when presenting the fiscal bill in August of the preceding year. The problem concerns notably municipalities.

Growth is set to slow further but with rising cost pressures

With global financial turmoil lingering, weak export demand is projected to weigh on growth, both this year and next. Business investment is also set to weaken from high levels. Private consumption is expected to grow at a moderate pace, stimulated by wage growth, but tempered by more cautious saving behaviour as housing wealth contracts. Unemployment is projected to rise, but to remain below its estimated structural level, and inflationary pressures will persist. The fiscal surplus should remain large, not least thanks to buoyant revenues from North Sea oil and gas production.

Inflation surprises are a major risk

Global financial turmoil and its international reverberations are casting shadows over the near-term outlook, as are developments in the Danish housing market. Yet, inflation has recently jumped up and may become a major challenge as well.

FINLAND

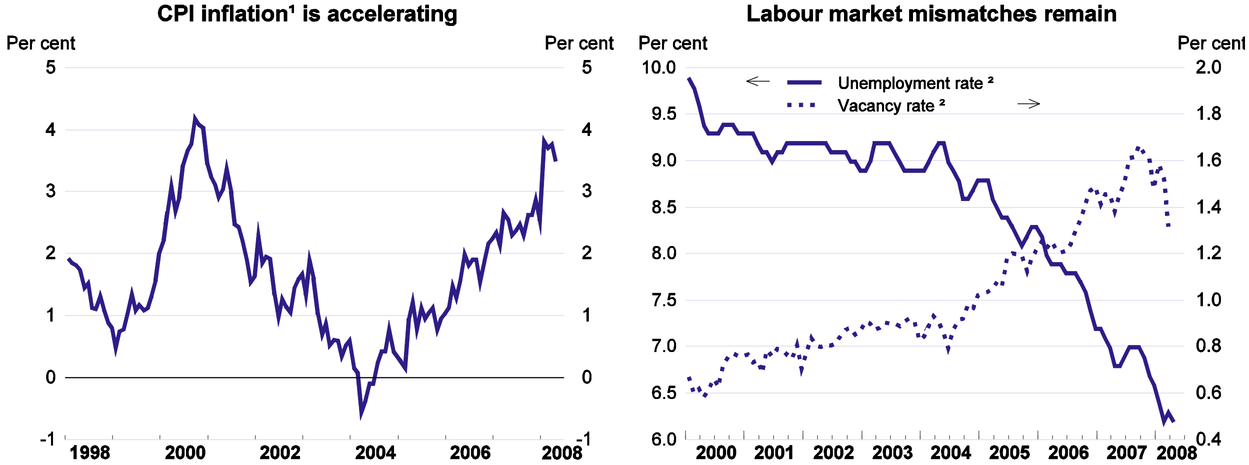
Output grew briskly in 2007 although there was a notable deceleration in the second half of the year. The pace of activity is expected to moderate further over 2008 on the back of weakening world demand and lower confidence domestically. The recently completed round of wage negotiations has resulted in large wage increases which, coupled with higher import prices, are feeding through to a significant pick-up in inflation.

Fiscal policy might have to be tightened further to offset the inflationary effects of the recently completed wage negotiations. Also, more needs to be done to address worsening labour market imbalances including stronger activation measures and action to better address inter-regional mismatches.

Economic activity has moderated

After exceptionally strong export and consumption growth over the previous two years, activity decelerated somewhat over the course of 2007 with deteriorating conditions internationally beginning to impact on export growth. Despite the slowdown in consumption, the household saving ratio fell to a historic low of -3.8% in 2007 with consumption growth outpacing growth in real disposable income. The supply of housing remains tight, particularly in the faster growing regions of the country, and house prices have continued to rise although at a somewhat slower pace than in recent years. While recent indicators suggest a further slowing in activity into

Finland



1. All items, year-on-year percentage change.

2. Per cent of labour force. The job vacancies series was seasonally adjusted by the OECD.

Source: Statistics Finland.

2008 inflation has strongly accelerated in recent months, driven by food, energy and housing costs. The public balance sheet remained healthy in 2007 with the general government recording a surplus of 5.3% of GDP in 2007, driven by strong revenue growth from both taxes (particularly business taxes) and social security contributions.

Finland: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices € billion	Percentage changes, volume (2000 prices)				
Private consumption	78.0	3.7	4.2	3.6	2.8	2.6
Government consumption	33.3	1.7	0.1	0.9	1.3	1.5
Gross fixed capital formation	27.7	3.6	4.9	7.5	4.0	3.3
Final domestic demand	139.0	3.2	3.4	3.8	2.7	2.5
Stockbuilding[1,2]	2.4	1.1	-0.3	0.1	0.0	0.0
Total domestic demand	141.5	4.3	3.0	3.8	2.6	2.4
Exports of goods and services	60.8	7.0	11.8	4.8	3.5	3.7
Imports of goods and services	50.1	11.9	7.8	4.0	4.1	4.0
Net exports[1]	10.7	-1.1	2.1	0.6	-0.1	0.0
GDP at market prices	152.2	3.1	4.8	4.3	2.8	2.3
GDP deflator	_	0.2	1.6	2.3	2.4	2.0
Memorandum items						
GDP without working day adjustments	_	2.8	4.9	4.4	..	..
Harmonised index of consumer prices	_	0.8	1.3	1.6	3.5	2.5
Private consumption deflator	_	0.5	1.5	1.6	3.2	2.4
Unemployment rate	_	8.4	7.7	6.9	6.3	6.0
General government financial balance[3]	_	2.7	4.0	5.3	4.4	3.8
Current account balance[3]	_	3.6	4.5	4.3	3.4	2.4

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. Including statistical discrepancy.
3. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Imbalances in the labour market remain and wage growth has picked up

The labour market has continued to perform well in many respects with the unemployment rate falling below 7% for the first time in 17 years. Nevertheless, the unemployment rate remains high relative to the best performing OECD countries, particularly among the younger and older cohorts, whilst the number of vacancies has climbed to historical highs. In many sectors of the economy firms are finding it increasingly difficult to source skilled workers. The variance in labour market performance across regions of the country remains large, in part because limited housing supply in fast growing regions is constraining the mobility of the workforce and exacerbating inter-regional mismatches. Mismatch problems are also exacerbated by weak enforcement of the obligations on those on unemployment benefits to move if offered a job in another region of the country. The recently completed wage round has resulted in large wage gains which are likely to lead to higher inflation and will put serious competitive strains on the economy at a time of heightened international risks.

GDP growth is expected to moderate further

Economic growth is projected to decelerate to around 2¾ per cent this year and to moderate further in 2009. Export growth in particular is expected to ease over the next two years as international demand weakens and because of capacity constraints, labour shortages, and the continuing trend of off-shoring the production exportable goods. While employment growth and significant wage increases should boost consumption, purchasing power will at the same time be eroded by higher inflation. Moreover, the historically low household saving ratio and climbing household debt levels are contributing to a substantial decline in consumer confidence, as are perceptions of deteriorating international conditions and historically high inflation expectations. The unemployment rate is projected to continue to fall over the next two years although at a more measured pace, stabilising at around 6% by the end of 2009. The large wage increases agreed to in the 2007-08 wage negotiations will feed through to considerably higher inflation, although this will be somewhat offset by changes in the taxation of automobiles (implemented at the beginning of 2008) and plans to reduce the value-added tax on food.

Risks are building up in the external sector and the labour market

The risks to GDP growth are skewed to the downside for a number of reasons. The relative importance of the external sector and Finland’s reliance on a limited number of narrow export sectors make it particularly vulnerable to a downturn in foreign demand, while the recent high wage outcome reduces international competitiveness. The growing tightness in the labour market, despite the relatively high unemployment rate, also poses a risk to sustained growth.

GREECE

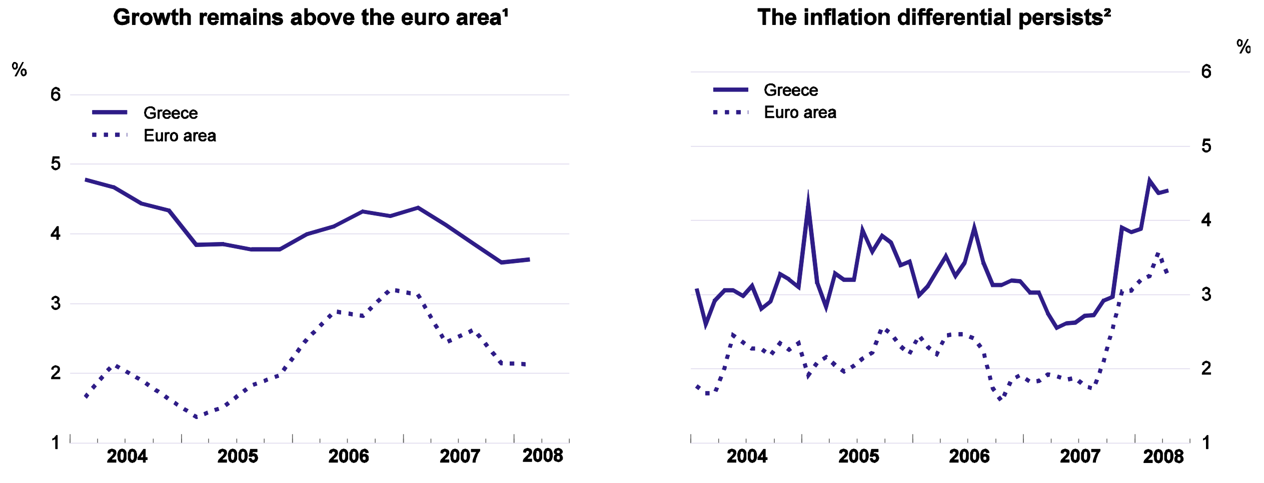
GDP grew briskly in 2007. Output expanded by 4%, though economic activity slowed during the year reflecting a weakening in domestic demand. The economy is expected to grow by around 3½ per cent in both 2008 and 2009. Headline inflation has jumped but should ease back as the impact of the oil and commodity price hikes wanes. Inflation is likely to remain above the euro area average, however, thus weighing on competitiveness. The current account deficit is set to widen further.

Continuing fiscal consolidation should be a key priority and focus on reductions in primary spending and a broadening of the tax base. To cope with demands resulting from population ageing, the reduction of public debt as a share of GDP must be sustained. Rigorous implementation of the recent pension reform is vital. A comprehensive reform in the healthcare system and greater administrative efficiency are also indispensible.

Activity has moderated but inflation is up

GDP growth was robust in 2007, although it decelerated in the course of the year, falling below potential. This slowing largely reflects a deceleration in investment activity, driven by a sharp fall in residential construction, following a tax-induced surge in 2006. Consumption spending also weakened but remained healthy, on the back of still rapid credit growth and rising incomes. The external sector continued to act as a drag on growth. The current account deficit soared to 14% of GDP. Recent activity and economic sentiment indicators show signs of a further slowdown in

Greece



1. Year-on-year percentage change in real GDP.

2. Year-on-year percentage change.

Source: OECD Economic Outlook 83 database and Main Economic Indicators database.

growth. Following an uptick in the fourth quarter of 2007, headline inflation edged up further to 4½ per cent in February 2008, remaining broadly unchanged in March and April. The differential *vis-à-vis* the euro area stands at almost one percentage point. Sharp increases in energy and food prices are the main factors behind the rise in inflation. Core inflation has also risen, but by much less, to 2.7% in April 2008. The unemployment rate has declined to around 8% in 2007, which is below the estimated structural rate. It is still well above that in the best performing OECD countries.

Greece: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices € billion	Percentage changes, volume (2000 prices)				
Private consumption	130.8	4.2	4.2	3.2	2.8	2.8
Government consumption	31.6	1.4	-0.7	10.3	2.3	1.4
Gross fixed capital formation	45.2	0.7	14.8	4.4	5.8	6.1
Final domestic demand	207.6	3.0	5.9	4.4	3.5	3.4
Stockbuilding[1,2]	0.6	0.1	-0.4	0.1	0.0	0.0
Total domestic demand	208.2	3.0	5.5	4.5	3.5	3.4
Exports of goods and services	40.3	2.7	5.1	5.9	5.5	6.0
Imports of goods and services	63.3	0.4	8.7	7.0	3.5	5.1
Net exports[1]	- 23.0	0.4	-2.0	-1.3	-0.1	-0.6
GDP at market prices	185.2	3.8	4.2	4.0	3.5	3.4
GDP deflator	_	3.3	3.4	2.9	4.0	3.1
Memorandum items						
Harmonised index of consumer prices	_	3.5	3.3	3.0	4.2	3.2
Private consumption deflator	_	3.3	3.5	3.1	4.3	3.1
Unemployment rate	_	9.5	8.6	8.0	7.7	7.7
General government financial balance[3]	_	-5.3	-2.9	-3.1	-2.1	-2.1
Current account balance[4]	_	-7.2	-11.1	-14.1	-15.3	-15.2

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. Including statistical discrepancy.
3. National Account basis, as a percentage of GDP.
4. On settlement basis, as a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Fiscal consolidation needs to continue and at a faster pace

The general government deficit for 2007 exceeded original expectations, partly owing to one-off measures of around ¼ per cent of GDP. The 2008 budget, which aims at a deficit reduction of more than 1% of GDP, incorporates the abolition of the transfer tax on main residences, in addition to further personal income tax cuts. The revenue loss from these initiatives should be more than compensated by higher excise taxes on fuel, increased property tax revenue arising from a simplification of the system, and additional measures to curtail tax evasion. The OECD projection shows a reduction in the general government deficit from 3.1% of GDP in 2007 to 2.1% in both 2008 and 2009, implying a restrictive fiscal stance in 2008. The projected deficit for 2008 is around ¼ per cent of GDP higher than the official estimate, reflecting a slightly less favourable growth scenario and a more cautious assumption for tax revenues. A faster improvement would be necessary to meet the official target of bringing the government finances into balance by 2010.

Activity should strengthen again

Economic activity is likely to slow over the next few quarters, but to regain steam in 2009, moving closer to the potential growth rate by the end of the projection period. On an annual basis, real output is projected to grow by around 3½ per cent this year and next, which is above the euro area average. Less accommodative financial conditions and higher inflation are expected to constrain domestic demand. A weaker external environment and a loss in competitiveness are also likely to act as a drag on activity. Growth should be supported, however, by a number of investment-promoting measures, tax cuts and a faster absorption of European Union funds. Strong wage increases under the new two-year national collective agreement should provide further stimulus. Inflation is set to decline to approximately 3¼ per cent by 2009, as the impact of high oil and commodity prices dissipates and the output gap becomes negative. At around 7¾ per cent, the unemployment rate will remain close to its current level.

There are both external and domestic risks to the outlook

A significant risk to the outlook is that growth in the south-eastern trading partners could become less buoyant than in recent years. Moreover, inflation may not recede as quickly as projected, in view of tight labour market conditions and recent wage outcomes. It may also be difficult to meet the fiscal target.

HUNGARY

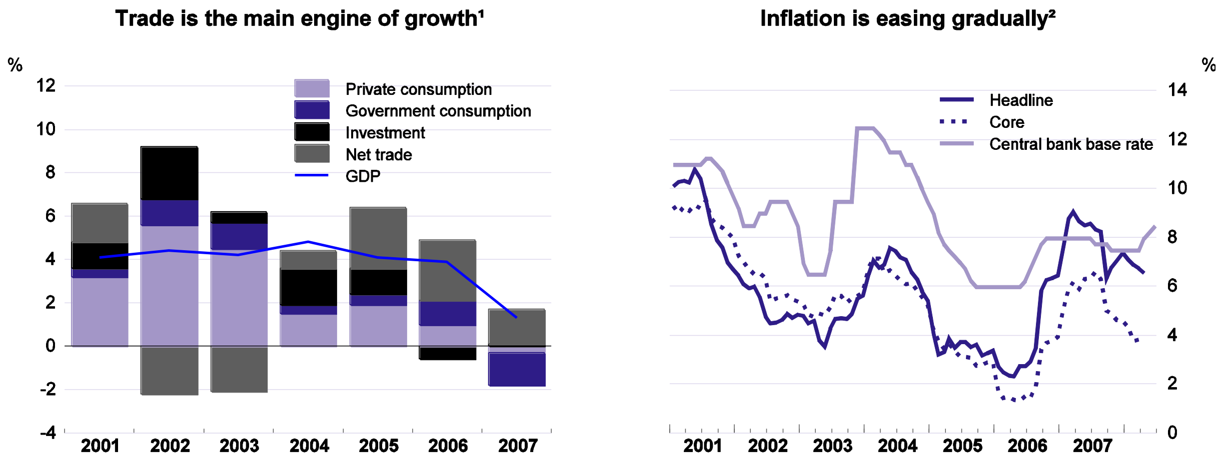
Growth was weak in 2007, reflecting fiscal consolidation. Though remaining below the trend rate, it is projected to recover in 2008-09, with robust exports favouring investment, while decelerating inflation should support household purchasing power and help consumption. The current account deficit should continue to decline.

The main challenge remains restoring the sustainability of public finances. If the momentum of public spending reform is maintained, it will provide more room for reducing taxes and social security wedges. Healthier public finances will also expand the monetary authorities' scope for action. Such progress, along with reforms to improve labour supply, will be conducive to more stable growth in the longer term.

Growth slowed markedly in 2007

The slowdown in activity which began in mid-2006, following the launching of fiscal consolidation, continued in 2007. Real GDP growth was 1.3% for the year as a whole, the weakest performance in the past decade. Private consumption declined -- the consequence of falling household real incomes -- along with public investment, as infrastructure works decreased. By contrast, strong spending on machinery and equipment by export-oriented enterprises made for robust investment at the end of the year. With the rise of industrial exports exceeding export market growth by a wide margin and weak private consumption holding back the expansion of imports, net exports contributed positively to GDP growth and the current account deficit fell significantly.

Hungary



1. Real GDP growth deviates from the sum of the contributions of components shown because stock building is excluded.

2. Inflation is measured by the year-on-year change in the consumer price index. Core is headline excluding food and energy.

Source: Magyar Nemzeti Bank; OECD Economic Outlook 83 database; and OECD, Main Economic Indicators database.

Growth is driven by the export sector

Indicators suggest that the export sector will continue to be the main driving force of economic activity in the near future. Indeed, manufacturing exports have been strong in the first quarter of 2008, with Russia and the Balkan region (notably Bulgaria and Romania) being the most dynamic export markets. The rapid pace of export growth has supported the investment momentum.

Hungary: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices HUF billion	Percentage changes, volume (2000 prices)				
Private consumption	11 294.5	3.4	1.8	-0.5	1.4	2.1
Government consumption	4 636.6	2.4	4.7	-6.5	-3.0	0.4
Gross fixed capital formation	4 650.7	5.3	-2.8	0.4	4.2	6.2
Final domestic demand	20 581.8	3.6	1.4	-1.7	1.0	2.7
Stockbuilding[1]	721.5	-2.3	-0.3	1.3	0.0	0.0
Total domestic demand	21 303.3	1.4	1.0	-0.3	1.1	2.6
Exports of goods and services	13 147.9	11.5	18.9	14.1	10.8	11.1
Imports of goods and services	13 734.0	6.8	14.5	12.2	9.8	10.8
Net exports[1]	- 586.2	2.8	2.8	1.6	1.0	0.6
GDP at market prices	20 717.1	4.1	3.9	1.3	2.0	3.1
GDP deflator	_	2.2	3.7	5.4	5.1	3.1
Memorandum items						
Consumer price index	_	3.6	3.9	8.0	6.3	3.7
Private consumption deflator	_	3.8	3.3	6.6	6.5	3.7
Unemployment rate	_	7.3	7.5	7.4	7.7	7.6
General government financial balance[2]	_	-7.8	-9.3	-5.5	-4.1	-3.5
Current account balance[2]	_	-6.8	-6.1	-5.0	-4.4	-4.1

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Monetary policy is focussed on the inflation target

Although core and headline consumer price inflation have eased from the high rates of 2007, there remain uncertainties about the transmission into inflation of the food and energy price increases seen to date. Indeed, industrial producer prices have experienced a strong acceleration since the turn of the year. Wage data show that the regular wage component (defined to exclude the impact of bonuses) also increased significantly at the beginning of 2008, despite high unemployment. These developments prompted three increases in monetary policy rates between April and May (from 7.5% to 8.5%), in line with the Monetary Council's primary objective to anchor inflation expectations.

The budget deficit has fallen but less consolidation is planned

Frontloaded fiscal consolidation induced major improvements in fiscal balances during 2007. The general government deficit fell by about 3½ per cent of GDP, down to 5.5%, undershooting the initial target of 6.8%. The reduction reflected a combination of higher tax revenues, partly driven by measures to widen the tax base, and lower government consumption. These achievements more than offset the impact of one-off expenditures, notably the payment of some military aircraft and the recapitalisation of the national railway company. For 2008, the OECD projection is broadly in line with the government's deficit target of 4% of GDP for the general government. Restraints to current spending are expected to continue and further progress in tax collection is likely, but the disappearance of one-off cost factors also plays a mechanical role. Meeting the 2009 deficit target will require further efforts at structural spending reforms, in particular concerning social transfers and subsidies, as well as public administration reform. The projected deficit for 2009 of 3.5% implies a slippage of almost half a percentage point of GDP.

GDP could accelerate supported by the export sector

GDP growth is likely to recover in 2008 and 2009, though remaining below trend. Despite temporary slowing in world trade, activity is to be fuelled by strong exports, which should stimulate investment. Slowing inflation is set to improve consumers' purchasing power and to sustain private consumption over the projection period. Despite the recent hike, wage increases should remain moderate as the unemployment rate is expected to remain high. Continued market share gains are projected to result in an improvement of the current account, more than offsetting the impact of some terms of trade losses.

There are downside and upside risks

The main risk is that slowing export markets will have a more severe impact on the economy than expected. Domestically, wage increases could be stronger than expected. While this would provide some immediate boost to consumption, inflation pressures would strengthen, leaving the economy vulnerable to a loss of competitiveness with negative repercussions on economic growth and employment. On the other hand, if inflation decelerates more rapidly than projected, monetary policy would not need to remain as restrictive as currently assumed. This would raise household incomes enhancing the prospect of a stronger pick-up in private consumption and investment demand.

ICELAND

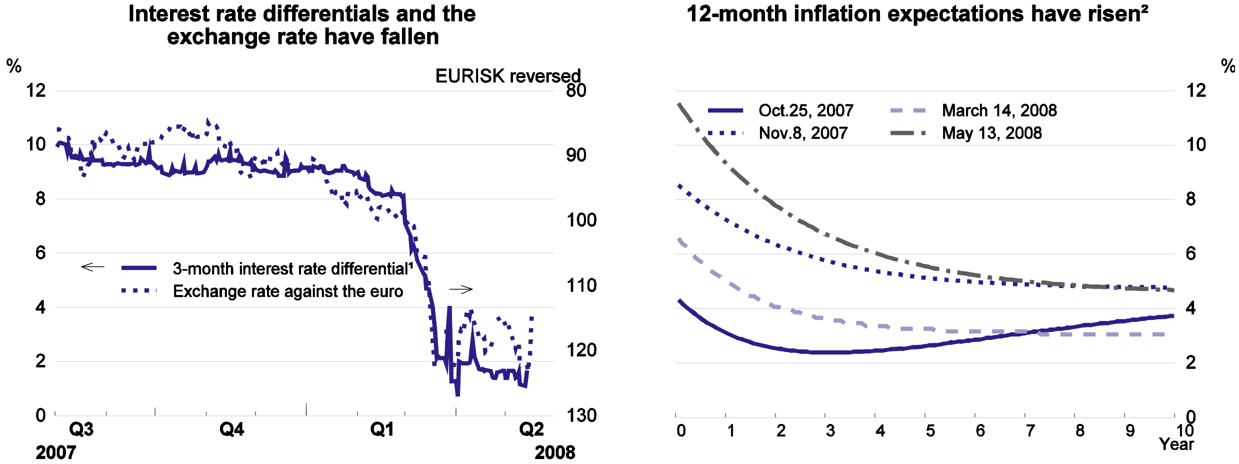
Economic growth is projected to fall sharply and unemployment to rise markedly. Following a large depreciation of the exchange rate, inflation is likely to soar this year but to fall subsequently as this effect passes. A further reduction in the current account deficit is anticipated.

Monetary policy should remain restrictive to ensure that the recent exchange rate depreciation does not have a lasting effect on inflation. The bilateral currency swap agreements reached with Nordic central banks in mid-May 2008 have bolstered international liquidity available to the Central Bank of Iceland, thus helping to rebuild confidence. In view of the uncertainty in international financial markets, it would be prudent for the authorities to accumulate further foreign exchange reserves. As well, in light of the expected slowdown of economic activity, they should continue to strengthen bank supervision.

Economic growth has started to slow sharply

The economy again grew strongly in 2007, prolonging the boom underway since 2004. However, activity began to weaken in the fourth quarter, when GDP growth fell to 1.4% (annual rate). The slowdown was manifest in most components of domestic demand. The entry into service of new capacity in aluminium smelting resulted in a very large increase in exports and fall in the current account deficit, to 15.6% of GDP in 2007.

Iceland



1. FX-implied ISK rates minus LIBOR.

2. Difference between forward nominal and indexed interest rates.

Source: Bloomberg; Central Bank of Iceland.

Employment growth slowed progressively over 2007 but remained robust, pushing the survey-based unemployment rate down to 2% by the end of the year. Despite very tight labour-market conditions, growth in wage rates fell to 7.7% year-on-year in the first quarter of 2008 from 10.1% a year earlier. Inflation declined during 2007 owing to a reduction in value-added tax (VAT) in March and the passing of the effects of the large exchange rate depreciation that had occurred earlier, but has since picked up strongly to 11.6% in the year to April 2008 as the base effects of the VAT reduction dropped out and the effects of the 20% depreciation of the exchange rate since the beginning of 2008 started to feed through. Inflation expectations are not well anchored, having risen in step with the depreciation of the exchange rate. The housing market has turned down following a large boom in recent years, reducing inflationary pressures.

Iceland: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices ISK billion	Percentage changes, volume (2000 prices)				
Private consumption	530.3	13.0	4.4	4.2	-0.9	-4.0
Government consumption	233.1	3.5	3.9	3.3	2.9	2.5
Gross fixed capital formation	218.5	35.7	20.4	-14.9	-5.7	-5.6
Final domestic demand	981.9	15.8	8.3	-1.5	-1.3	-2.9
Stockbuilding[1]	- 0.9	0.0	1.1	-1.0	-0.3	0.0
Total domestic demand	981.0	15.8	9.3	-2.3	-3.0	-3.0
Exports of goods and services	316.9	7.2	-5.0	18.1	6.5	4.9
Imports of goods and services	369.2	29.4	10.2	-1.4	-4.0	-1.5
Net exports[1]	- 52.3	-9.2	-6.1	6.5	4.1	2.8
GDP at market prices	928.7	7.5	4.4	3.8	0.4	-0.4
GDP deflator	_	2.8	9.0	5.5	9.1	6.2
Memorandum items						
Consumer price index	_	4.0	6.7	5.1	9.8	6.0
Private consumption deflator	_	1.9	7.6	4.5	9.0	6.0
Unemployment rate	_	2.6	2.9	2.3	3.4	5.7
General government financial balance[2]	_	4.9	6.3	5.2	2.2	-1.1
Current account balance[2]	_	-16.1	-25.0	-15.7	-13.3	-8.6

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Financial turmoil has severely restricted access to foreign capital

The economy is highly exposed to the global financial turmoil that began in mid-2007. The country's three largest banks have expanded aggressively offshore in recent years, increasing their total assets from less than 100% of GDP in 2000 to nine times that in 2007. Although these banks have little direct exposure to subprime loans in the United States and have relatively high capital and liquidity ratios, concerns have grown about their lack of access to a credible lender of last resort facility. Consequently, the price of credit default swaps (CDSs) for these banks has soared, reaching a peak of 1 000 basis points in late March, although this price has since declined by about 600 basis points. This has made borrowing in foreign markets expensive for these banks. It has also resulted in a drastic reduction in interest rate differentials between domestic and foreign interbank markets, and hence in the forward premium on foreign currency. This development precipitated the near collapse of the foreign exchange swap market and the precipitous decline of the spot exchange rate. The central bank increased its policy rate by 125 basis points to 15% in late March and by a further 50 basis points in early April to support the króna and reduce inflationary pressures; the policy rate is assumed to rise another 25 basis points in mid-2008 and only to begin falling again in the second quarter of 2009. The central bank also announced on 16 May 2008 euro/Icelandic króna bilateral swap facility agreements with the central banks of Sweden, Norway and Denmark of € 500 million each.

A recession is imminent

The economy is projected to contract until early next year, cutting economic growth to minus 0.4% for 2009 as a whole and opening up a large negative output gap. Consumption expenditure and residential construction are projected to be particularly weak. Large planned increases in public investment and a solid contribution from net exports should, however, attenuate the downturn. Unemployment is projected to soar to 5.7% in 2009. Inflation is likely to remain high in 2008 as the price effects of the depreciation pass through, but should subsequently fall back to around 4% year-on-year in late 2009. The current account deficit is projected to decline only modesty this year owing to J-curve effects, but should fall, to around 9% of GDP in 2009. The major risk surrounding this forecast is that the global credit crunch turns out to be more protracted than anticipated, deepening the economic downturn and causing further exchange rate depreciation.

IRELAND

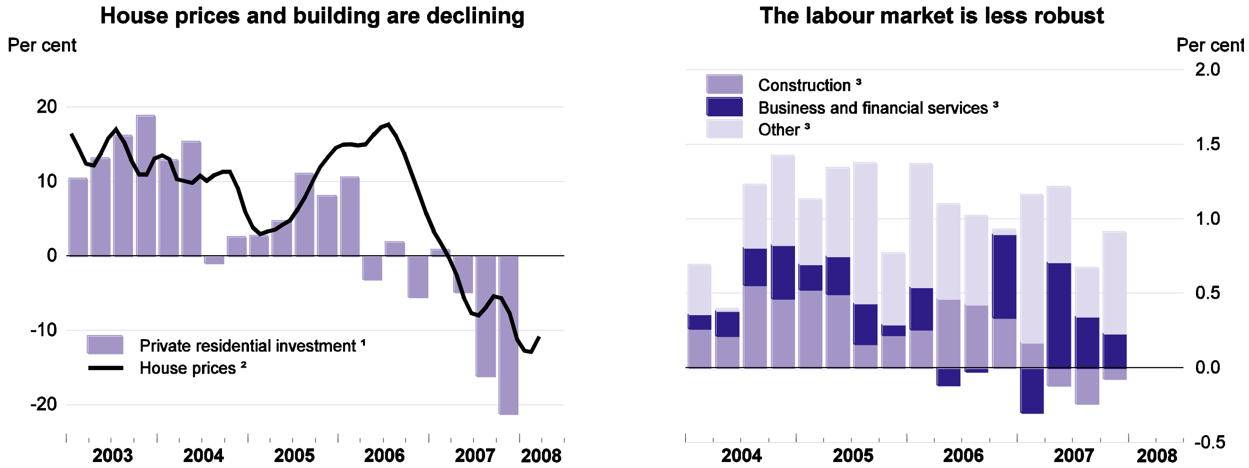
GDP growth slowed in the second half of 2007 and is expected to remain well below trend at 1½ per cent in 2008. The housing market continues to adjust, with further sharp reductions in house-building and falling house prices. Domestic demand will stay weak this year and into 2009, but GDP growth should turn around to reach 3¼ per cent in 2009 as the housing construction cycle bottoms out.

Wage restraint will be required in the short run to help maintain competitiveness and crowd in foreign demand. Public spending growth needs to slow substantially as set out in the budget for 2008. To improve public services, it will become even more important to get better value for money. Better economic performance requires stronger competition in network industries and sheltered service sectors, further raising education standards and doing more to encourage female labour force participation.

Activity has weakened

Economic activity slowed sharply during 2007. Consumption growth eased markedly in the second half of the year, partly because temporary supporting factors waned. Government consumption, non-residential business investment and net exports also weakened during the year. The main factor behind the slowdown, however, was the 21% fall in housing construction over the year, detracting around 1¼ per cent from annual GDP growth.

Ireland



1. Year-on-year percentage change.
2. National house price index, three-month moving average, percentage growth relative to previous three months, annual rate.
3. Quarter-on-quarter contributions to employment growth.

Source: OECD, Economic Outlook 83 database; Central Statistics Office and permanent tsb.

The housing market correction continues

The housing market is continuing to adjust: house-building is shrinking at a fast pace and house prices are falling. Although the impact on overall activity is partly mitigated by infrastructure projects and repairs, the volume of building and construction production is down by over 15% since its peak. The increase in construction jobs was an important driver of employment growth in recent years, but these jobs have fallen by 9% since their peak. House prices fell by 8.9% in the year to March 2008 and have been falling at a fast pace in recent months. Housing market transactions have slowed and loan approvals are down by almost a fifth.

Ireland: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices € billion	Percentage changes, volume (2005 prices)				
Private consumption	67.8	7.4	5.3	5.4	3.0	2.6
Government consumption	23.2	4.1	6.4	6.5	4.3	3.6
Gross fixed capital formation	35.1	11.9	3.0	-0.1	-9.2	1.5
Final domestic demand	126.1	8.0	4.8	4.0	-0.2	2.5
Stockbuilding[1]	0.1	-0.1	0.7	-1.0	0.0	0.0
Total domestic demand	126.2	8.0	5.7	2.8	-0.2	2.6
Exports of goods and services	124.8	5.2	4.5	8.2	5.0	3.8
Imports of goods and services	102.4	7.7	4.4	6.4	3.4	2.9
Net exports[1]	22.4	-1.0	0.6	2.1	1.6	1.1
GDP at market prices	148.6	5.9	5.7	4.0	1.5	3.3
GDP deflator	_	2.7	2.3	1.4	1.5	2.1
Memorandum items						
Harmonised index of consumer prices	_	2.2	2.7	2.9	3.4	2.1
Private consumption deflator	_	1.4	2.6	3.4	3.4	2.1
Unemployment rate	_	4.4	4.4	4.5	5.7	6.5
General government financial balance[2]	_	1.6	3.0	0.3	-1.3	-2.6
Current account balance[2]	_	-3.5	-4.2	-5.0	-5.0	-3.8

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

The labour market has softened

Employment growth eased substantially during 2007. The unemployment rate jumped to reach 5.5% in April compared with 4.8% in December. It remains to be seen how far a reduction in inward migration could mitigate the effect of the weakening job market on unemployment.

Growth will remain sluggish in the near term

GDP growth is set to remain sluggish in 2008 and well below its trend rate, before recovering modestly in 2009 as house-building bottoms out at a more sustainable level. Consumption growth should continue to ease over the coming year as house prices fall and weak consumer confidence, pressures on real incomes and the deterioration of the labour market all play a role. Business investment and government spending growth are expected to slow further. Net exports should contribute to growth, although both exports and imports are likely to slow. Headline inflation is projected to remain strong in the early part of 2008, reflecting sharp increases in energy and food prices, but will slow sharply thereafter. Core inflation should decelerate because of growing cyclical slack.

Public spending growth needs to slow

Tax revenues have slowed sharply as growth has eased and the property cycle has turned, although the effect this will have on the budget is hard to predict accurately. Current expenditure growth should slow in line with the budget for 2008. It is important to avoid locking-in further expensive commitments, particularly on public-sector pay.

Risks remain from housing and have increased from external developments

Many of the risks to the housing market have materialised, but there remains the possibility of a sharper correction. The impact on the wider economy could also be more severe than anticipated and it is important that external competitiveness improves to ensure that foreign demand is able to pick up some of the slack in the economy. Recent developments in the international economy have increased downside risks to activity. The Irish economy is very open to trade and has particularly strong links to the United Kingdom and the United States. The appreciation of the euro against both sterling and the dollar, as well as weakness in both economies, could have a more negative effect on exports and foreign direct investment than anticipated. Ireland may be particularly exposed to an international slowdown in financial and business services given its specialisation in these sectors.

KOREA

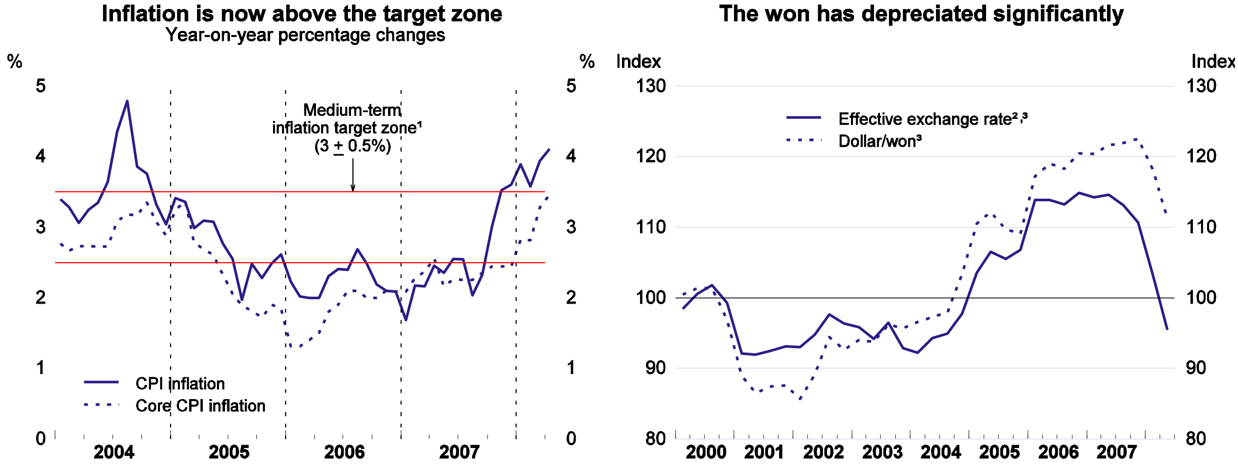
After a slowdown in 2008, reflecting weaker external demand and soaring oil prices, output growth is projected to increase to 5% in 2009, thanks to a pick-up in both exports and domestic demand. While rising import prices have pushed inflation above the central bank's target zone, slower growth in 2008 is likely to damp inflationary pressures.

Regulatory reform and measures to reverse the declining trend in inflows of foreign direct investment are essential to sustain high growth. Planned tax cuts should be accompanied by spending reductions to maintain Korea's strong fiscal position.

Output growth is slowing while inflation has accelerated…

Following two years of output growth at a 5% pace, signs of a slowdown have emerged, despite still-buoyant exports. Output growth decelerated in the first quarter of 2008 to less than 3% (seasonally-adjusted annual rate) and facility investment declined in the context of increasing uncertainty about the outlook for the world economy. Inventories of semiconductors in March 2008 were 52% above their year-earlier level, suggesting further weakness in production in this sector. Meanwhile, construction orders have fallen due to problems in the housing market, as the stock of unsold apartments reached its highest level since 1996. In addition to weaker business-sector confidence, the consumer sentiment

Korea



1. In 2007, the target was changed from core consumer price inflation to the overall consumer price inflation.
2. Calculated vis-à-vis 41 trading partners.
3. The figure for the second quarter of 2008 is the average of April and the first half of May.

Source: OECD Economic Outlook 83 database and Bank of Korea.

index has dropped from 92 in the third quarter of 2007 to 80 in the first quarter of 2008, while employment growth has slowed. Household income gains are being eroded by the pick-up in consumer price inflation to 3.8% in the first quarter of 2008 (year-on-year), slightly above the central bank's medium-term target zone of 2.5% to 3.5%.

Korea: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices KRW trillion	Percentage changes, volume (2000 prices)				
Private consumption	401.5	3.6	4.5	4.5	3.2	3.4
Government consumption	105.5	5.0	6.2	5.8	4.0	4.0
Gross fixed capital formation	230.2	2.4	3.6	4.0	1.8	3.8
Final domestic demand	737.2	3.4	4.4	4.5	2.8	3.6
Stockbuilding[1]	9.0	-0.2	-0.2	-0.4	0.2	0.0
Total domestic demand	746.2	3.2	4.2	4.1	3.1	3.6
Exports of goods and services	342.9	8.5	11.8	12.1	8.6	9.2
Imports of goods and services	309.6	7.3	11.3	11.9	7.4	7.8
Net exports[1]	33.2	1.3	1.3	1.3	1.6	1.8
GDP at market prices	779.4	4.2	5.1	5.0	4.3	5.0
GDP deflator	_	-0.2	-0.5	1.2	1.1	1.0
Memorandum items						
Consumer price index	_	2.8	2.2	2.5	4.0	3.2
Private consumption deflator	_	2.6	2.1	2.6	4.0	3.2
Unemployment rate	_	3.7	3.5	3.2	3.1	3.1
Household saving ratio[2]	_	4.7	3.4	2.5	2.5	2.5
General government financial balance[3]	_	3.0	3.6	4.6	4.5	4.4
Current account balance[3]	_	1.9	0.6	0.6	-0.9	-1.0

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of disposable income.
3. As a percentage of GDP.
Source: OECD Economic Outlook 83 database.

… leaving uncertainty about the monetary and fiscal policy response

The increase in inflation is partly explained by the rising oil import bill, which was 63% above its year-earlier level during the first quarter of 2008. The impact of higher energy prices was exacerbated by the depreciation of the won relative to the dollar, which itself has weakened against most other currencies. This has translated into a 19% effective depreciation since mid-2007, thereby easing monetary conditions. The pick-up in headline inflation has spilled over to core inflation (excluding food and energy), which increased from 2.4% in 2007 to 3% in the first quarter of 2008 (year-on-year). Faced with higher inflation and the prospects of slower growth, the Bank of Korea has left the short-term policy interest rate at 5% since mid-2007. Meanwhile, the government cut the tax on gasoline by 16% to mitigate the impact of higher energy prices and has promised to reduce the corporate tax rate imposed by the central government from 25% to 22%. In addition, there is discussion of a supplementary budget in 2008 to boost the economy, using extra fiscal revenue from 2007. However, the 2007 National Fiscal Act restricts the use of supplementary budgets to situations in which there is a risk of a recession or large-scale unemployment. Given the time needed to implement a supplementary budget, there is always a risk that its impact would be felt so late that it would have a pro-cyclical effect.

Growth is projected to pick up to 5% in 2009…

The economy is projected to bottom out in mid-2008 and to begin a gradual recovery that will see output growth in 2009 of 5%, close to Korea's potential growth rate. The upturn is likely to be led by a pick-up in exports, reflecting a rebound in overseas demand and the weaker exchange rate. Stronger exports, combined with the planned tax cuts, are expected to boost business investment. Inflation is projected to ease back towards the mid-point of the medium-term target zone in the context of slower growth and the stabilisation of energy and raw material prices. This will also help limit the current account deficit, which exceeded 2% of GDP during the first quarter of 2008, to around 1% for the year as a whole.

… although there are a number of risks

Given the importance of the information and communication technology sector (15% of GDP) and energy imports (10%), the Korean economy is very sensitive to world developments in these sectors. There are other risks, including the level of household debt, which has risen from 85% of disposable income in 1998 to nearly 150% in 2007. On the upside, the new government's business-friendly policies, such as regulatory reform, the negotiation of additional free trade agreements and measures to encourage inflows of foreign direct investment, may lead to a faster pick-up in growth in 2009.

LUXEMBOURG

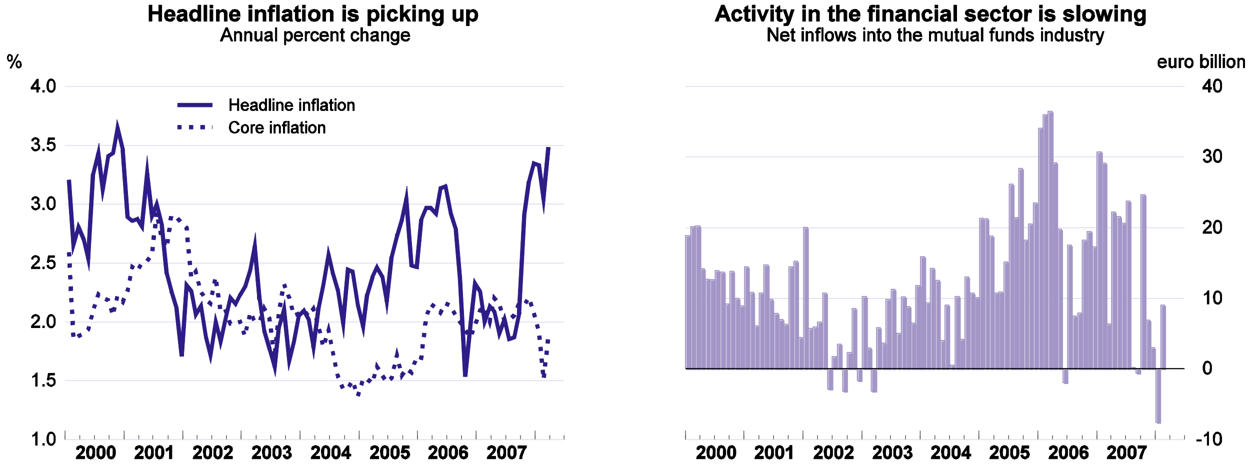
The economy expanded strongly once again during most of 2007, reflecting strong growth in the financial-services sector. The global financial turmoil has been taking its toll since the end of the year, as investors became more cautious and lower equity prices hit commission fees, weakening activity in 2008. Assuming a gradual normalization of financial markets, growth should return toward potential. Domestic demand is projected to remain relatively strong, boosted by fiscal measures. Unemployment is set to increase, while inflation should remain high as the rapid rise in oil and food prices is likely to feed into core inflation through higher wages.

After a large fiscal surplus last year, the budgetary position is projected to deteriorate as a consequence of the sharp slowdown in tax revenues from the financial sector. Automatic stabilisers should be allowed to operate during the downswing, but the government should abstain from discretionary fiscal measures.

The global financial turmoil takes its toll

Output growth was once again very strong in the first half of 2007, before slowing in the second half of the year and in early 2008. Domestic demand has remained rather buoyant, but the turmoil on international financial markets has started to impact on activity from mid-2007 onwards, reducing growth in exports of services. The financial sector appears to have escaped nearly unscathed from the subprime mortgage debacle, but financial institutions have nevertheless made a seven-fold increase in banking provisions, reducing financial results and hitting public tax

Luxembourg



Source: OECD, Main Economic Indicators; Commission de Surveillance du Secteur Financier.

receipts. Furthermore, net inflows into investment funds declined in early 2008, depressing earnings of financial institutions. Growth in business investment dropped at the end of the year as business sentiment softened

Inflationary pressures are expected to increase

Headline inflation accelerated from end-2007 onwards as the result of higher energy and food prices, reaching 3½ per cent year-on-year in spring 2008. At the same time, core inflation has fluctuated around 2%. However, wage indexation is likely to push core inflation upwards over the remainder of 2008. Employment growth remained strong during most of last year, with the number of job vacancies reaching an historical high. Labour market tensions continue to put pressure on the growth of private-sector wages, which exceeded 3% in 2007.

Luxembourg: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices € billion	Percentage changes, volume (2000 prices)				
Private consumption	10.9	3.7	2.1	2.0	2.0	2.2
Government consumption	4.6	2.6	2.0	2.4	2.8	2.1
Gross fixed capital formation	5.7	1.9	4.9	13.7	4.6	5.2
Final domestic demand	21.2	3.0	2.8	5.2	2.9	3.1
Stockbuilding[1]	- 0.1	1.1	-1.5	-1.0	-0.5	0.0
Total domestic demand	21.1	4.4	0.8	3.7	2.3	3.1
Exports of goods and services	40.7	6.4	9.7	5.5	5.0	4.0
Imports of goods and services	34.4	6.7	7.4	5.2	4.5	3.6
Net exports[1]	6.3	1.1	5.2	2.0	2.2	1.8
GDP at market prices	27.5	4.8	5.9	4.6	3.0	4.0
GDP deflator	_	4.4	6.3	2.1	1.3	1.8
Memorandum items						
Harmonised index of consumer prices	_	3.8	3.0	2.7	4.0	2.1
Private consumption deflator	_	2.9	2.9	2.5	3.3	2.1
Unemployment rate	_	4.7	4.4	4.4	4.5	4.9
General government financial balance[2]	_	-0.1	1.3	3.0	1.7	1.3
Current account balance[2]	_	11.1	10.5	9.9	9.0	9.2

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

A large government surplus re-emerged in 2007 but will fall

In 2007, the general government financial position improved markedly, with a surplus of 3% of GDP, due to better-than-expected revenues. The 2008 budget incorporates a mild fiscal easing, mostly on the revenue side. Moreover, tax revenues from the financial sector will contract sharply. In sum, the budget surplus is expected to halve.

Growth should fall below potential

Growth is projected to remain below potential in 2008 and then increase again, reflecting the normalization of international financial markets. Domestic demand should accelerate at the end of the projection horizon thanks to renewed strength of consumption and residential investment. Despite some expected labour hoarding of high skilled workers, unemployment is likely to increase as the expansion of labour supply outpaces that of employment. The easing of labour market tensions should put downward pressure on wage inflation towards the end of the projection period. Nevertheless, in the near term wages will continue to grow strongly as high headline inflation feeds into the wage indexation mechanism. Headline inflation will start to come down towards the end of 2008, when the effects of higher oil and commodity prices dissipate. Nevertheless, there is a risk that wage indexation creates more persistence in inflation than projected. The main uncertainty relates to the duration and severity of the turmoil on the international financial markets. Although there are some downside risks in the short term, once the financial turmoil abates the bounce back in Luxembourg could be sharper than projected.

MEXICO

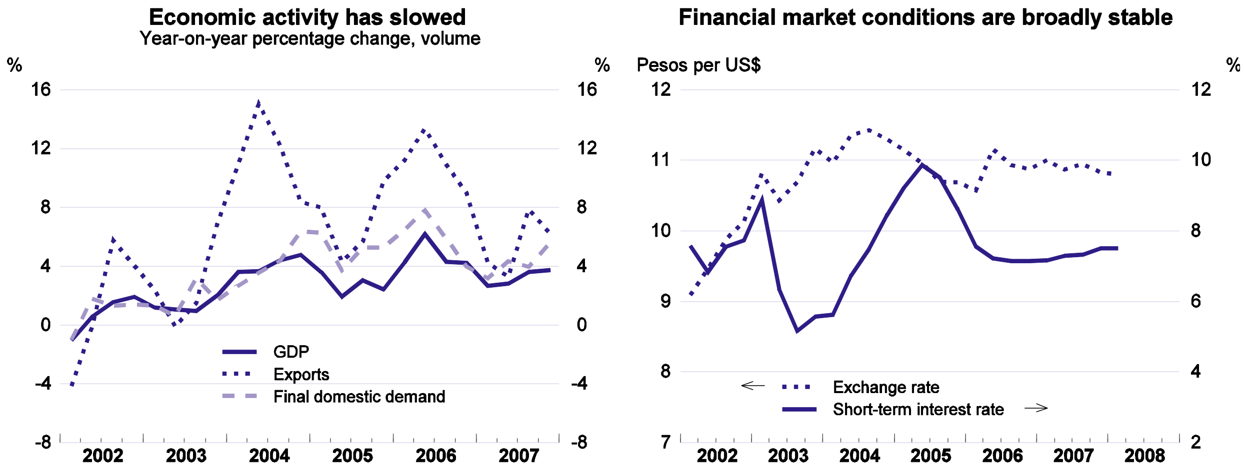
After a slowdown in 2008, reflecting weaker external demand, growth is set to pick up to 3.3% in 2009. The approval of the fiscal reform should boost business confidence, underpinning stronger domestic and foreign investment, while the new infrastructure fund is expected to lift public investment. Inflation is projected to remain close to 4% until end-2008, easing back thereafter, and the current account deficit is expected to widen gradually.

Balancing inflation pressures and higher risks of a slowdown, the central bank kept the interest rate target unchanged at its May meeting. The recent tax reform should increase tax receipts and reduce reliance on oil revenue. To improve longer-run growth prospects, priority should be given to improving public spending efficiency and to renewed efforts to enhance product market competition.

Economic activity slowed in late 2007

Household consumption has weakened since mid-2007, but private investment has been expanding briskly and exports have outpaced the growth of export markets, both in the United States and increasingly in other regions. Imports have increased more rapidly, however, and net foreign trade has acted as a drag on GDP growth. Terms-of-trade gains have contained the deterioration in the current account deficit, which remained below 1% of GDP. Foreign direct investment (FDI) inflows continued on a large scale, at around 2% of GDP. Employment in the formal sector expanded rapidly until end-year, including in construction and services.

Mexico



Source: OECD Economic Outlook 83 database and Bank of Mexico.

After a pick up, inflation is expected to ease in 2009

Food prices rose sharply in April 2008, pushing inflation up to 4.6% (year-on-year), above the variability interval around the central bank's 3% target. Core inflation has also been creeping up, largely on account of processed food, and over the past six months it has remained just above or at headline inflation. Inflation expectations for end-2008 have climbed to just above 4%, but they come back down by ½ percentage point at the end-2009 horizon. Contractual wage awards have remained around 4½ per cent. After inching up in late 2007, short-term interest rates eased somewhat and remained broadly unchanged at 7.5% in recent months. Faced with stronger inflationary pressures and greater risks of slower growth arising from the sharp slowdown in the United States, the Bank of Mexico left the overnight interbank interest rate target unchanged at its May meeting. The OECD projections rest on the assumption that interest rates will start declining in the third quarter of 2008, as below par growth should exert a moderating influence on inflationary pressures over the forecast horizon.

Mexico: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices MXN billion	Percentage changes, volume (1993 prices)				
Private consumption	5 254.3	5.1	5.0	4.1	3.2	4.2
Government consumption	912.2	0.2	6.1	0.6	4.4	3.1
Gross fixed capital formation	1 512.6	7.6	9.9	6.6	7.8	7.6
Final domestic demand	7 679.2	5.2	6.1	4.4	4.3	4.9
Stockbuilding[1]	186.1	-1.6	-0.7	0.1	0.0	0.0
Total domestic demand	7 865.3	3.5	5.4	4.5	4.3	4.9
Exports of goods and services	2 279.4	7.0	11.1	5.5	4.4	3.9
Imports of goods and services	2 434.5	8.5	12.1	8.1	7.5	7.2
Net exports[1]	- 155.1	-0.8	-0.8	-1.4	-1.7	-1.9
GDP at market prices	7 710.2	2.8	4.8	3.3	2.8	3.3
GDP deflator	_	5.6	4.5	3.2	5.3	3.4
Memorandum items						
Consumer price index	_	4.0	3.6	4.0	4.4	3.3
Private consumption deflator	_	3.3	3.4	4.3	4.3	3.4
Unemployment rate[2]	_	3.5	3.2	3.4	3.7	3.6
Current account balance[3]	_	-0.7	-0.3	-0.8	-1.0	-2.0

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. Based on National Employment Survey.
3. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Fiscal stimulus is in train

The 2007 budget turned out in balance, as foreseen in the budget bill, and the public sector borrowing requirement was 1.3% of GDP. Oil and non-oil revenue were higher than expected. In the case of oil revenue, the high price of oil more than offset the impact from lower volumes of production and exports. An important tax reform was passed in September introducing, in particular, a minimum income tax on firms and professional activities. The 2008 budget targets a balanced budget, with a reduction in oil-related revenue as a proportion of GDP but an increase in tax revenue as a result of the tax reform. Overall, higher budget revenues are projected, helping to finance additional spending on infrastructure, healthcare and education. An infrastructure fund was introduced in February 2008, to support investment programmes starting in 2008. In March, a stimulus package was introduced granting immediate reductions in taxes on firms and in employer social security contributions. Furthermore, development bank credit is set to expand significantly.

Growth is set to slow in the near future

Private consumption growth is likely to be slightly weaker this year than in 2007, reflecting lower real wage gains and less buoyant migrants' remittances. However, the fiscal stimulus and infrastructure projects should underpin strong private and public investment over the projection period. Reflecting the slowdown in the US economy, exports are projected to expand only moderately this year and net exports should continue to exert a drag on growth. GDP growth is set to dip slightly under 3% in 2008 but should regain strength in 2009 as the external headwinds abate. The current account deficit is projected to widen somewhat, to 2% of GDP in 2009, while FDI is expected to continue to flow in on a large scale.

A longer or sharper US slowdown is the main risk

The main risk to the outlook is that the recovery in the United States is delayed, denting Mexico's exports more durably. That said, there are also uncertainties on the upside, related to a more speedy US recovery, a better-than-expected export market performance and stronger-than-projected public revenue and spending.

NETHERLANDS

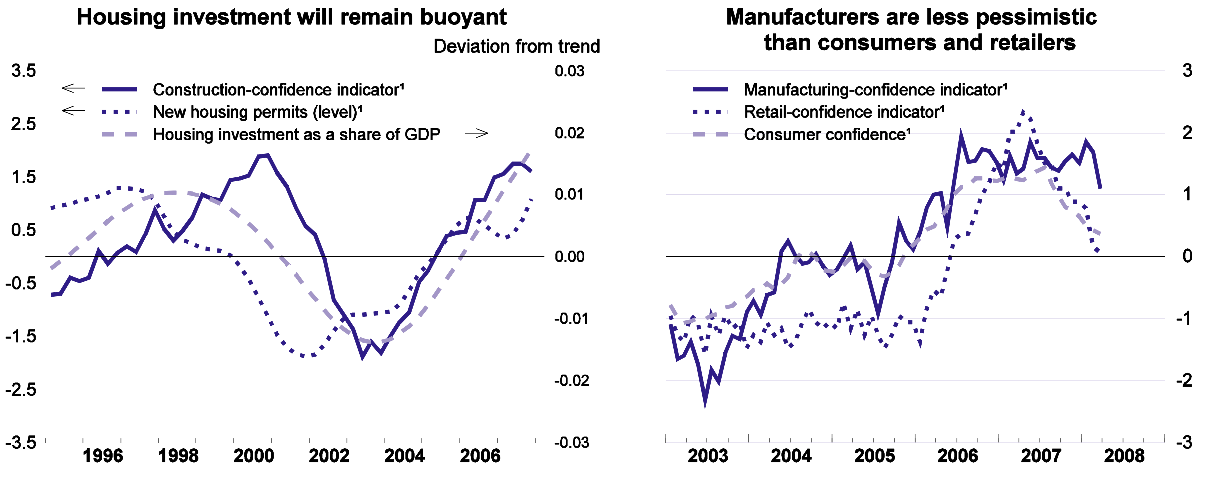
After enjoying a strong expansion during the past two years, the Dutch economy softened in early 2008, reflecting tighter international financial conditions and slower world trade. Growth should remain moderate in the near term, followed by recovery in the course of 2009, bringing the pace of growth back above potential. Despite the softening of activity, the output gap should remain positive in the near term and widen thereafter. Labour shortages are likely to persist, partly reflecting population ageing, implying that core inflation is expected to edge up.

Given the unusual uncertainty in short-term economic prospects, the government should be ready to let automatic stabilisers operate freely.

Activity took a hit at the beginning of 2008…

Following another year of above-trend growth, output slowed markedly at the beginning of 2008. Export growth declined in reaction to the further appreciation of the euro and lower-than-expected expansion of world trade. As well, private consumption decelerated, in line with weakening household confidence. Business sentiment nevertheless stayed firm in the manufacturing sector and residential investment remained robust on the back of higher real house prices. Order book levels have reached historic highs. Hence, despite the global slowdown, there is still considerable momentum in the Dutch economy.

Netherlands



1. The indicator is around the historical average. The series is presented in units of standard deviation.

Source: OECD, Main Economic Indicators 2008; OECD Economic Outlook 83 database; and Statistics Netherlands, 2008.

… but the labour market remained tight

The labour market remained tight at the start of the year. The number of job vacancies has reached an historic high, while the unemployment rate (national definition) fell to 4.1% in early 2008, dropping below its estimated structural level. The tighter labour market also had an impact on contractual wages, which started to move up, reaching 2.7% in 2007. Consumer price inflation also started to rise, reaching almost 2% in 2008Q1, but is set to accelerate in the second half of the year, as the effects of higher oil prices feed into retail energy prices due to a relatively long delay in adjusting contractual natural gas prices.

Netherlands: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices € billion	Percentage changes, volume (2000 prices)				
Private consumption[1]	242.8	0.7	-0.8	2.1	2.1	1.2
Government consumption[1]	118.9	0.0	9.4	2.7	0.3	0.8
Gross fixed capital formation	92.4	3.0	7.2	5.1	5.8	2.8
Final domestic demand	454.1	1.0	3.5	2.9	2.4	1.5
Stockbuilding[2]	0.8	-0.1	-0.1	-0.2	0.1	0.1
Total domestic demand	455.0	0.9	3.4	2.6	2.5	1.5
Exports of goods and services	326.1	5.9	7.0	6.4	4.2	3.0
Imports of goods and services	289.9	5.5	8.1	5.5	5.3	2.7
Net exports[2]	36.2	0.7	-0.1	1.0	-0.4	0.4
GDP at market prices	491.2	1.5	3.0	3.5	2.3	1.8
GDP deflator	_	2.1	1.9	1.2	1.4	2.2
Memorandum items						
Harmonised index of consumer prices	_	1.5	1.7	1.6	2.4	3.0
Private consumption deflator	_	2.1	2.3	1.7	2.8	2.8
Unemployment rate	_	4.9	4.1	3.3	2.6	2.7
Household saving ratio[3]	_	6.3	6.4	7.2	6.9	6.4
General government financial balance[4]	_	-0.3	0.5	0.4	1.1	1.4
Current account balance[4]	_	7.2	8.3	6.5	6.1	5.9

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. The introduction of a health care insurance reform in 2006 caused, in national accounts, a shift of health care spending from private consumption to public consumption.
2. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
3. As a percentage of disposable income, including savings in life insurance and pension schemes.
4. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

The fiscal position remains strong

Despite the strong expansion of activity, the general government budget surplus did not improve in 2007, due to expenditure overruns and lower gas related revenues. The budget balance should improve in 2008, mainly reflecting cyclical improvements as well as the resumed increase in gas-related budget receipts. The budget should improve further in 2009 on the back of stronger economic growth and because of significant fiscal measures in the form of the announced raising of the general value-added tax (VAT) rate from 19% to 20% and the reduction of unemployment benefits for the younger unemployed.

Growth should return above its potential rate…

After the near-term slowdown, growth should return above potential in the course of next year. Domestic demand is expected to regain speed, reflecting strong private consumption on the back of high employment growth and rising real wages. Business investment is likely to soften only temporarily, reflecting tighter monetary conditions. Residential construction should cool off only slightly. Excess demand on the labour market should ease somewhat, but unemployment is set to remain below its structural rate, leading to a continuous increase in wage inflation throughout the projection horizon and putting upward pressures on consumer prices. Inflation will be boosted further in 2009 due to the increase in the general VAT rate. Apart from the short term impact of this measure, domestic demand will grow robustly. On the other hand domestic production will be held back by capacity constraints, notably on the labour market. Thus domestic demand will be increasingly met by rising imports.

… although there are risks pertaining to global economic prospects

Downward risks continue to be related to international developments, notably high uncertainty on financial markets. Moreover, faster-than-projected growth in wages could boost consumer price inflation even further after the hike in VAT rates in 2009.

NEW ZEALAND

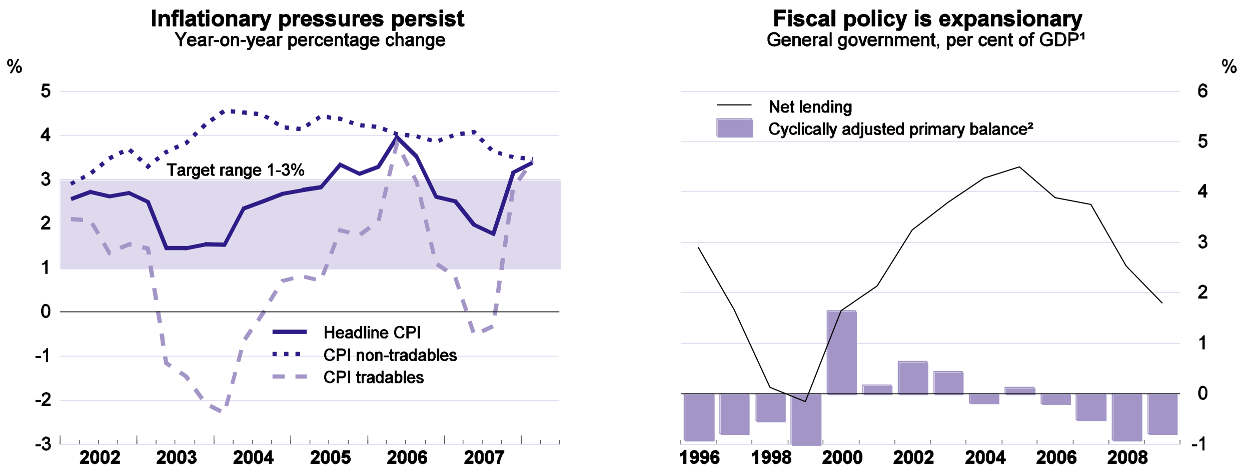
Strong growth, booming commodity prices, tight labour markets and capacity constraints have driven up inflation recently, requiring a very tight monetary policy stance since mid-2007. Real exchange rate appreciation, tight credit and widening credit spreads, together with drought conditions, are provoking slower growth in 2008. A widening output gap should reduce inflation pressure by year-end, allowing monetary policy to be eased and growth to pick up in 2009.

Personal and corporate income tax cuts are a good use of the budget surplus, and the low level of gross public debt will help to prepare for population ageing. However, heavy foreign debt is a point of vulnerability, especially if external funding were to dry up. It is important to reduce tax distortions favouring housing over productive investments, as well as those that discourage labour supply.

Demand is slowing

The economy grew by 3½ per cent in 2007, driven by record commodity prices, greater housing wealth and robust wage and employment growth in the context of tight labour markets. Housing investment faltered by year-end, reflecting the pass-through of high policy interest rates into borrowing costs, topped up by widening interest margins.

New Zealand



1. Per cent of potential GDP for cyclically adjusted primary balance.

2. Change from previous year. Negative sign denotes a fiscal expansion, positive sign a fiscal restriction.

Source: Statistics New Zealand and OECD Economic Outlook 83 database.

Thus far in 2008, soft retail and slow house sales together with a sharp decline in consumer confidence suggest substantial further demand weakening. Consumers face headwinds from higher interest rates and inflation, and smaller house price rises are hitting balance sheets. Moreover, employment fell sharply in the first quarter, though a decline in labour market participation limited the increase in unemployment that occurred. Net outward migration (mostly to Australia) has been intensifying domestic labour-market tightness and has contributed to the weakness in the housing market. Drought conditions have prevented exporters from profiting more fully from elevated dairy prices, while the high exchange rate is squeezing tradable-goods producers. Business confidence has plummeted in response to decelerating demand and profits, pointing to easing investment despite record capacity utilisation, and labour and skills shortages.

New Zealand: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices NZD billion	Percentage changes, volume (1995/1996 prices)				
Private consumption	86.3	5.0	2.5	4.3	1.5	2.2
Government consumption	25.9	4.2	4.7	4.4	4.2	3.0
Gross fixed capital formation	34.8	3.9	-1.6	4.9	1.9	0.9
Final domestic demand	147.0	4.6	1.9	4.5	2.1	2.1
Stockbuilding[1]	0.0	-0.2	-0.7	0.3	-0.5	0.0
Total domestic demand	148.7	4.3	1.0	5.0	1.7	2.1
Exports of goods and services	43.1	-0.4	1.7	3.6	3.2	4.2
Imports of goods and services	43.8	5.4	-2.8	8.9	4.7	4.1
Net exports[1]	- 0.7	-1.7	1.3	-1.7	-0.5	0.0
GDP at market prices	147.9	2.8	2.3	3.4	1.3	2.1
GDP deflator	_	1.8	2.4	4.1	3.9	1.8
Memorandum items						
GDP (production)	_	2.7	1.5	3.1	1.6	2.1
Consumer price index	_	3.0	3.4	2.4	3.4	2.8
Private consumption deflator	_	1.8	2.8	1.7	2.7	2.2
Unemployment rate	_	3.7	3.8	3.6	3.8	3.8
General government financial balance[2]	_	4.5	3.9	3.8	2.5	1.8
Current account balance[2]	_	-8.5	-8.6	-7.9	-7.7	-8.1

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Yet inflation keeps rising

Consumer price inflation rose further to reach 3.4% in the first quarter of 2008, above the Reserve Bank's target band, led by price rises for food, petrol, electricity, rents and education. After correcting for increased subsidies to education and health, non-tradables inflation was close to 4%. Firms' pricing intentions and widespread cost increases point to even higher inflation ahead. Despite the weakening economy and downside global financial risks, the Reserve Bank has sent a strong anti-inflation signal in maintaining its official cash rate unchanged at 8¼ per cent, well above the OECD's estimate of the neutral rate. The government's recent decision to delay the introduction date for parts of a greenhouse gas emissions trading scheme removes an additional contributor to near-term inflation pressures.

Fiscal policy stimulus is ample

A medium-term (2008-12) fiscal stimulus of nearly 2¾ per cent of GDP was announced with the 2007 and 2008 budgets, with main new measures appearing on the tax side. The corporate tax rate was cut from 33 to 30% on 1 April 2008, and the government signalled its intention to cut personal income taxes going forward. Together with NZD 1 billion less than expected investment returns by New Zealand Superannuation and other government funds in 2007, this fiscal expansion will slow and eventually net asset accumulation ongoing since 2002.

Imbalances in the economy should unwind

GDP growth is projected to slow to under 1½ per cent in 2008, given the damping effect of high interest rates and inflation on domestic demand, and that of exchange-rate appreciation and drought on net exports. After peaking around mid-2008, inflation should abate as persistently tight monetary policy results in a widening of the negative output gap. It is assumed that the Bank could start easing by end-2008 or early 2009. Together with the return to normal weather patterns, this should enable growth to rebound, reaching a 2½ per cent annual rate by end-2009 while inflation moderates to 2½ per cent. The current account deficit should stabilise at around 8% of GDP.

Risks appear symmetric

Further global financial turbulence could harm growth prospects, given substantial external indebtedness boosted by annual current account deficits of 7 to 10% of GDP since 2004, with most such borrowing having been channelled into consumption and housing rather than business investment. Even so, persistently tight labour markets and energy price rises imply upside risks to inflation.

NORWAY

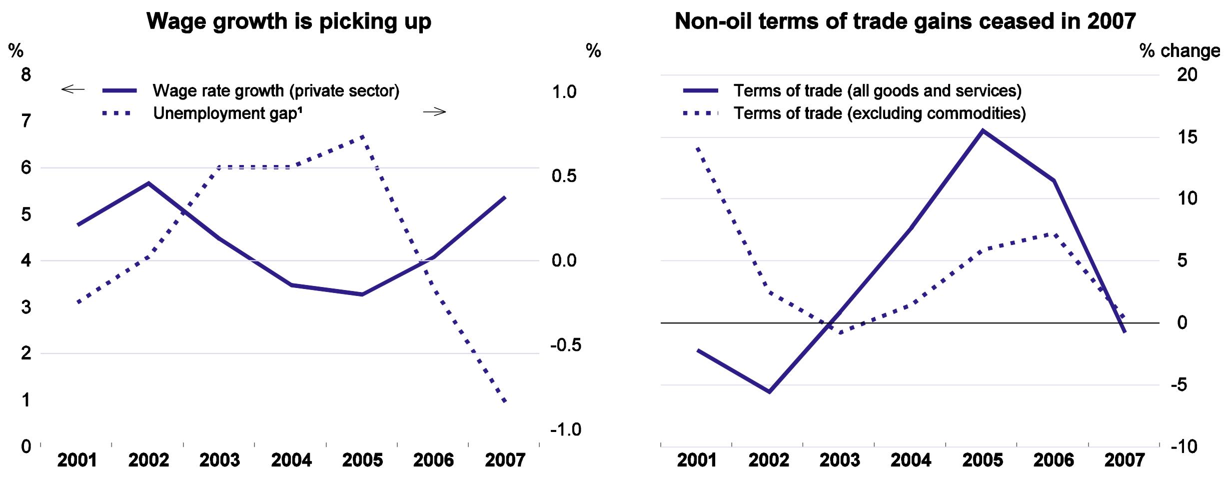
After reaching a peak last year, the growth of activity in mainland Norway is projected to gradually moderate in 2008-09. Wage increases are currently edging up and import prices are no longer declining, both with unfavourable effects for inflation prospects and real incomes. The high level of household gross debt is projected to weigh on private consumption and lead to a higher personal saving ratio.

In a situation where demand appears to have already weakened and financial conditions are uncertain, macro policies need to remain tight but alert for further signs of a slowdown in activity or of greater-than-expected inflation. Policies in the field of innovation and product-market competition, aimed at preserving strong productivity growth, are needed to contain unit labour costs.

A supercharged economy

Outperforming expectations, the mainland economy grew very rapidly until the final quarter of 2007. Driven by domestic demand, which in turn was sustained by an acceleration of incomes and profits, GDP growth was the strongest since the early 1970s. In the wake of surging oil prices, oil production rebounded from a falling trend. As capacity utilisation hit record-high levels, imports accelerated markedly in the second half of 2007. By contrast, growth was weak in early 2008 as domestic demand slowed, although employment growth continued quite strongly.

Norway



1. The unemployment gap is calculated as the actual unemployment rate minus the estimated structural unemployment rate.

Source: Norwegian Technical Committee for wage settlement; OECD Economic Outlook 83 database.

Tight macroeconomic policies

With a labour market more under strain than ever, wages have grown rapidly but unit labour cost growth remained under check, thanks to strong productivity. Inflation (both headline and core) was subdued until the final quarter of 2007, but the picture is now changing fast: import prices are no longer falling and domestic inflation is starting to bite. Concerned about overheating, the Norges Bank increased interest rates further. On the fiscal side the structural non-oil deficit was lower than expected, unchanged from 2006, and the 4% fiscal rule (according to which an average, over the cycle, of 4% of the value of the Pension Fund is transferred to the budget every year) was significantly undershot for the first time since its inception, with almost no transfer of oil-related fiscal resources to the budget.

Norway: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices NOK billion	Percentage changes, volume (2005 prices)				
Private consumption	786.0	4.0	4.7	6.4	3.9	2.6
Government consumption	373.3	0.7	2.9	3.2	3.1	2.0
Gross fixed capital formation	314.2	13.3	7.3	9.6	4.9	1.3
Final domestic demand	1 473.5	5.2	4.9	6.4	3.9	2.1
Stockbuilding[1]	33.7	0.4	0.7	-0.6	0.3	0.0
Total domestic demand	1 507.2	5.5	5.5	5.4	4.3	2.1
Exports of goods and services	732.7	1.1	0.4	3.2	1.9	2.6
Imports of goods and services	496.8	8.7	8.1	8.6	6.5	4.1
Net exports[1]	235.9	-2.0	-2.1	-0.9	-1.1	0.1
GDP at market prices	1 743.0	2.7	2.5	3.5	2.6	1.8
GDP deflator	_	8.7	8.4	2.3	8.3	1.8
Memorandum items						
Mainland GDP at market prices[2]	_	4.6	4.8	6.0	3.3	1.5
Consumer price index	_	1.5	2.3	0.7	3.6	2.5
Private consumption deflator	_	1.1	2.1	0.7	3.2	2.5
Unemployment rate	_	4.6	3.4	2.5	2.5	2.8
Household saving ratio[3]	_	10.1	0.1	-1.2	-0.5	1.4
General government financial balance[4]	_	15.1	18.5	17.3	17.9	17.1
Current account balance[4]	_	16.3	17.3	16.4	19.4	18.6

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. GDP excluding oil and shipping.
3. As a percentage of disposable income.
4. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Output is expected to slow

There are opposing forces driving the economy. The ongoing wage negotiation is expected to result in further strong wage increases and employment growth is still very high. Consumption and investment have seen four years of strong growth until early 2008, when consumption slowed considerably and investment fell. Household financial positions have weakened considerably, with household debt servicing absorbing over 10% of disposable income. Together with rising interest rates and higher inflation, this exerts a drag on consumption. Business prospects are deteriorating, as a result of the weaker external outlook, rising unit labour costs and expectations of falling profits. Although there are few signs of serious credit crunch effects, monetary conditions are becoming more restrictive. Credit growth to the private sector has started to suffer from tighter lending conditions in the wake of international financial turbulences. High oil prices and interest-rate differentials with trading partners put upward pressure on the currency, but non-commodity terms of trade are nonetheless deteriorating. The monetary policy stance remains tight, augmented by the higher-than-usual spread between money market and policy interest rates. After a pause in 2007, the fiscal stimulus will by contrast increase again in 2008, with higher public expenditure.

Challenging time for macroeconomic policies

Overall, growth in the mainland economy is projected to slow considerably from the exceptional pace of the past two years. The moderating forces already noted are expected to put downward pressure on demand, and activity will grow below potential. This will bring domestic demand more into line with the economy's production capacity, reducing the output gap and easing inflationary pressures. Nevertheless, the balance of risks looks challenging. On the upside, labour market pressure could continue for some time, with continued demand for labour keeping unemployment low, so that large wage increases could persist in the near term. On the downside, the high household debt burden and cooling housing market may hit private consumption and investment more than projected. Tighter lending conditions, which are already affecting the private sector, may also turn out to be more severe if there are further tensions in financial markets where Norwegian banks are significant borrowers. Finally, external risks include a possible terms of trade deterioration and the consequences for competitiveness of the still widening gap between fast-growing Norwegian wages and those in its trading partners.

POLAND

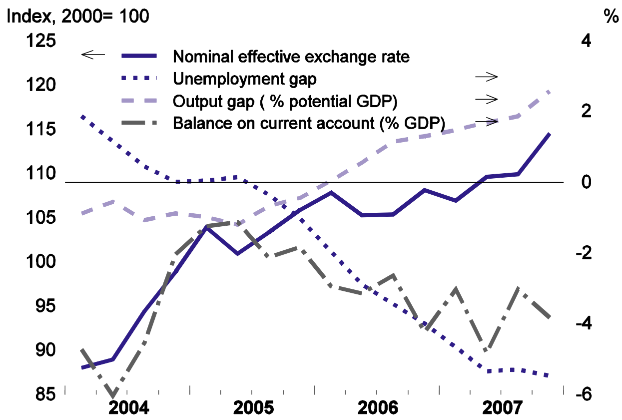
The rapid pace of economic expansion has continued, fuelled by robust investment and private consumption. The labour market has tightened further, leading to double-digit wage increases. This, combined with soaring fuel and food prices, hikes in regulated tariffs and general excess-demand pressures, has pushed the inflation rate well above the central bank's target. With enormous real income gains, the economy should continue to expand above potential rates for some time, resulting in a widening current account deficit.

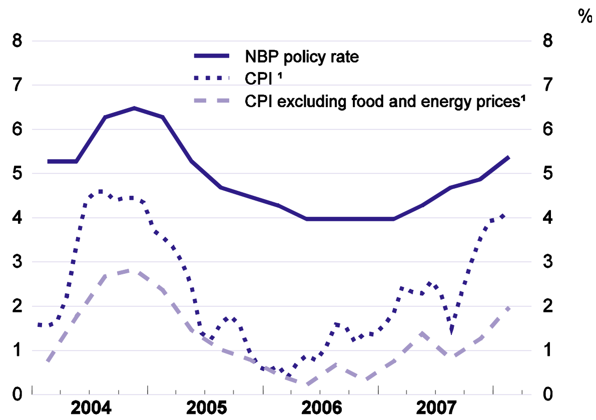
The budget balance has improved markedly, partly due to buoyant cyclical revenues and lower-than-expected expenditures. But a loosening of fiscal policy in 2008 is complicating the task of the monetary authorities, and further substantial interest rate increases will be needed to bring inflation back towards the official target. Limiting access to early retirement schemes would help achieve a better policy mix by reducing government spending while boosting much needed labour supply.

Economic activity has remained buoyant

The economy has sustained its momentum: real GDP increased 6.8% (year-on-year) in the final quarter of 2007 and by 6.6% on average over the year. The latest data confirm that the pace of activity remains fairly robust, propelled by domestic demand and an only limited impact thus far from the global slowdown. Higher transfers of EU funds, robust economic prospects, significant foreign direct investment, healthy financial positions

Poland





1. Year-on-year changes.

Source: OECD Economic Outlook 83 database; National Bank of Poland; Central Statistical Office (GUS); OECD calculations based on National Bank of Poland; and Eurostat data.

of firms and favourable lending terms have all contributed to buoyant investment outcomes. Household expenditure, which rose less quickly than GDP, has been supported by rising employment, substantial wage gains, lower social security contributions and steadily growing bank lending. Despite strong export growth, net exports have subtracted substantially from GDP.

Poland: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices PLZ billion	Percentage changes, volume (2000 prices)				
Private consumption	594.7	2.0	4.8	5.2	6.1	5.7
Government consumption	162.7	5.2	5.8	5.8	6.1	3.0
Gross fixed capital formation	167.2	6.5	15.6	19.3	16.5	11.3
Final domestic demand	924.5	3.4	7.0	8.1	8.4	6.5
Stockbuilding[1]	18.4	-0.9	0.4	0.4	0.2	0.0
Total domestic demand	942.9	2.4	7.3	8.3	8.5	6.4
Exports of goods and services	346.6	7.9	14.6	8.5	9.6	8.0
Imports of goods and services	365.0	4.6	17.4	12.3	15.4	11.1
Net exports[1]	- 18.3	1.2	-1.1	-1.7	-2.7	-1.6
GDP at market prices	924.5	3.6	6.2	6.6	5.9	5.0
GDP deflator	_	2.6	1.5	3.2	5.6	6.6
Memorandum items						
Consumer price index	_	2.2	1.3	2.5	4.5	5.5
Private consumption deflator	_	2.1	1.2	2.3	3.9	5.4
Unemployment rate	_	17.7	13.8	9.6	7.8	6.9
General government financial balance[2,3]	_	-4.3	-3.8	-2.0	-2.6	-2.7
Current account balance[2]	_	-1.2	-2.7	-3.7	-4.5	-5.6

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.
3. With private pension funds (OFE) classified outside the general government sector.

Source: OECD Economic Outlook 83 database.

Unit labour costs have surged

Unemployment has continued to fall rapidly, but the high job creation, a record since the start of the transition process, has not resulted in any major improvement in labour force participation, which has remained at a very low level. With wage compensation growth of around 9% not matched by comparable labour-productivity gains, unit labour cost increases surged to close to 7% (year-on-year) at end-2007.

Fiscal policy should support the inflation fight

The general government deficit was significantly reduced to around 2% of GDP in 2007, partly due to structural improvements but also because of the strength of the current upswing, which led to cyclical revenue surprises and lower-than-budgeted expenditures, particularly on unemployment benefits. Even though the central government budget recorded a cash surplus in the first quarter of 2008, a number of measures are contributing to a sizeable fiscal stimulus this year. A significant reduction in public spending would help the central bank in combating inflationary pressures. In this respect, the government's programme "50+", which aims at increasing the participation rate of older workers, notably by eliminating most early retirement schemes, would also help to lighten wage pressures.

Monetary conditions have to be tightened more

Consumer price inflation reached 4% in the year to April 2008, and the central bank has continued the tightening cycle, raising official rates by ¾ per cent thus far this year. Even though the nominal effective exchange rate has appreciated rapidly, price pressures can be expected to intensify further as a result of a jump in quasi-regulated prices (gas, electricity, tobacco, rentals, heating, refuse collection), as well as tight capacity conditions in labour and product markets. Given the extent of the positive output gap -- estimated at around 2.5% of potential GDP in 2008 -- and the current level of real interest rates, these projections embody an increase in the policy rate to 7 per cent by the end of the year, though further currency appreciation could assist in the fight against overheating.

Growth may edge down

The economy is projected to grow at a rapid, albeit slowing pace in 2008 and 2009, above estimated potential rates for most of the period. Consumption and investment are expected to move up briskly before decelerating in 2009 under the weight of tighter monetary conditions. The current account deficit will continue to widen but should be easily financed by long-term capital inflows. Given the lags in the monetary transmission process and the strength of excess demand, the inflation rate is projected to pick up further and reach 5.5% in 2009.

Second-round effects are a concern

Mounting price pressures and an insufficient anchoring of inflation expectations, entail the risk of triggering second-round effects that could prove costly to reverse. Capital outflows from emerging markets as a consequence of the global turmoil could reverse the recent appreciation, further adding to inflation dynamics. A sharper slowdown in economic activity would follow.

PORTUGAL

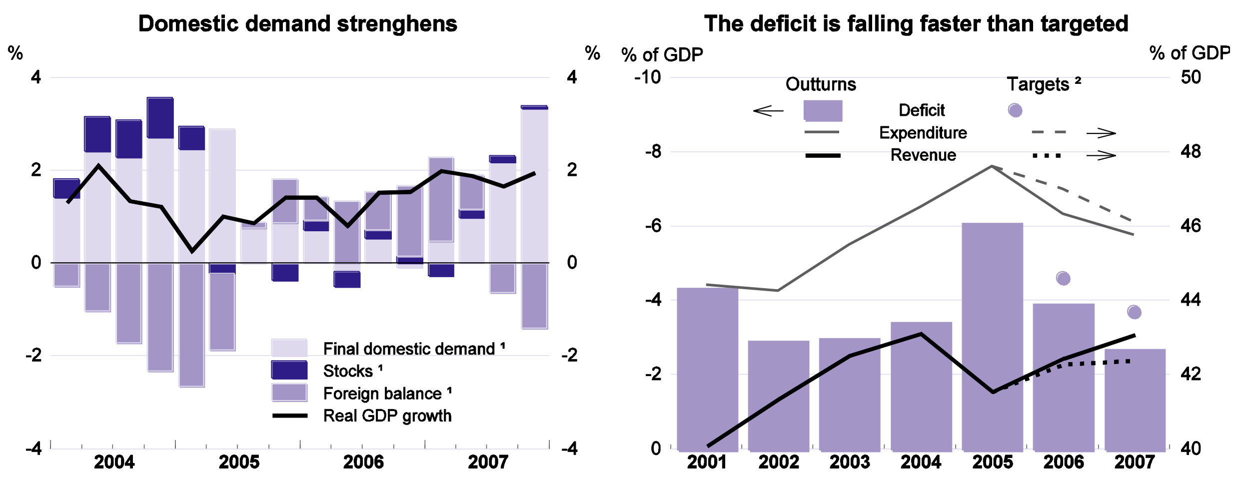
The expansion, which has been increasingly underpinned by domestic demand, continued in 2007. Growth is expected to slow somewhat in 2008 and 2009 owing to a weaker world economy and tighter credit market conditions. Accordingly, the unemployment rate is likely to remain at its current high level. A sizeable negative output gap is expected to contain underlying inflation pressures despite higher food and energy prices.

The budget deficit shrank further in 2007, falling below 3% of GDP. Additional fiscal consolidation and structural reforms are called for despite the weaker external environment. The lower fiscal deficit, greater public sector efficiency and a more favourable business environment are important assets that will help sustain private sector confidence and economic growth.

Domestic demand has gathered pace

The mild expansion continued in the second half of 2007 with annual growth at around 2%. Quickening consumption and investment growth has been offsetting weaker export growth. Boosted by higher food and energy prices, harmonised consumer price inflation was 2.5% in April 2008 while core inflation continued to decline. Reflecting difficulties in accessing wholesale funding experienced by banks across the euro area, Portuguese banks have tightened credit conditions since the summer of 2007.

Portugal



1. Contribution to GDP growth, as per cent of real GDP in the same period of previous year.
2. Portuguese Stability Programme 2005-2009.

Source: OECD Economic Outlook 83 database and Ministry of Finance.

The deficit continued to fall faster than expected

The general government budget deficit was reduced from 3.9% of GDP (national accounts definition) in 2006 to 2.7% in 2007, well below the target of 3.3%. This achievement reflects strong revenue growth, particularly from direct taxes, and is due to both better tax administration and the pick-up in growth. Furthermore, strict control of admissions to the public sector using the one-for-two hiring rule has made a significant contribution to expenditure reduction. The government has announced a 1 percentage point cut in the value-added-tax (VAT) rate from mid-2008, which will contribute to slow the pace of fiscal consolidation over the next two ears. Taking into account the tax rate cut and other measures, the government projects a further reduction in the deficit to 2.2% of GDP in 2008. Overall, on the basis of current and announced policy settings, the 2008 target is within reach and a small additional decline in the deficit is in the offing for 2009.

Portugal: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices € billion	Percentage changes, volume (2000 prices)				
Private consumption	92.3	2.0	1.1	1.5	1.4	1.6
Government consumption	29.7	3.2	-1.2	0.3	0.5	0.5
Gross fixed capital formation	32.6	-0.9	-1.0	3.2	3.0	3.1
Final domestic demand	154.7	1.6	0.2	1.6	1.6	1.7
Stockbuilding[1]	0.7	0.0	0.1	0.0	0.1	0.0
Total domestic demand	155.4	1.6	0.3	1.6	1.6	1.7
Exports of goods and services	41.0	2.0	9.2	7.1	4.0	5.3
Imports of goods and services	52.2	3.5	4.6	5.4	3.7	4.3
Net exports[1]	- 11.3	-0.8	1.1	0.1	-0.2	0.0
GDP at market prices	144.1	0.9	1.3	1.9	1.6	1.8
GDP deflator	_	2.5	2.7	3.0	2.7	2.1
Memorandum items						
Harmonised index of consumer prices	_	2.1	3.0	2.4	3.0	2.2
Private consumption deflator	_	2.7	3.3	2.7	3.0	2.2
Unemployment rate	_	7.7	7.7	8.0	7.9	7.9
Household saving ratio[2]	_	9.2	7.9	6.4	6.2	6.5
General government financial balance[3,4]	_	-6.1	-3.9	-2.7	-2.2	-2.0
Current account balance[3]	_	-9.5	-10.1	-9.8	-11.6	-11.6

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of disposable income.
3. As a percentage of GDP.
4. Based on national accounts definition.

Source: OECD Economic Outlook 83 database.

The expansion is expected to continue but at a slower pace

The expansion is projected to continue but at a more sedate pace, with growth at about 1½ per cent in 2008 and edging up to just under 2% in 2009. High-frequency indicators for consumption, investment and exports point to some near-term weakening of growth. Against a backdrop of eroding consumer confidence, private consumption is expected to be affected by banks' greater caution to lend and the lagged effects of past interest rate increases. Slower export growth and tighter credit conditions are projected to moderate investment spending. Economic growth is projected to be only just enough to maintain the unemployment rate below 8% over the forecast horizon. The VAT rate cut is projected to put off some durable goods spending to the second half of the year and to damp inflation in 2008. The large negative output gap should help to keep core inflation moderate over the forecast horizon.

There are risks on both sides

Weaker-than-expected growth in the euro area and a long and protracted credit crisis in wholesale money markets could inhibit growth more than projected. Working in the opposite direction, ongoing structural change in the economy may hold in store positive surprises as regards export market performance and GDP growth.

SLOVAK REPUBLIC

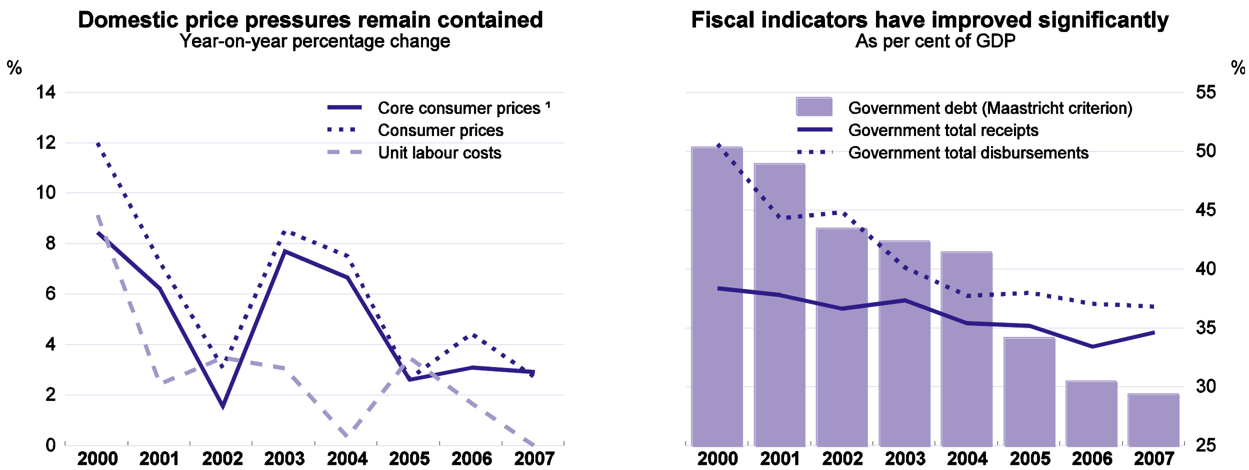
The high pace of growth in the Slovak Republic is mainly shaped by waves of foreign direct investments coming on stream. Activity will gradually decelerate from growth of over 10% in 2007 towards 6% in 2009, close to the economy's estimated potential growth rate. Inflationary pressures will remain muted because of still very large labour reserves and rising labour force participation, as well as net immigration.

The main challenge for 2008 is the country's preparation for entry into the euro area. Avoiding a boom-bust scenario will require cautious use of fiscal instruments. Recent plans to advance the balancing of public budgets by a year are helpful in this regard and the government should implement these intentions swiftly.

Record breaking growth without overheating

New production capacities, mainly in car manufacturing and consumer electronics were put into operation in the course of 2007 and propelled industrial production, gross domestic product and exports to more than 10% above previous year levels. Employment continued to increase vigorously, without any noteworthy instances of bottlenecks. The removal of border controls has facilitated labour mobility, in particular return migration. Inflation has increased in the wake of rising food and energy prices, but no second round effects are observable to date as unit labour costs barely increased in 2007. Inflationary pressures have been countered by a strong appreciation of the Slovak koruna with the effective exchange rate having increased by around 10% in 2007. Assuming that one-fifth of exchange rate

Slovak Republic



1. Excluding food and energy.

Source: OECD Economic Outlook 83 database.

changes pass through into consumer prices over a period of two years, annual inflation is likely to be reduced by about 1 percentage point compared with what it would have been otherwise.

Slovak Republic: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices SKK billion	Percentage changes, volume (2000 prices)				
Private consumption	779.4	6.5	5.6	7.1	4.7	4.7
Government consumption	260.5	3.5	10.1	0.7	2.0	2.3
Gross fixed capital formation	326.4	17.6	8.4	7.9	8.0	8.6
Final domestic demand	1 366.4	8.6	7.1	6.1	5.1	5.3
Stockbuilding[1]	32.0	0.1	-0.5	-0.1	3.8	0.0
Total domestic demand	1 398.4	8.5	6.5	5.9	8.8	5.2
Exports of goods and services	1 014.2	13.9	21.0	16.0	13.4	9.0
Imports of goods and services	1 050.9	16.1	17.7	10.4	11.5	8.0
Net exports[1]	- 36.7	-2.1	1.7	4.3	1.6	0.9
GDP at market prices	1 361.7	6.6	8.5	10.4	7.3	6.1
GDP deflator	_	2.4	2.9	1.1	2.3	3.5
Memorandum items						
Consumer price index	_	2.7	4.5	2.8	4.0	3.6
Private consumption deflator	_	2.6	4.9	2.6	3.7	3.6
Unemployment rate	_	16.1	13.3	11.0	10.3	9.6
General government financial balance[2]	_	-2.8	-3.6	-2.2	-2.0	-1.6
Current account balance[2]	_	-8.6	-7.0	-5.3	-4.3	-3.1

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Prudent fiscal policy shoulders two tasks at the same time

Efforts to bring the general government deficit below the level required for euro entry have been successful, helped by buoyant revenues whose share of GDP increased by around one percentage point in 2007. In addition, government consumption as a share of GDP has fallen by almost two percentage points. Fiscal prudence is not only important to ensure sustainability, but more and more to avoid overheating. Thanks to past fiscal reforms, work incentives have improved markedly and the abundant labour demand of the economy can now be satisfied more easily.

Monetary policy is on its way out

The Slovak National Bank has successfully steered inflation below the threshold required for euro entry. Backed by favourable economic fundamentals the koruna appreciated considerably. This development was also driven by expectations of a strong euro conversion rate. So far the Slovak economy has been sheltered from the financial crisis as the foreign banks that dominate the financial sector appear not to have been hit by any subprime spill-over effects. In addition, domestic house price growth and mortgage lending remain robust. There is no extraordinary development in forced housing sales or bankruptcies on mortgages. Assuming that Slovakia is admitted to the euro zone, the preparation and management of euro adoption will be the dominant challenge for the Slovak Central Bank.

High growth will go on but price stability will need further efforts

The projections for the Slovak economy are driven by the continuing inflow of greenfield investments and to some extent also European structural funds. Real GDP growth will fall to an annualised rate of 7.6% this year. Despite some pick-up in activity during the course of next year, the annual growth rate will decline to its potential rate of around 6% in 2009. The growth contribution from net exports will remain positive during this year and next, though domestic demand and in particular investment in plant and equipment will be the main driver of economic growth. Private consumption expenditure will continue to grow along with real wages. The outlook for inflation this year is shaped by the pass-through of energy and food price hikes on one side, and a strong damping effect from exchange rate appreciation on the other side. Consumer price inflation is projected to increase to 4% in 2008 and to decelerate only slightly to 3.6% in 2009, partly reflecting price increases related to the euro changeover which are assumed to be of similar magnitude as those experienced by other countries.

The boom-bust cycle is the biggest risk

The strong growth of the economy and the introduction of the euro imply that this projection is surrounded by considerable uncertainty. The biggest risk is that low real interest rates associated with the euro entry could result in excessive demand, possibly leading to a boom-bust cycle, which could require tighter fiscal policy.

SPAIN

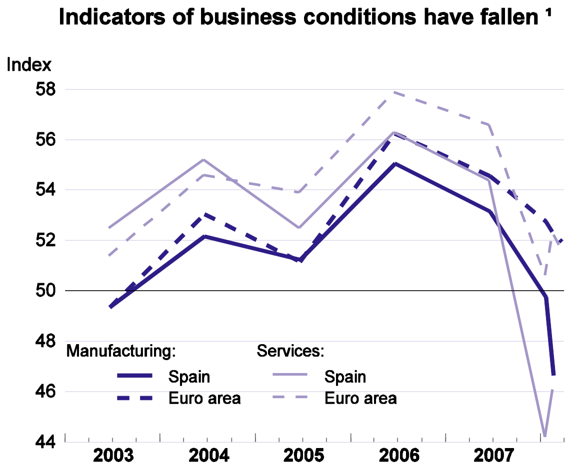
Real GDP growth slowed significantly in the first quarter of 2008 and is expected to remain sluggish over the next 18 months, as the effects of the deteriorating housing market feed into domestic demand. After edging up in 2008, inflation should decline as a negative output gap opens up.

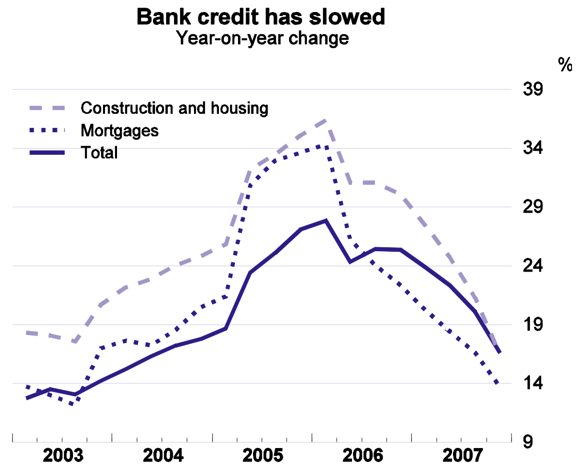
Eliminating the indexation of wages to past inflation would help to reduce the cost of disinflation in terms of employment as domestic demand slows. Some easing of fiscal policy is appropriate and measures lowering the structural budget surplus by around 0.7% of GDP have been announced. However calls for additional government support to the residential construction industry should be resisted.

A slowdown in activity is underway

After maintaining its momentum late in 2007, real GDP growth slowed sharply to a rate of 1.2% in the first quarter of this year. While no breakdown of GDP growth is yet available, it appears that domestic demand, in particular consumption and construction investment, were less dynamic, while net exports recovered. The housing sector is shrinking: residential construction permits are continuing to plunge, housing prices are dropping in real, if not nominal, terms, and the number of new mortgages has fallen by almost 25% from a year ago. Layoffs in the construction sector have pushed up unemployment and hit consumer confidence. Retail and car sales are falling. Measures of business conditions in the services and manufacturing sectors have fallen sharply and lie in contraction

Spain





1. As measured by the Purchasing Manager Index. A value of the index below 50 suggests the sector is contracting.

Source: Ministry of Finance and Bank of Spain.

territory, suggesting that the slowdown will deepen. Inflation is still increasing, reaching 4.2% (year-on-year) in April, driven by the effects of rising prices for food and energy. The inflation differential with the euro area was again above 1 percentage point. Core inflation has also been on an uptrend, reaching 3.1%.

Spain: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices € billion	Percentage changes, volume (2000 prices)				
Private consumption	487.1	4.2	3.8	3.2	1.2	1.1
Government consumption	149.8	5.5	4.8	5.1	5.1	5.2
Gross fixed capital formation	235.8	6.9	6.8	5.9	0.0	-2.8
Final domestic demand	872.6	5.1	4.8	4.3	1.5	0.7
Stockbuilding[1]	2.0	-0.1	0.1	0.0	0.0	0.0
Total domestic demand	874.6	5.1	4.8	4.3	1.5	0.7
Exports of goods and services	218.2	2.6	5.1	5.3	4.3	4.6
Imports of goods and services	251.8	7.7	8.3	6.6	3.6	2.9
Net exports[1]	- 33.6	-1.6	-1.2	-0.7	0.0	0.3
GDP at market prices	841.0	3.6	3.9	3.8	1.6	1.1
GDP deflator	_	4.2	4.0	3.1	3.2	2.2
Memorandum items						
Harmonised index of consumer prices	_	3.4	3.6	2.8	4.6	3.0
Private consumption deflator	_	3.4	3.4	2.8	4.6	3.0
Unemployment rate[2]	_	9.2	8.5	8.3	9.7	10.7
Household saving ratio	_	11.0	10.5	10.4	10.5	10.9
General government financial balance[2]	_	1.0	1.8	2.2	0.7	-0.3
Current account balance[2]	_	-7.4	-8.6	-10.1	-10.1	-9.8

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Fiscal policy will be looser

The general government surplus was 2.2% of GDP in 2007, significantly higher than expected. However, tax receipts are likely to come down because of the economic slowdown, the tax stimulus package (worth around ½ per cent of GDP in 2008) and more generous child benefits. In addition, public spending on infrastructure is being brought forward, and subsidies to the purchase of social housing will be increased. Hence, fiscal policy is set to be expansionary in 2008.

Financial conditions are tightening

Spanish banks have not sustained losses from the subprime crisis, and solvency ratios remain elevated relative to regulatory requirements. However, the banks' exposure to the domestic residential construction sector is high, especially in the case of savings banks, which cannot easily raise external capital. This may contribute to a slowdown in credit growth. Borrowing rates have risen and lending standards have tightened. The still expanding supply of housing, reflecting the large number of housing starts in 2007, is likely to continue weighing on house prices. Non-performing loans, while still low by international and historical standards, have increased significantly.

Growth will be lower due to the shrinking housing sector

The fall in residential construction investment is projected to steepen as the housing market continues its decline, while investment in machinery and equipment should also contract because of the slowdown in demand, waning confidence and more restrictive financial conditions. Higher public-works investment may cushion only part of the decline in other investment. Private consumption should slow significantly, reflecting lower employment growth and real wage gains, and tighter credit conditions, although the projected fall in short-term lending rates should provide some relief. The fiscal surplus could be reduced significantly in 2008 and may disappear in 2009. The current account deficit may fall only slightly, to below 10% of GDP, as moderate growth in export markets is likely to limit export increases, and higher import prices and external debt service payments offset the impact of the deceleration in imports. Declining job creation is expected to push the unemployment rate back above 10%, which will contribute to keep real wage growth at modest rates. Recent increases in oil and food prices will result in headline inflation spiking in the coming months before it slows to around 3% in 2009. This would still be higher than the euro area average.

Housing and credit markets pose risks

A large increase in non-performing loans, which could result from a more pronounced adjustment in the housing market, could have a bigger effect on credit conditions for firms and households, further weighing on activity.

SWEDEN

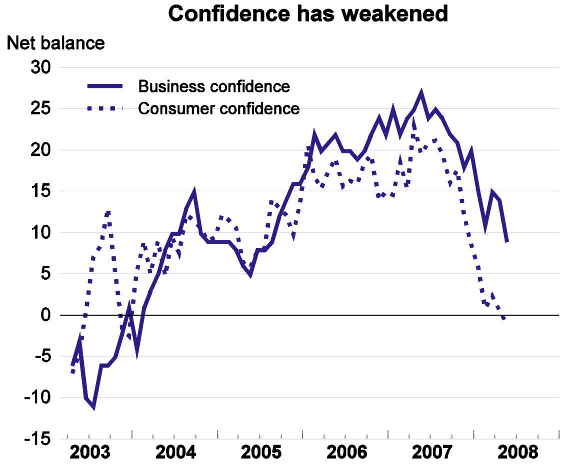
After slowing in 2007, due mainly to weaker export growth, the Swedish economy is projected to decelerate further in 2008 reflecting softening domestic demand. Employment growth should moderate and the unemployment rate may rise slightly. Slower GDP growth is projected to take output down to a level just below potential, easing inflationary pressures.

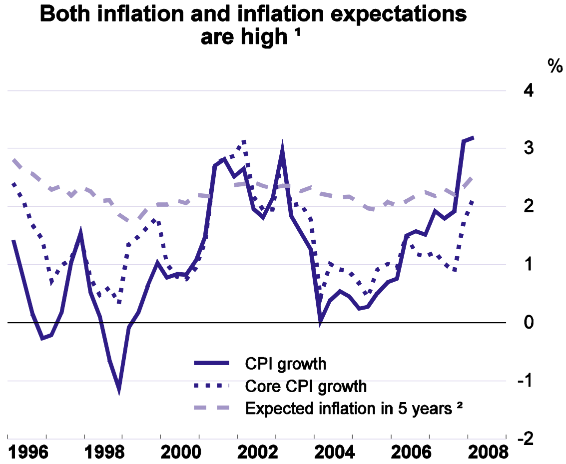
While inflation is projected to moderate in 2009, the Riksbank should stand ready to raise official interest rates further in 2008 if inflation expectations remain high. Fiscal policy should focus on further reforms to strengthen the productive capacity of the economy, without necessarily adding demand stimulus.

Economic activity is slowing but inflation has picked up

GDP growth slowed in 2007 from the rapid pace of 2006, mainly due to weaker export growth. However, indicators of domestic demand weakened noticeably around the end of 2007 and in early 2008. Retail sales growth has softened, and new motor vehicle registrations and consumer confidence have sagged. Business sentiment has also become more subdued even though business conditions remain around average. Elimination of investment incentives as from the start of 2007 led to residential building permits being brought forward in late 2006, which boosted construction in early 2007. As this effect waned, residential investment lost momentum

Sweden





1. Year-on-year percentage change.

2. Expected inflation in 5 years is the average of all survey respondents expectations of the inflation rate 5 years from when the survey was conducted.

Source: National Institute of Economic Research; TNS Prospera inflationary expectations survey; and OECD Economic Outlook 83 database.

later in 2007. Employment growth has slowed from the rapid pace recorded earlier in 2007. Even as signs were emerging of weaker economic activity, inflation took off, due to rising food and energy prices combined with domestic capacity pressures. Importantly, inflation expectations moved up to levels not seen since the mid-1990s and eased only slightly in the early months of 2008.

Sweden: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices SEK billion	Percentage changes, volume (2000 prices)				
Private consumption	1 278.1	2.7	2.5	3.1	2.6	2.6
Government consumption	702.5	0.4	1.5	0.8	0.6	0.4
Gross fixed capital formation	431.6	8.9	7.7	8.0	4.1	2.1
Final domestic demand	2 412.2	3.1	3.2	3.4	2.4	1.9
Stockbuilding[1]	- 1.2	0.0	0.2	0.7	-0.6	0.0
Total domestic demand	2 411.0	3.1	3.4	4.1	1.6	1.9
Exports of goods and services	1 215.8	7.0	8.6	5.9	5.4	5.3
Imports of goods and services	1 001.8	6.1	8.2	9.8	5.9	5.5
Net exports[1]	213.9	0.9	0.8	-1.2	0.2	0.3
GDP at market prices	2 625.0	3.3	4.5	2.8	2.1	2.1
GDP deflator	_	0.9	1.5	3.1	2.2	2.1
Memorandum items						
Consumer price index	_	0.5	1.4	2.2	3.2	2.8
Private consumption deflator	_	1.2	0.9	1.3	2.5	2.4
Unemployment rate[2]	_	5.8	5.3	4.6	4.3	4.4
Household saving ratio[3]	_	6.8	7.1	8.2	8.1	7.8
General government financial balance[4,5]	_	2.0	2.2	3.4	3.1	2.7
Current account balance[4]	_	6.8	8.5	8.3	8.6	8.4

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. Historical data and projections are based on the definition of unemployment which covers 16 to 64 year olds and classifies job-seeking full-time students as outside the labour force.
3. As a percentage of disposable income.
4. As a percentage of GDP.
5. Maastricht definition.

Source: OECD Economic Outlook 83 database.

Tighter financial conditions constrain domestic demand

While international financial market turmoil does not appear to have significantly affected the Swedish financial system so far, the cost of borrowing has increased due to widening credit spreads and tighter monetary policy. In addition, share prices have fallen from the high levels reached in mid-2007. The associated income and wealth effects, combined with eroding confidence and a deteriorating outlook for employment, point to weak consumption growth over the projection period. Less favourable financial conditions have also affected business confidence but so far to a smaller extent. Business investment is expected to slow but high capacity utilisation should provide some support for investment in the near term. Residential investment is also likely to be affected by higher financing costs and weak consumer confidence.

Further monetary policy tightening cannot be ruled out

With the output gap remaining positive in the near term and commodity prices assumed to remain high, inflation is likely to stay well above the Riksbank's target over 2008, before easing in 2009. As a result, the Riksbank is unlikely to be in a position to lower official interest rates in the near term. In fact, sustained high inflation expectations would be a threat to economic stability. Hence, the Riksbank should stand ready to raise official interest rates again in 2008 unless there are further signs of moderation in inflation expectations. The government has signalled a modest easing of fiscal policy in 2009, which would further reduce the scope for any monetary policy easing. Fiscal policy should focus on further reforms to strengthen the productive capacity of the economy, without necessarily adding demand stimulus.

Slower growth is likely to lead to higher unemployment

Domestic demand growth is projected to be slower in 2008 and 2009, while export growth is expected to be stable at a rate slightly below that in 2007. Import growth should soften in line with domestic demand, implying a small positive contribution to GDP growth from the external side. Employment growth should weaken and there is likely to be some cyclical easing in labour force participation. The unemployment rate is likely to rise only slightly, to around 4.5% -- or just over 6% using the new definition introduced by Statistics Sweden in late 2007.

External risks dominate

Downside risks to the Swedish economy arise from the direct and indirect effects of international economic developments. Export markets might slow more than expected, directly reducing GDP growth. In addition, if international financial market stress were to spill over more seriously to the Swedish financial sector, borrowing costs would rise and confidence would deteriorate further, compounding the slowdown in domestic demand. Of particular concern is the high exposure of Swedish banks to the Baltic States.

SWITZERLAND

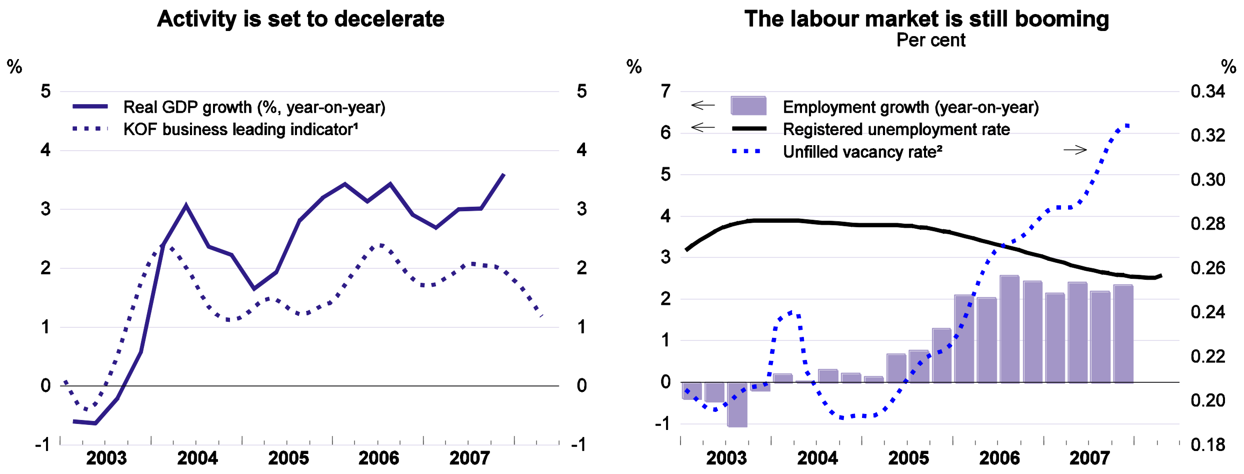
Economic growth is expected to slow to 2% in 2008 and 1½ per cent in 2009, largely on account of the effects of the financial turmoil. Job creation is likely to ease and unemployment to rise somewhat. Inflation is projected to fall as oil price effects subside. The budget surplus could shrink and may reach balance in 2009.

Should economic growth recover in the course of 2009, as projected, a small increase in policy interest rates may be necessary. Strengthening competition in product markets, such as by reforming regulation of the network industries, would raise sustainable growth prospects. Improving the incentives for cantons to match the unemployed to jobs could help slow the rise in unemployment.

Output growth has been vigorous but is weakening

Activity accelerated in the final quarter of 2007, on the back of a large contribution from rising stocks, which overcame a slowdown in final demand. Exports, in particular, decelerated, and continued to weaken in the first quarter 2008, notably to the United States. Investment activity lost momentum, notwithstanding still high levels of capacity utilisation, and

Switzerland



1. Composite leading indicator of business cycle trends in manufacturing, private consumption, financial services, construction and EU export markets.

2. Per cent of labour force.

Source: KOF institute (Swiss Federal Institute of Technology); OECD, Main Economic Indicators database and OECD Economic Outlook 83 database.

production expectations in manufacturing declined in the first months of 2008, albeit from a high level. Meanwhile retail sales continued to grow, as private consumption benefited from the vigorous expansion of employment. Confidence in banking services, which made a strong contribution to economic growth throughout 2007, declined, while housing starts have continued to fall at a modest pace. Consumer price inflation rose, largely on account of higher oil prices, but core inflation also increased somewhat, reflecting demand pressures and a tight labour market, with the (survey-based) unemployment rate falling to 3.5% in the fourth quarter of 2007. However, the trend increase in job vacancies appears to have come to an end, albeit at a high level, and registered unemployment flattened more recently at 2½ per cent.

Switzerland: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices CHF billion	Percentage changes, volume (2000 prices)				
Private consumption	272.3	1.8	1.5	2.1	1.8	1.5
Government consumption	53.0	0.5	-1.4	0.1	-0.1	0.8
Gross fixed capital formation	93.9	3.8	4.1	2.7	-0.7	1.0
Final domestic demand	419.3	2.1	1.7	2.0	1.0	1.3
Stockbuilding[1]	1.0	-0.2	-0.3	-1.6	1.2	0.0
Total domestic demand	420.3	1.8	1.4	0.3	2.4	1.3
Exports of goods and services	209.1	7.3	9.9	9.9	3.1	4.2
Imports of goods and services	178.0	6.7	6.9	5.2	4.1	4.4
Net exports[1]	31.1	0.6	1.9	2.9	-0.2	0.3
GDP at market prices	451.4	2.4	3.2	3.1	2.0	1.4
GDP deflator	_	0.3	1.6	1.4	1.4	1.8
Memorandum items						
Consumer price index	_	1.2	1.1	0.7	2.2	1.5
Private consumption deflator	_	0.8	1.4	0.9	1.8	1.5
Unemployment rate	_	4.4	4.0	3.6	3.6	3.8
General government financial balance[2]	_	-0.7	0.7	0.8	0.5	0.1
Current account balance[2]	_	13.7	14.7	16.9	9.9	11.0

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.
Source: OECD Economic Outlook 83 database.

Financial turmoil has tightened monetary conditions somewhat

The external environment is likely to continue deteriorating this year, on account of a further marked slowdown in demand from the US and Europe and the impact of some appreciation of the Swiss franc over the past six months. In view of the diminished growth prospects, the central bank has kept its target range for the three-month interbank rate on hold between 2.25 and 3.25%. The recent asset write-downs by the two largest Swiss banks -- which account for about 30% of domestic banking assets -- could have some impact on lending conditions, although about half of the resulting losses have been offset by subsequent equity issuance. International financial market turmoil is lowering business prospects in asset management, in which Swiss banks are specialised, as recent declines in equity prices reduce fee income. Once the impact of the financial crisis subsides and economic growth picks up in the course of 2009, as projected, an increase in the target range by ¼ per cent may be necessary to withdraw remaining monetary policy stimulus.

Fiscal policy remains neutral

While the impact of the impending cyclical downturn on the government balance is likely to be marked, as lower profits in the financial sector depress government revenues, fiscal policy is expected to follow a broadly neutral stance over the projection period. Budget surpluses in recent years have left some room for revenue losses to be absorbed without violating budgetary rules at the federal government level and in many cantons. Past consolidation measures are continuing to damp growth of government consumption and transfer spending, offsetting federal and cantonal income tax reductions. Progress has been made in identifying medium-term spending reductions.

Growth will slow, pushing up unemployment

Economic growth is expected to decline to about 2% in 2008 and 1½ per cent in 2009, mostly on account of diminished export prospects and poorer business conditions in the financial sector. Declining external demand and more restrictive credit terms will damp investment activity; while consumption is expected to continue supporting GDP growth, underpinned by continued increases in disposable incomes. Employment gains should slow, and the unemployment rate may rise but is projected to remain below 4%. Annual inflation is set to decline to 1.4% at the end of 2009. The general government surplus is projected to move down to close to balance in 2009.

Prospects depend on developments in world financial markets

A deeper or more drawn-out international financial crisis than projected would further adversely affect activity, damping exports and financial-sector value added. Additional asset write-offs in the banking sector would lower tax revenues beyond projected levels and could lead to significant tightening of domestic lending conditions.

TURKEY

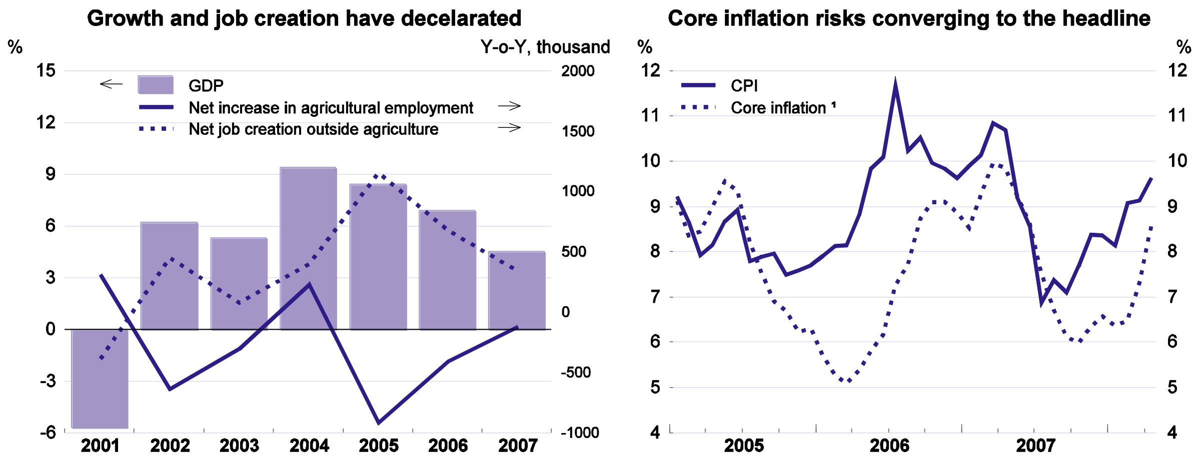
The deceleration of growth through 2007 appears to be extending into 2008 as unfavourable international conditions and domestic political uncertainty continue to weaken confidence. Growth is projected to decline to below 4% in 2008, before rising to about 4½ per cent in 2009.

In a context of uncertainties on a broad range of public governance conditions, maintaining confidence in the resilience of economic policies is important. Following the expected termination of the Stand-By Agreement with the International Monetary Fund in May, the announcement of additional initiatives on fiscal transparency and rules and structural reforms, would help increase confidence and accelerate the economic upturn.

Growth has decelerated

Growth decelerated through 2007 to an annualised rate of 3.4% in the final quarter and settled at 4.5% for the year as a whole. The deterioration of the net contribution of trade to growth following important competitiveness losses spilled over to all sectors of the economy, and to all demand components. Net job creation slowed down at the end of 2007 and unemployment picked up. A sharp output decline in agriculture as result of a drought also contributed negatively to growth.

Turkey



1. Excluding energy, unprocessed food products, alcoholic beverages, tobacco products and gold.

Source: OECD Economic Outlook 83 database and Central Bank of Turkey.

Headline inflation has risen

Headline inflation has soared since October, as a result of increases in international energy and food prices. It reached 8.4% at the end of 2007, well above the Central Bank's 4±2% target for 2007-09. Headline inflation continued to increase in early 2008 and reached 9.2% at the end of the first quarter. Approximately two-thirds of annual inflation was due to exogenous food and energy price increases, while core inflation stayed below headline inflation although picking up strongly in March. Fostered by pass-through effects from exchange rate depreciation in early 2008, inflation expectations have risen above 9% for end-2008.

Turkey: **Demand, output and prices**

	2004	2005	2006	2007	2008	2009
	Current prices TRL billion	Percentage changes, volume (1998 prices)				
Private consumption	398.6	7.9	4.6	4.6	3.0	4.1
Government consumption	66.8	2.5	8.4	2.8	1.1	4.6
Gross fixed capital formation	113.7	17.4	13.3	3.3	2.0	4.7
Final domestic demand	579.1	9.1	6.8	4.1	2.6	4.3
Stockbuilding[1]	- 5.3	0.0	-0.1	1.5	0.8	0.0
Total domestic demand	573.8	9.2	6.7	5.5	3.4	4.2
Exports of goods and services	131.7	7.9	6.6	6.7	6.3	4.9
Imports of goods and services	146.4	12.2	6.9	11.1	4.4	3.7
Net exports[1]	- 14.7	-1.3	-0.3	-1.6	0.2	0.1
GDP at market prices	559.0	8.4	6.9	4.5	3.7	4.5
GDP deflator	_	7.1	9.3	8.1	9.5	7.3
Memorandum items						
Consumer price index	_	8.2	9.6	8.8	9.6	7.5
Private consumption deflator	_	8.3	9.8	8.2	9.5	7.5
Unemployment rate	_	10.0	9.7	9.5	10.2	10.5
Current account balance[2]	_	-4.7	-6.1	-5.8	-5.4	-5.3

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

Risk premia increased and the exchange rate weakened

Risk premia increased and the exchange rate depreciated in the first quarter of 2008. Deteriorating international financial conditions and a Constitutional Court case against leading politicians from the ruling party created uncertainties in the political environment, contributing to a larger increase in Turkey's risk premia and real interest rates than in other emerging countries. Turkey's risk premia rose above emerging market averages in April, after having successfully undercut them during most of the past three years. A major revision of national accounts in March, which left GDP more than 30% higher and reduced the net public debt/GDP and current account deficit/GDP ratios to more benign levels, did not exert any positive impact on Turkey's credit rating and risk premia. One rating agency even downgraded Turkey's rating outlook in April.

Uncertainties persist

Two sources of uncertainties remain in the economy: *(i)* how to maintain confidence in macroeconomic policies after the termination of the Stand-By Agreement with the International Monetary Fund (IMF) in May 2008; and *(ii)* how market expectations and short- and medium-term economic policies will be affected by ongoing political tensions. In the absence of a credible commitment to rigorous macroeconomic policies and additional structural reforms, confidence may deteriorate further.

Fiscal and monetary policies are expected to remain tight

The fiscal stance is expected to remain tight, after drifts in the electoral year 2007. In the weaker conditions of 2008, tightening can be smaller than planned to account for cyclical conditions, and the authorities announced a medium-term fiscal plan in May with a lower primary surplus than initially envisaged. If the government sticks rigorously to this plan without any slippage, and supplements it with confidence-building safeguards such as effective spending ceilings, this initiative could help preserve a rigorous fiscal stance. Monetary policy is expected to remain tight, as the central bank struggles to defend the credibility of its inflation target in the face of above-target inflation outcomes. The recent exchange rate depreciation helped with competitiveness, but if it goes too far it could strain corporate balance sheets as many firms have high foreign currency debt. In these circumstances, as entrepreneurs have increasingly less recourse to informal activity and employment in responding to shocks, the need for additional structural reforms to encourage the expansion of economic activity in the formal sector increases.

Growth may weaken in the short term before gradually accelerating

GDP growth is expected to slow to below 4% in 2008, before picking up to about 4½ per cent in 2009, assuming that the uncertainties ease. There are downside risks associated with a less smooth exit from the IMF programme, and possible further political complications, which would increase risk premia and interest rates and hamper growth. If, however, confidence is restored in economic policies and the implementation of structural reforms accelerates, growth could pick up more rapidly.

BRAZIL

GDP grew by 5.4% in 2007, the fastest pace of expansion since 2004, but is expected to decelerate over the projection period. Private consumption continued to be the main driver, aided by improving labour-market conditions and still robust credit creation. Investment rebounded strongly, helping to alleviate emerging capacity constraints. Exports are performing well, despite a strong real. The trade surplus is shrinking fast due essentially to rising imports, especially of capital goods and intermediate inputs. Energy and food price hikes have pushed inflation up well above the 4.5% central target.

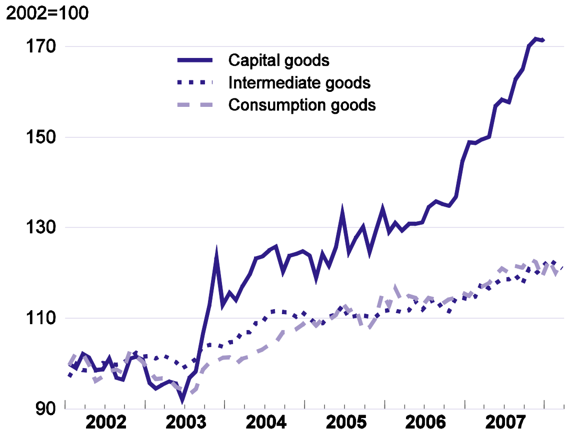
The policy mix is shifting towards needed monetary restraint. The official interest rate was raised in April, and further tightening is expected in the course of the year. Fiscal policy remains on track, and the consolidated primary surplus exceeded the end-2007 target by a small margin. Continued compliance with the fiscal targets is consistent with a further reduction in public indebtedness in 2008-09. But an additional counter-cyclical fiscal retrenchment would be welcome.

The momentum of GDP growth continued into 2008

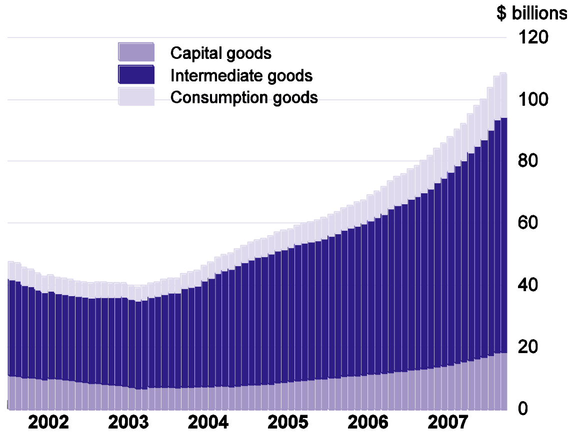
The current expansion gathered further vigour in the second half of 2007 on the back of monetary easing until October and still supportive global market conditions. Domestic demand growth has been brisk due to robust job creation and rising real earnings. Unemployment fell to its lowest level in 11 years. Investment performed particularly well, rising by

Brazil

Industrial production is trending up[1]



Import growth has been strong[2]



1. Seasonally adjusted.
2. Cumulated 12-month flows.

Source: IBGE and FUNCEX.

over 13% in 2007, the fastest pace in nearly 15 years. Exports continued to grow in value terms, aided in part by terms-of-trade gains. The strength of manufacturing exports has allayed concerns about the effects of a strengthening real on external competitiveness. Import volumes are growing rapidly, especially for capital goods and intermediate inputs, fuelled by the dynamism of investment demand. From the supply side, industrial production has risen in tandem with surging capacity utilisation, especially of capital goods. Agricultural output has recovered in earnest after a weak start in 2007.

Brazil: Macroeconomic indicators

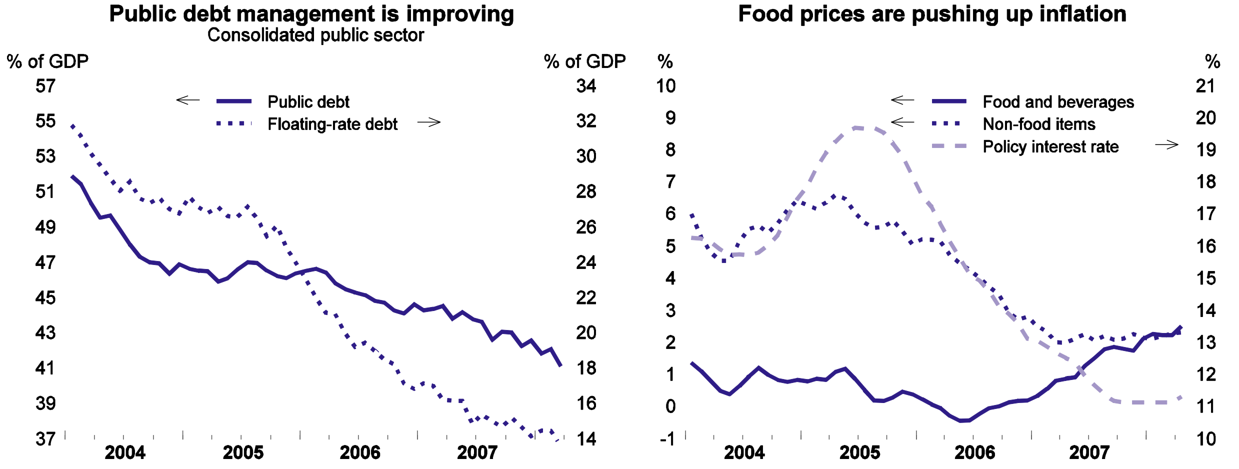
	2005	2006	2007	2008	2009
Real GDP growth	3.2	3.8	5.4	4.8	4.5
Inflation (CPI)	5.7	3.1	4.5	4.9	4.5
Fiscal balance (per cent of GDP)	-3.0	-3.0	-2.3	-1.9	-1.5
Primary fiscal balance (per cent of GDP)	4.4	3.9	4.0	3.8	3.8
Current account balance (per cent of GDP)	1.6	1.3	0.1	-1.0	-1.4

Note: Real GDP growth and inflation are defined in percentage change from the previous period. Inflation refers to the end-year consumer price index (IPCA).
Source: Figures for 2005-07 are from national sources. Figures for 2008-09 are OECD projections.

Monetary policy is being tightened

Headline inflation has risen substantially since mid-2007, owing essentially to food and energy price hikes. These supply shocks, together with the strength of domestic demand growth, have prompted the central bank to raise its policy interest rate by 50 basis points in April to 11.75%. Inflation expectations have also risen considerably for 2008-09 since end-2007. The currency has gathered further strength over the last six months. Measures have been put in place to mitigate pressures on the exchange rate, including the removal of the remaining surrender requirements for export earnings and the elimination of tax incentives for non-resident investment in government securities.

Brazil



Source: IBGE and Central Bank of Brazil.

Financial conditions are solid

Financial markets are weathering the global financial turmoil rather well, despite an uptick in sovereign interest spreads since mid-2007. The domestic yield curve has nevertheless steepened, reflecting a tightening of credit conditions, in addition to rising inflation expectations. Net capital inflows remained positive in the first quarter of 2008. At nearly \$200 billion, international reserves now exceed the country's external commitments, giving Brazil an external net creditor position. A leading rating agency has recently raised Brazil's sovereign credit to investment grade.

Brazil: **External indicators**

	2005	2006	2007	2008	2009
			$ billion		
Goods exports	118.3	137.8	160.6	179.6	192.8
Goods imports	73.6	91.4	120.6	152.4	173.6
Trade balance	44.7	46.5	40.0	27.2	19.2
Services, net	- 8.3	- 9.6	- 13.4	- 14.3	- 14.5
Invisibles, net	- 22.4	- 23.3	- 25.2	- 29.9	- 30.7
Current account balance	14.0	13.5	1.5	- 17.0	- 26.0
			Percentage changes		
Goods export volumes	9.3	3.3	5.5	3.5	3.3
Goods import volumes	5.4	16.1	22.0	17.0	9.0
Terms of trade	0.9	5.3	2.1	0.0	- 0.5

Source: Figures for 2005-07 are from national sources. Figures for 2008-09 are OECD projections.

Fiscal performance is on track despite rising expenditure

The consolidated (public sector) primary budget surplus exceeded the 3.8% of GDP 2007 target by 0.2% of GDP. The states and municipal governments continue to deliver large primary surpluses, offsetting at least in part the weaker performance of the public enterprises. Federal capital outlays surged in the first quarter of 2008, essentially due to a delayed implementation of investment programmes announced in 2007 in support of the federal government's Programme for Growth Acceleration (PAC). The consolidated debt-to-GDP ratio fell further in 2007 on the back of robust output growth and continued adherence to the fiscal targets. Financial management is benefiting from additional reductions in the share of floating-rate securities in the traded debt stock. However, current expenditure continues to ratchet up, especially payroll outlays at the federal level.

Revenue performance is strong, supported by the dynamism of activity

The revenue-to-GDP ratio continues to rise, owing predominantly to the buoyancy of income-elastic tax bases, including corporate profits and earnings. This cyclical improvement in revenue performance is offsetting, at least in part, the loss in revenue associated with the non-renewal at end-2007 of the bank debit tax (CPMF), which yielded nearly 1.5% of GDP in revenue. Additional compensatory measures were taken, such as an increase in the financial transactions tax (IOF) on selected operations and a somewhat larger-than-expected sequestration of discretionary budgetary appropriations for 2008. A tax-reform proposal was submitted to Congress at end-February, aiming at tackling long-standing challenges in the tax system. These include the need for forestalling predatory tax competition among the states in the value-added tax (ICMS) and alleviating the tax burden on labour income and enterprise turnover.

Output growth is likely to lose some steam…

GDP growth is projected to decelerate to about 4.8% in real terms in 2008. Domestic demand is set to continue to be the main driver, supported by continued dynamism in investment. The labour market is poised to perform well and to underpin the expansion of private consumption, albeit at a slower clip than in 2007. The trade surplus will in all likelihood continue to shrink on the back of growing import demand. Second-round effects of food and energy price rises will exert some upward pressure on inflation, which is nevertheless unlikely to exceed the upper bound of the target range. On the supply side, agricultural production is expected to gather some additional strength thanks to the supply response to high prices, especially for grains.

… in a context of increasing policy restraint

The policy mix will become less expansionary in 2008. Some additional gradual monetary tightening is expected over the course of the year, before rates are cut again in 2009. Fiscal policy is not expected to be changed over the projection horizon. Maintenance of consolidated primary surpluses in the neighbourhood of 3.8% of GDP is consistent with a further gradual decline in public indebtedness in relation to GDP. Nevertheless, an additional counter-cyclical fiscal retrenchment would be welcome.

The balance of risks is tilted to external sources

The deterioration of the global financial environment is the main source of risk to an otherwise fairly benign outlook. Brazil has enjoyed greater resilience to external shocks over the years. But a sharper-than-projected global deceleration would take its toll on export growth. At the same time, diminishing appetite for emerging-market assets would impinge on domestic credit conditions. Growth prospects would also likely suffer from a stronger-than-anticipated monetary tightening, should inflation readings and expectations deteriorate further.

CHINA

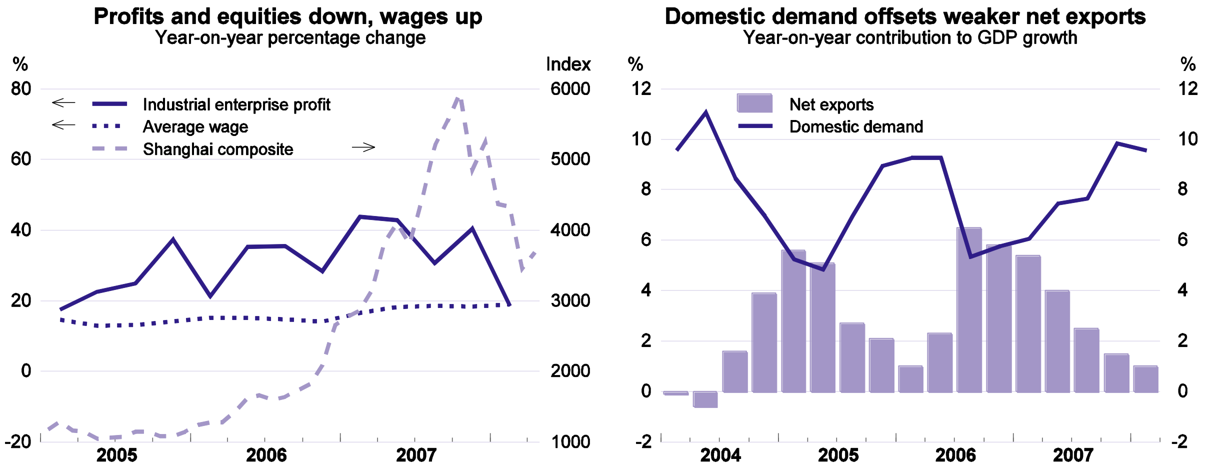
Economic growth has eased slightly, to 10.6% year-on-year in the first quarter of 2008. It is expected to slacken further over the remainder of 2008 and in 2009, as the contribution from net exports declines, and the current account surplus is set to fall to 9½ per cent of GDP by 2009. Domestic demand growth is projected to remain robust over the forecast horizon, with buoyant incomes driving up consumption. Inflation has increased sharply, driven by soaring food prices, but is expected to ease somewhat going forward provided food prices stabilise, offsetting rising non-agricultural prices.

With a positive output gap and inflation spreading beyond food, macroeconomic policies need to continue working to reduce overheating pressures. Chinese interest rates are already higher than US rates and further increases would add to the problems of sterilising capital inflows. While a step revaluation of the currency would give more scope to raise interest rates and help moderate inflation, it would conflict with the authorities' desire to limit currency appreciation and would expose some sectors of the economy to adjustment pressures. The fiscal balance is healthy and the government is well placed to raise social spending and infrastructure investment, and to support domestic growth if the global economy slows by more than expected.

Output growth is slowing to a more sustainable pace

Economic growth was extremely rapid in 2007at 11.9%. It slowed in the fourth quarter of 2007 and in the first quarter of 2008 as the contribution of net exports declined. Facing a slowdown in trading partner growth and cuts in value-added tax rebates for exporters, exports decelerated from mid-2007, particularly in volume terms. Growth in exports to the US was particularly

China



Source: CEIC.

weak and the European Union is now China's largest export market. In contrast, imports have been robust, outpacing exports. The terms of trade have declined, contributing to a reduction in the trade surplus.

China: **Macroeconomic indicators**

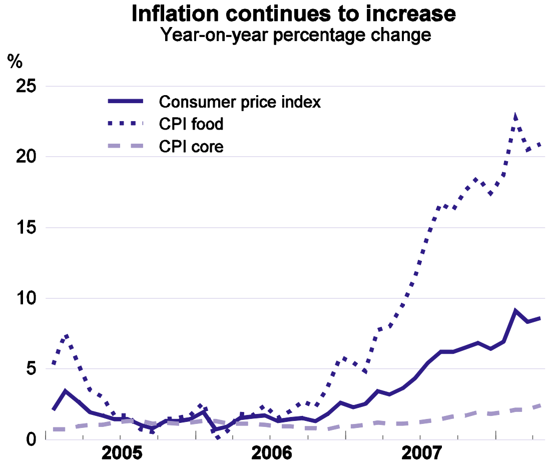
	2005	2006	2007	2008	2009
Real GDP growth	10.4	11.6	11.9	10.0	9.5
Inflation[1]	4.1	3.2	5.0	6.4	5.6
Consumer price index[2]	1.8	1.6	4.8	6.1	4.2
Fiscal balance (per cent of GDP)[3]	-0.2	0.5	2.2	2.4	2.3
Current account balance (per cent of GDP)	7.2	9.4	10.8	10.0	9.5

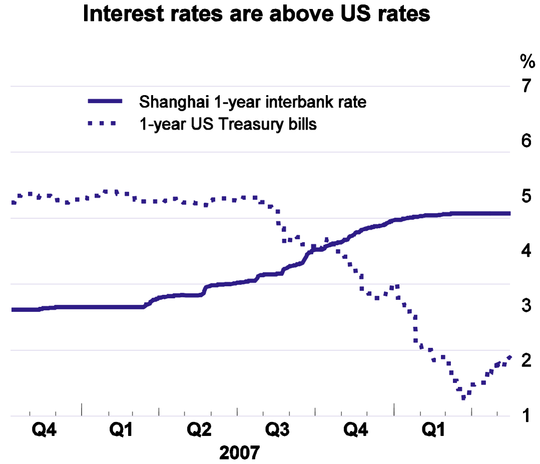
Note: The figures given for GDP and inflation are percentage changes from the previous year.
1. Percentage change in GDP deflator from previous period.
2. Change in Laspeyres fixed base year index (base year 2005).
3. Consolidated budgetary and extrabudgetary accounts on a national accounts basis.
Source: National sources and OECD projections.

Domestic demand is picking up as net export growth slows

Domestic demand growth picked up during 2007, partially offsetting the impact of slowing net exports on GDP growth. Despite devastating snowstorms, growth in retail sales remained robust in early 2008. In part, this reflects solid growth in labour income, which is currently at a 12-year high. Soaring prices for agricultural produce have buoyed rural incomes. In contrast to household income, profit growth has eased since the end of 2007, reflecting large increases in raw material prices and wages. Indeed, profits grew more slowly than the wage bill for the first time this decade, one of the factors generating a near halving in the value of the equity market composite index. Growth in fixed asset investment and industrial production has also slowed somewhat since late 2007.

China





Source: CEIC.

Inflation is spreading beyond food

Consumer price inflation peaked at 8.7% in February, its highest level in more than a decade, despite controls on oil product prices, which the government has kept at a level consistent with a world crude oil price of $76 a barrel, through direct subsidies, refunds to refiners of the value-added tax paid on imports of crude and petroleum products and by insisting on lower profits for domestic oil companies. Sharp increases in food prices continue to be the main driver of consumer price inflation. The tragic earthquake in Sichuan province, a major agricultural producing area, may add upward pressure to food prices. With the Chinese economy growing faster than potential and a sizeable positive output gap, upstream pricing pressures remain strong: producer prices have accelerated in aggregate as well as across a broad range of industry segments and the non-agricultural GDP deflator accelerated markedly in 2007.

China: **External indicators**

	2005	2006	2007	2008	2009
	$ billion				
Goods and services exports	836.9	1 061.7	1 338.7	1 644.5	1 986.6
Goods and services imports	712.1	852.8	1 044.3	1 336.9	1 649.1
Foreign balance	124.8	208.9	294.5	307.6	337.5
Net investment income and transfers	36.0	41.0	60.2	82.6	98.4
Current account balance	160.8	249.9	354.7	390.2	435.8
	Percentage changes				
Goods and services export volumes	23.8	23.9	19.5	11.5	12.9
Goods and services import volumes	13.6	16.0	14.8	12.2	14.9
Export performance[1]	14.4	14.6	12.9	5.6	6.4
Terms of trade	- 0.3	- 0.8	- 1.1	- 3.4	- 0.3

1. Ratio between export volume and export market of total goods and services.
Source: OECD Economic Outlook 83 database.

Sterilisation has been effective but is becoming increasingly expensive

In response, the People's Bank of China has continued its gradualist tightening cycle, lifting interest rates by 27 basis points in December. The currency has recently been allowed to appreciate faster against the dollar, by a cumulative 4½ per cent in the first five months of 2008. However, the effective exchange rate rose much less over the same period. In spite of a moderating trade surplus, the reported increase in foreign exchange reserves was $154 billion in the first quarter of 2008, the largest quarterly increase ever. To sterilise these inflows the Bank has intensified bond issuance and progressively increased the reserve ratio for commercial banks to 16.5%. Administrative guidance also continues to be used to moderate lending. On balance, these policy measures have been successful in sterilising inflows and growth in base money, M2 and bank lending has been relatively moderate in the first quarter of 2008. However, with the size of inflows growing and Chinese interest rates now higher than comparable US rates, the costs of ongoing sterilisation are increasing.

The fiscal balance has moved into surplus

Government revenue increased by 32% in 2007, outpacing expenditure growth by 10 percentage points, and the national government budget moved to a surplus of 0.7% of GDP. In addition, reflecting buoyant wages, the surplus in the social security system has continued to rise strongly, reaching

1% of GDP. In total, the combined fiscal surplus, including extra-budgetary revenue and expenditure, is estimated to have exceeded 2% of GDP in 2007. The 2008 budget foresaw continued rapid growth of expenditure and a decline in the fiscal surplus. However, stronger-than-budgeted nominal demand growth and greater revenue buoyancy are expected to maintain the surplus, even allowing for tax cuts announced after the budget.

A soft landing is likely given appropriate policy settings

Looking forward, export competitiveness will continue to erode over 2008 and 2009, reflecting wage and price inflation. Coupled with ongoing weakness in external demand, exports and the pace of market share gains are projected to slow markedly. With increased imports, stemming from robust domestic demand, and a significant deterioration in the terms of trade, the current account surplus is projected to fall as a percentage of GDP, although it is set to increase by over $80 billion in absolute terms, to $435 billion in 2009. With wages continuing to grow faster than national income and government transfer spending accelerating, the contribution of consumption spending to GDP growth is expected to rise. Consumer price inflation is projected to remain high this year before retreating in 2009 as food prices stabilise, offsetting persistent acceleration in non-agricultural prices.

Entrenched inflation and speculative inflows are risks

The Chinese economy is slowing to a more sustainable pace and there are early indications that the pattern of growth is beginning to rebalance away from net exports to domestic demand. In addition, equity markets have cooled with valuations becoming more consistent with fundamentals. However, persistent inflation pressures and increasing speculative inflows of foreign currency continue to pose risks to an orderly transition to more balanced growth. Moreover, there is some risk that current capital inflows might accelerate and that sterilisation would become less effective, exacerbating inflation pressures *via* excess liquidity. The longer inflation is allowed to persist, the higher the risk of rising inflation expectations, necessitating more of a slowdown than currently projected.

INDIA

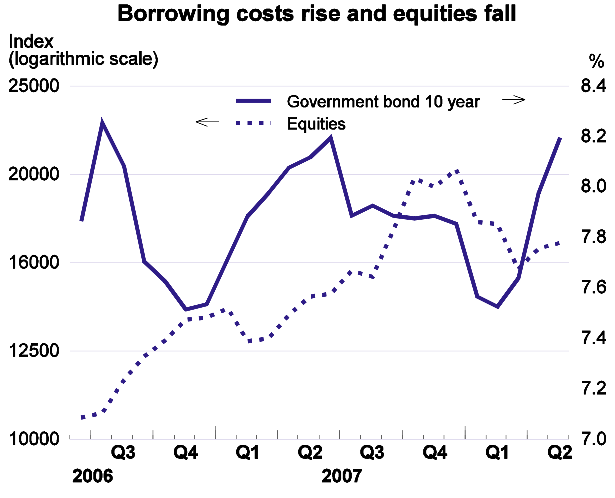
Growth slackened over the course of 2007, to 8.5% by the fourth quarter of the year, partly as a result of tighter monetary policy. It would have eased more but for strong farm output. Even so, consumer and wholesale price inflation picked up, reaching nearly 8% by the spring of 2008. With a more restrictive monetary policy stance and a more normal harvest, output growth is projected to gradually slow to below 8% in 2008 and then to recover slightly in 2009. Higher oil and commodity prices are likely to push the current account deficit to 2% of GDP this year. With world food prices stabilising, the rise in the consumer price index is expected to ease back to 5.5% in 2009.

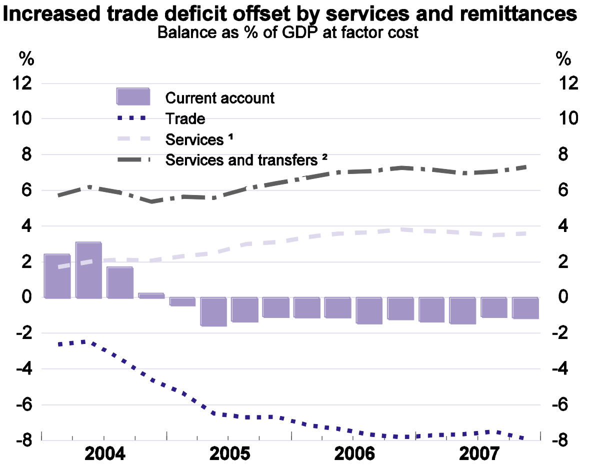
The current budget does not take into account likely pay increases for public employees nor debt write-offs for small farmers. These measures need to be phased in gradually if a significant fiscal shock is to be avoided. A new system for determining government employee pay is needed that avoids once-per-decade pay hikes. Elsewhere, the lowering of tariffs, halted in this budget, needs to continue and progress is called for in moving towards a national value-added tax, consolidating state and union indirect taxes, while oil subsidies should be brought on to the budget and then be phased out.

The economy has started to slow

After a period of strong economic expansion, with GDP growth topping 10% in early 2007, momentum eased somewhat by the end of 2007. The slowdown was particularly marked in manufacturing and

India





1. Non factor services.

2. Non factor services and private transfers.

Source: Center for Monitoring the Indian Economy.

construction, where growth rates fell by over 2 percentage points. The long-running expansion of the business service sector, primarily related to information technology and business process outsourcing, also lost some steam. On the other hand, growth was helped by above-average performance in agriculture. Preliminary estimates suggest GDP was up 8.4% in the year to the first quarter of 2008, though the weakness in industrial production in March suggests that this figure may be revised down.

India: **Macroeconomic indicators**

	2005	2006	2007	2008	2009
Real GDP growth	9.2	9.7	8.7	7.8	8.0
Inflation[1]	4.4	5.6	4.1	4.4	5.0
Consumer price index[2]	4.4	6.7	6.1	6.7	5.5
Short-term interest rate[3]	6.6	8.2	8.9	8.7	8.7
Long-term interest rate[4]	7.1	7.8	7.9	8.4	8.2
Fiscal balance (per cent of GDP)[5]	-7.0	-7.4	-6.1	-6.3	-6.5
Current account balance (per cent of GDP)	-0.9	-1.1	-1.2	-2.0	-1.6

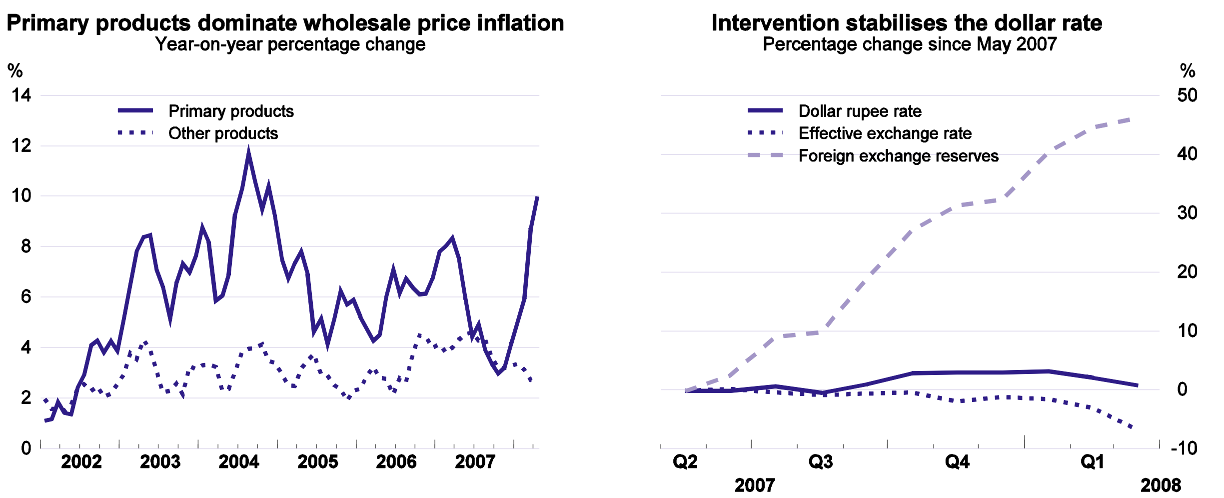
Note: Data refer to fiscal years starting in April.
1. Percentage change in GDP deflator from previous period.
2. Consumer price index for industrial workers.
3. Mumbai three month offered rate.
4. 10 year government bond.
5. Gross fiscal balance for central and state governments, includes net lending and transfers to oil, food and fertiliser companies and recurrent Pay Commission awards, but not backpay nor debt write-offs for small farmers.

Source: CMIE and OECD projections.

Export growth has moderated but investment remains strong

Gross fixed capital formation has remained the most buoyant component of demand, up 15% in the year to the last quarter of 2007. By contrast, recorded private consumption has not increased as fast as GDP, though this is partly because household purchases of gold and jewellery, which surged in 2007, are counted separately from consumption and

India



Source: Center for Monitoring the Indian Economy.

investment in the national accounts. With strong investment, imports have been buoyant while export growth has moderated, reflecting an earlier appreciation of the currency. Despite the terms-of-trade deterioration, the current account deficit remained broadly unchanged relative to GDP, reflecting a substantial increase in migrant remittances.

India: **External indicators**

	2005	2006	2007	2008	2009
			$ billion		
Goods and services exports	166.1	204.3	252.7	306.6	344.0
Goods and services imports	192.3	235.6	301.4	373.4	417.1
Foreign balance	- 26.1	- 31.4	- 48.8	- 66.2	- 73.1
Net investment income	- 5.0	- 6.0	- 4.3	- 6.5	- 7.4
Transfers	23.7	27.6	38.9	46.9	56.5
Current account balance	-7.5	-9.8	-14.1	-26.4	-24.0
			Percentage changes		
Goods and services export volumes	11.7	15.1	11.0	11.0	10.0
Goods and services import volumes	44.8	21.9	10.6	8.0	9.5
Terms of trade	22.1	5.3	-0.7	-4.7	0.0

Note: Data refer to fiscal years starting in April.
Source: National sources and OECD projections.

Inflation has picked up again

Inflation eased in the second half of 2007, under the influence of moderating food prices and as the increase in oil prices was not fully passed through to consumers due to regulatory policies. Moreover, the exchange rate had been appreciating earlier in the year. By spring of 2008, however, inflation had regained momentum, with both wholesale and consumer prices up by close to 8% over a year earlier. Soaring primary product prices have continued to drive inflation and the increases in world market prices have no longer been tempered by currency appreciation. However, the increase in non-primary product prices has been modest and does not yet show signs of being affected by rising commodity prices.

Off-budget expenditures are increasing the consolidated deficit

The pace of fiscal consolidation eased considerably in fiscal year (FY) 2007, with the announced Union government fiscal deficit only falling by 0.3% of GDP to 3.1%. State governments were slightly more vigorous in reducing their deficits, with the result that the combined fiscal deficits of the states and central government fell to 5.4% of GDP. Despite rapid growth of spending in the FY 2008 budget and income tax cuts, the government foresees a further reduction in its fiscal deficit this year. As a result, the official estimate of the combined fiscal deficit of the Union and the States is 4.5% of GDP, well below the deficit target of 6% enshrined in the Fiscal and Budget Management Act. However, the published estimates of the budget deficits do not account for two major expenditure items: subsidy payments to oil, food distribution and fertiliser companies (amounting to 0.7% of GDP in FY 2007) and a pay award for public sector employees set by the Pay

Commission that takes effect in FY 2008 (amounting to 0.9% of GDP on a full year basis). Taking these two items into account, the fiscal deficit remains above 6% of GDP. Moreover, the Pay Commission recommended backdating pay awards to January 2006, at a cost of 2.5% of GDP, and the government plans to write off the bank debt of small farmers, at a cost of 0.8% of GDP. As no concrete plans have been announced for implementation of the two latter items, they have not been incorporated in the projections.

In the face of capital inflows money growth has picked up

Domestic monetary policy has been attempting to neutralise capital inflows. The last increase in interest rates in March 2007, when the repo rate reached 7¾ per cent. Shortly after this hike, the effective exchange rate stopped appreciating and, since October 2007, the exchange rate against the dollar has been stable. With net private capital inflows exceeding the current account deficit, the Reserve Bank had to increase its purchases of foreign exchange and reserves grew by $109 billion in the year to mid-May 2008, boosting money supply. However, with the Reserve Bank raising reserve requirements, the growth of credit has slackened, even if it remains well above the growth of nominal GDP, at 20% in the year to March 2008. With inflation well above the authorities' objective, policy interest rates are projected to be raised during 2008. Reflecting both increasing inflationary expectations and the end to fiscal consolidation, long-term interest rates moved up in the spring of 2008 and equity prices were just over 15% below their peak by mid-May 2008.

Some moderation in growth seems likely

A further moderation in growth seems in the offing this year and next, to around 8%. With higher long-term interest rates, rising costs and lower equity prices, some slackening of investment is projected. Short-term interest rates are likely to rise somewhat because of hikes in the cash reserve ratio and higher official rates. This should slow the growth in vehicle sales which are in any case being hit by the realisation that many auto loans have been poorly documented. Although consumers have been shielded from much of the increase in crude oil prices by increased subsidies, the deterioration in the remainder of the terms of trade is bound to weigh on the growth of consumption in 2008. In so far as commodity prices are set to stabilise, inflation may moderate, which would make room for a measure of monetary policy easing in 2009.

Excessive fiscal stimulus might drive up inflation expectations

The principal risk to this projection is that of inflation not moderating. This risk stems from the considerable boost to demand that would occur if the total Pay Commission award for government employees were to be paid out immediately. Quick action to write off small farmers' debt would also add substantially to demand. This would be in a context where, absent a marked fall in world oil prices, action may eventually have to be taken to raise petroleum prices. In such circumstances, inflationary expectations might deteriorate and the current account deficit widen.

RUSSIAN FEDERATION

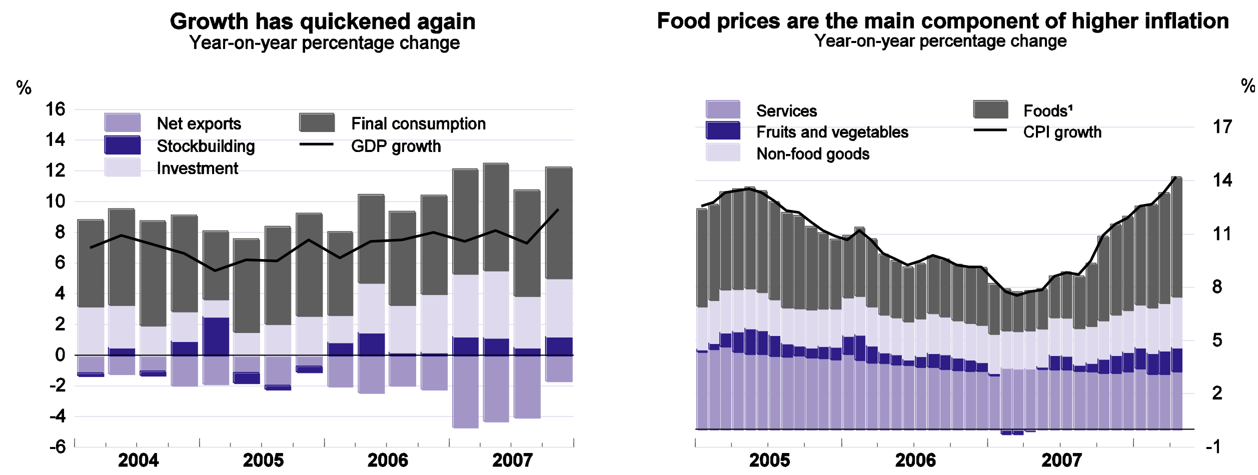
Real activity rose in 2007, but should moderate over the projection period as oil and metals prices stabilise around their current high levels. Domestic demand will continue to advance strongly, but net exports will exert a growing drag as imports surge while energy export volume growth is held back by supply constraints. Inflation is rising, propelled by steep rises in food prices, and validated by the central bank's unsterilised intervention to manage the exchange rate, which has yielded very rapid money supply growth.

Fiscal loosening has added to inflationary pressures and the non-oil fiscal balance continues to deteriorate, although it should stabilise in 2011 according to the Budget Code. High oil prices should ensure continued growth of the two new funds that have succeeded the former oil price stabilisation fund. The new government will hopefully steer policies in the direction of combining neutral fiscal policy with a monetary policy more firmly oriented towards price stability and structural reform to enhance the economy's growth potential.

Growth is at its fastest rate since 2000

GDP growth rose during 2007, hitting an eight-year high on an annual basis. Domestic demand again led the way, fuelled by further gains in the terms of trade and record capital inflows. The largest increase came in fixed investment, but household consumption also continued to advance strongly, boosted by rapid real wage growth and expanding credit to households. Net exports exerted a strong drag on growth until the fourth quarter, when a jump in exports permitted year-on-year real GDP growth to rise to 9.5%. On the production side, the strongest growth was among market services, where a number of sectors experienced double-digit growth, but

Russian Federation



1. Without fruits and vegetables.

Source: Russian Federal Service for State Statistics and Central Bank of Russia.

manufacturing activity also registered its fastest growth in five years. Various indicators suggest that the pattern and pace of growth in the first quarter of 2008 remained similar.

Russian Federation: **Macroeconomic indicators**

	2005	2006	2007	2008	2009
Real GDP growth	6.4	7.4	8.1	7.5	6.5
Inflation	10.9	9.0	11.9	13.0	10.0
Fiscal balance (per cent of GDP)[1]	7.7	8.4	6.1	6.0	3.0
Current account balance (per cent of GDP)	11.0	9.5	6.1	7.0	3.3

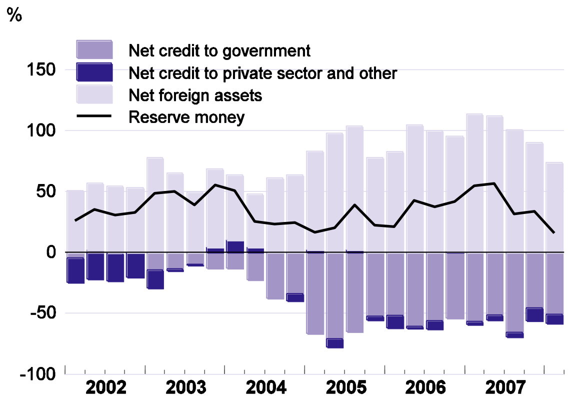
1. Consolidated budget.
Source: Data for 2005-06 are from national sources. Data for 2007-09 are OECD estimates and projections.

Inflation has reversed a long downtrend

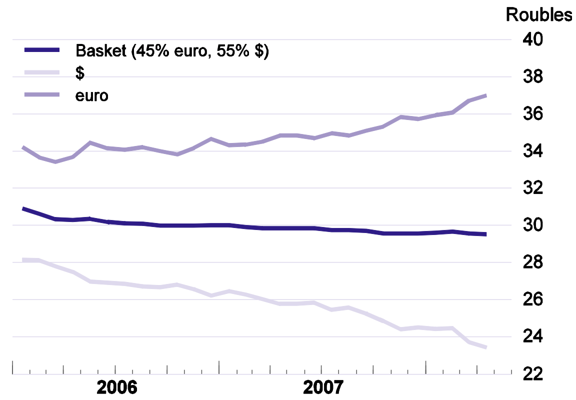
After declining every year since 1999, inflation turned up in 2007, and has continued to rise in 2008. The rise in inflation largely reflects the surge in food prices, despite price controls and measures to restrict food exports. The passthrough of food prices to overall inflation has, however, been validated by money supply growth, which picked up in 2007. The pace and variability of money supply growth reflect the fact that the central bank, despite having notional objectives for inflation, targets the nominal exchange rate (*versus* a basket of the US dollar and the euro) on an operational basis. The monetary impact of foreign exchange inflows is only sterilised to the extent that the government accumulates deposits at the central bank. A growing proportion of such inflows in 2007 came through the capital account. Unlike oil-windfall-driven current account inflows, capital inflows do not directly fill government coffers and are thus not automatically sterilised, reducing the share of sterilised foreign exchange inflows. In the first quarter of 2008 the capital account swung back into deficit, sharply reducing year-on-year monetary growth, but strong net capital inflows resumed in April.

Russian Federation

Monetary growth was very rapid in 2007
Contribution to year-on-year reserve money growth



Monetary policy is focussed on the exchange rate



Source: OECD calculations based on Central Bank of Russia.

Procyclical fiscal policy is contributing to overheating pressures

Fiscal policy has remained pro-cyclical, with an increase in spending in advance of parliamentary and presidential elections offsetting the unanticipated revenue increases arising from higher-than-assumed export commodity prices and faster growth. With higher oil and gas prices, windfall revenues in 2007 exceeded the targets set in the budget, and the Stabilisation Fund grew to about $150 billion (12% of GDP) at end-2007. In February 2008 the Stabilisation Fund was split into two new funds: the Reserve Fund, available to make up for revenue shortfalls if oil prices fall and funded up to its ceiling (10% of GDP), and the National Welfare Fund, a sovereign wealth fund, to which the remainder is allocated.

Russian Federation: **External indicators**

	2005	2006	2007	2008	2009
	$ billion				
Goods and services exports	269	335	395	550	610
Goods and services imports	164	209	283	395	500
Foreign balance	104	126	112	155	110
Invisibles, net	-20	-31	-34	-38	-45
Current account balance	84	94	78	117	65
	Percentage changes				
Goods and services export volumes	6.5	7.3	6.4	5.5	5.5
Goods and services import volumes	16.6	21.9	27.3	27.0	22.0
Terms of trade	15.4	11.4	4.3	20.0	1.3

Source: National sources and OECD projections.

Intra-government policy disagreements highlight some growing risks

Conflict within the government over economic policy has sharpened. Some agencies favour a more active use of industrial policies, which continued in 2007 with the creation of several new state entities, including a Development Bank (on the basis of the state-owned bank *Vneshekonombank*) and a state-run nanotechnology corporation. The Ministry of Economy has also advocated a cut in value added tax rates to stimulate growth, and there are pressures for greater domestic investment by the National Welfare Fund, which initially was foreseen to invest only in foreign assets. The Ministry of Finance has sought to curb such ambitions and in particular to limit the budgetary cost of new initiatives. A wish to promote economic diversification in Russia is understandable, given that resource-dependent economies have been found to suffer from boom-and-bust cycles with lower average growth and higher volatility than better-diversified countries. The recourse to industrial policy would, however, risk leading to a proliferation of expensive interventions which do little more than distort markets and waste resources, while undermining fiscal sustainability and exacerbating overheating and pressures for real appreciation of the rouble. A cut in value added tax rates would likewise worsen the fiscal situation while being less justifiable on efficiency grounds than some other possible tax reforms. Whatever the outcome of the internal policy debate, high oil prices should keep the budgetary surplus above the levels projected in the current three-year budget, but, as seen in previous years, amendments to permit a further widening of the non-oil deficit are possible.

Growth is projected to moderate gradually in 2008-09

With the strong recent terms of trade gains projected to dissipate, the growth of domestic demand and output should moderate over the projection horizon. Household consumption has strong momentum and will be sustained by tight labour markets and easy credit conditions. Investment growth will likely slow somewhat after the recent surge, and real appreciation of the rouble will put pressure on non-resource tradables. With oil and gas export volumes constrained by supply limitations, the current account surplus will be buoyed by higher energy prices in 2008 but will shrink rapidly in 2009. Foreign exchange inflows will remain strong, supported by Russia's relatively solid macroeconomic fundamentals. Given the rapid rate of M2 growth and rising inflationary expectations, getting inflation back onto the targeted downward path is not expected to be achieved until 2009.

External factors are the main area of uncertainty

The prices of oil and gas in particular and export commodities more generally are key to the momentum of domestic demand. Net capital flows are also an increasingly important factor. Given the existence of important resource rents and strong domestic demand growth, Russia has been attracting growing net inflows, notwithstanding negative trends in the business climate, which has worsened in the context of growing state control. The size and volatility of capital flows are likely to make the conduct of monetary policy even more challenging. There is a risk that further rising oil and gas prices as well as an associated boom of capital inflows will make it even harder for Russia to embark on an ambitious growth path with lower inflation.

CHAPTER 3

THE IMPLICATIONS OF SUPPLY-SIDE UNCERTAINTIES FOR ECONOMIC POLICY

Introduction

Supply-side uncertainties have increased the risk of policy errors…

The increases in real energy and capital costs caused by the oil price shock and financial turmoil are likely to reduce the productive potential of OECD economies. The extent and the speed of these effects are very difficult to estimate and will depend on how permanent the shocks prove to be. At the same time, past and ongoing structural reforms are boosting potential output, but with long and unknown lags. The net effect has been to increase the uncertainty that surrounds measures of economic slack, such as the "output gap", the unpredictability of which is a recurrent difficulty for macroeconomic policy setting at the best of times. At the current juncture, heightened uncertainties about supply-side developments combine with weakening activity and concerns about inflation to compound the risk of policy errors.

... both inflationary and deflationary

Policy errors could occur in both directions. The experience of stagflation in the 1970s and early 1980s showed that, while real-time measures of economic slack provided apparently legitimate grounds for easing policy, *ex post* it appeared that capacity conditions were actually tighter than such estimates suggested and that policy easing had fuelled inflation (Orphanides *et al*., 2000). On the other hand, overly tight policy based on an underestimate of potential output could imply a risk of creating unnecessary slack.[1]

The current study finds that…

To address the current issues, the chapter starts by looking at simple ways of estimating the possible impact of recent increases in real energy and capital costs on potential growth. After discussing the size of the growth-enhancing effects of economic reform, the chapter looks at the overall impact of these different forces on potential growth in coming years. The chapter then turns to the problems inherent to measuring the business cycle. Implications for monetary and fiscal policy are drawn in the final section. The main findings are as follows.

1 . Some authors argue that the unwarranted and eventually deflationary tightening of US monetary policy in 1928-29 was largely related to an excessively pessimistic assessment of potential output at the time (Orphanides, 2003).

… recent shocks may reduce potential growth…

- While the effects are subject to uncertainty, the lingering influence of recent financial turmoil and higher oil prices could reduce potential growth significantly, possibly on the order of 0.3 percentage points in the United States and the euro area.

… while other forces may be supporting growth…

- At the same time, economic reforms may continue to boost potential growth across the OECD area. In particular, structural unemployment has been falling in major OECD economies, in part as a result of past and ongoing economic reforms. Maintaining the pace of improvement will, however, take considerable reform effort.

… compounding the uncertainty due to actual GDP revisions

- In the current circumstances, the uncertainty created by unusual supply-side developments compounds the possible errors attaching to estimates of actual GDP which have been the main drivers of output gap uncertainty over recent decades.

With respect to monetary and fiscal policy settings, the following implications may be drawn:

Uncertainty calls for reliance on a wide array of inflation indicators

- The likely decrease in potential growth, together with observed longer lags in the response of inflation to output, increases the possibility of monetary policy errors at the current juncture, reinforcing the case for central banks to continue relying on a wide array of indicators of inflationary pressure.

Output gap uncertainty can distort real-time fiscal indicators

- Errors in the cyclically-adjusted fiscal balance arising from erroneous business cycle indicators appear in most cases to be relatively small. In certain situations, however, revisions to output and unemployment gaps can be large enough that estimates of steady-state debt-to-GDP ratios could be seriously distorted by output gap uncertainty.

Supply shocks require different policy responses

- The appropriate response of fiscal policy to output gap uncertainty depends on whether such errors are caused by demand- or supply-side developments. Usually, errors in output gap estimations reflect unforeseen demand fluctuations, in which case automatic stabilisers have a useful role to play. In contrast, a situation where output gap uncertainty arises from a negative supply shock may call for partially offsetting automatic stabilisers, especially if the shock works to depress the sustainable employment level.

Impact of recent developments on potential output

Higher real energy prices reduce equilibrium output…

Because energy is an important input to the production process in OECD countries, a sustained hike in real energy prices must entail lower equilibrium output. At a basic level, a higher relative price of energy means greater intensity in the use of other inputs (labour and capital) which are available only in inelastic or limited elasticity supply, implying a fall in productive potential. At an assumed level of $120 per barrel in the projection, the cost of crude oil relative to that of output is 240% above its 20-year average in the United States and 170% above in the euro area.[2] As an illustration, when using a very simple partial equilibrium framework to account for potential growth (Appendix 3.A1), such a massive move in the real cost of oil will cut about 4% off steady-state potential output in the United States and 2% in the euro area in the long run. The difference arises for two reasons. First, the share of oil and natural gas in production is about 50% larger in the United States than in the euro area. Second, the oil shock has been larger in the United States because of the falling dollar.

... and the potential growth rate…

The impact of the oil shock on annual potential growth depends on how quickly supply converges to its equilibrium value. Since neither current nor long-term potential output can be observed directly, reckoning how fast one converges to the other is fraught with difficulties. Nonetheless, the rate at which new equipment and building replace the existing capital stock may provide an indication of the speed at which current potential output converges to its long-term path. When this rate is estimated conservatively (Appendix 3.A1), the oil shock is reckoned to dent potential growth by 0.2 percentage points a year in the United States and 0.1 percentage points in the euro area in the first years of adjustment. Alternative ways of estimating the speed at which existing capital is replaced, which give greater weight to shorter-lived capital items, suggest that the near-term impact might possibly be higher (Appendix 3.A1). Moreover, it could be even larger to the extent higher oil prices lead to advance scrapping of existing capital equipment.

… but are also the flipside of growth enhancing forces

The rise in energy prices should be seen in the context of globalisation and the re-emergence of China and other developing countries in the world economy. Energy demand from fast-growing developing economies, and the associated increases in oil prices, are the flipside of the contribution these countries make to the growth of global supply, especially in manufacturing. In other words, globalisation increases the productive capacity of the world economy, reduces the prices of manufactured goods (and some tradeable services), and puts upward pressure on commodity prices. Because all effects do not occur at the same time, and in particular the fall in manufactured goods prices appears to have largely occurred before the increases in energy prices, globalisation can now seem to reduce potential output in OECD countries even though its overall contribution is positive. Furthermore, it should be noted that globalisation can hardly be seen as the sole driver of the oil price shock.

2 . The local currency price of Brent and the GDP deflator are used to measure the prices of crude oil and output. Consistent with this choice, the oil share in output is calculated on input-output tables at basic prices, which exclude value added tax, excise duties and retail margins.

Financial turmoil has led to higher real interest rates…

As for energy, a permanently higher cost of capital relative to output implies lower equilibrium output.[3] The financial market turmoil that started in August 2007 has increased the cost of borrowing, and therefore the cost of capital, for home buyers and most firms, with the exception of the best-rated corporations. In the second half of 2007, real borrowing costs for firms and home buyers rose by around ½ percentage point in both the United States and the euro area.[4] While the shock was initially larger in the United States, it has been partially offset by cuts in the Federal funds rate and a (partly resulting) decrease in longer-term rates (Table 3.1).[5] Hence, the shock to capital costs that is being applied to the simple partial equilibrium framework is considerably smaller than the shock to risk spreads that has been observed so far during the turmoil. Moreover, no attempt has been made to take into account the negative impact stemming from non-price rationing, which is likely to be substantial in the near term, especially in the United States where lenders have tightened credit standards considerably since mid-2007.

... with possibly significant effects on potential growth

Evaluating the impact of higher capital costs on potential output is challenging for several reasons. *First*, capital intensity adjusts slowly and therefore the pre-turmoil capital intensity may have been below what would have been implied by the pre-turmoil interest rate. *Second*, instead of deciding to expand their stock of physical capital, investors may have considered the pre-turmoil low interest rates as artificial and looked through them. In the five years to mid-2007, real interest rates charged to businesses were 1.8 percentage points below their average over the previous ten years in the United States (0.4 percentage points in the euro area). *Third*, and alternatively, the increase in interest rates charged to private borrowers that has taken place in the context of the financial turmoil may be partly transitory and could therefore be reversed to some extent. Notwithstanding these important caveats, the shock to real capital costs is calculated to reduce annual potential growth by 0.1 percentage points in the United States and 0.2 percentage points in the euro area in the first years of adjustment towards new capital costs.

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3 . Such a contraction in potential growth is not necessarily negative for economic welfare if the previous boost was the result of a credit bubble driving real interest rates to levels that were artificially low and ultimately destabilising. See for instance Ahrend *et al.* (2008).

4 . Business borrowing rates are measured using the yield on BBB corporate bonds. BBB rates provide a good measure of corporate borrowing costs because 70% of corporate borrowing from capital markets is rated BBB or immediately above or below at issuance (Standard and Poor's, 2007). Mortgage rates are averaged across categories of borrowers. Real rates are derived from nominal rates using a five-year moving average of the GDP deflator.

5 . For US home buyers, the moderate average development masks the fact that, while rates remained broadly stable for conventional mortgages eligible for purchase by government agencies in the course of 2007, they increased substantially for other categories of borrowers.

Table 3.1. **Illustrative impact estimates of recent supply shocks**

	United States	Euro Area
	Per cent	
Oil price shock		
Oil and gas share	3.2	2.1
Real oil price increase relative to the previous 20 years	240	170
Impact on steady-state output	-4.1	-2.1
	Percentage points	
Medium-term impact on potential growth	-0.2	-0.1
Shock to real interest rates from the 2007 turmoil		
Change in real mortgage rates	0.5	0.4
Change in real rates charged to businesses	0.4	0.6
Medium-term impact on potential growth	-0.1	-0.2
Medium-term impact of both shocks on potential growth	-0.3	-0.3

Source: OECD calculations.

The role of structural reforms in increasing potential growth

Successful reform raises potential output

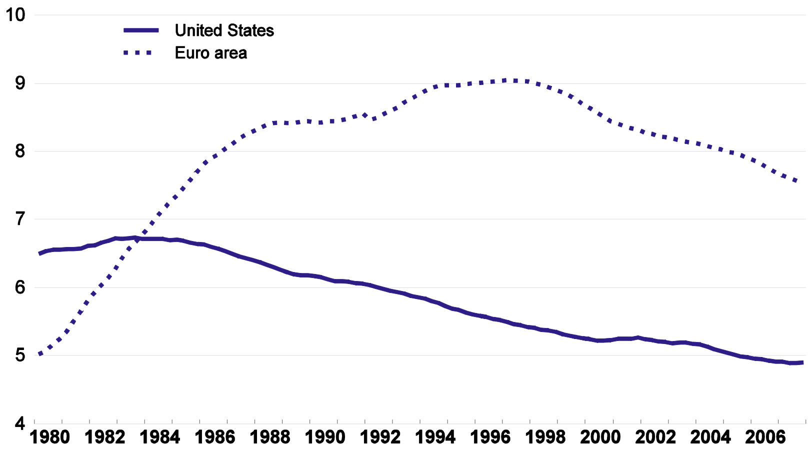
Policy reforms which serve to raise labour productivity or employment play an important role in improving the productive potential of economies. As regards employment, there are two categories of measures by which the employment rate could be sustainably increased: the first aims at expanding the labour force (*via* increases in the retirement age, for example), the second at achieving a permanent reduction in unemployment.

Equilibrium unemployment is on a falling trend…

The OECD routinely produces estimates of the structural unemployment rate, defined as the rate of unemployment consistent with stable inflation (the so-called NAIRU, or non-accelerating inflation rate of unemployment).[6] The latest updating exercise confirms the continuation of the decline in the structural unemployment rate for most OECD economies over the most recent period, to the end of 2007 (Gianella *et al.*, 2008). This is illustrated in Figure 3.1 which shows the evolution of the estimated NAIRU for the United States and the euro area over the past two decades. Overall, the cumulative decrease in the NAIRU over the past decade has been substantial, in particular for the euro area.

6 . The general background to and details of previous OECD work estimating time-varying NAIRUs within the Phillips curve framework are given by Richardson *et al*. (2000). The time-varying NAIRU is obtained *via* the estimation of a reduced form Phillips curve equation using a Kalman filter procedure.

Figure 3.1. The estimated NAIRU in the United States and the euro area



Source: OECD calculations.

… with non-negligible implications for potential growth

During this period, the decline in the NAIRU raised the rate of potential output by approximately 0.1 percentage points *per annum* in the euro area and by about half that in the United States. This means that, all other things being equal, a similar fall in the structural unemployment is needed in the future to maintain potential growth at its recent rate.

Reforms contributed significantly to this improvement

OECD studies indicate that changes in labour and product market policy settings can explain much of the non-cyclical movements of the unemployment rate (Box 3.1). On the basis of the most recent estimates, Table 3.2 reports the respective contributions of different structural reforms conducted over the period 1995-2003 to the evolution of the estimated NAIRU for, respectively, the United States and the euro area. However, the possibility that omitted variables could also play a substantial role in driving the NAIRU cannot be excluded. For example, recent large immigration flows may in some cases have helped to improve labour market performance but this factor is unlikely to continue to reduce structural unemployment.

Table 3.2. **Contributions of product and labour market reforms to changes in the structural unemployment**

	Contributions of 1995-2003 reforms					ΔNAIRU	ΔNAIRU
	Tax wedge	Replacement rate	PMR	Union density	Total	1995-2003	1995-2005
United States	0.1	0	-0.2	-0.1	-0.2	-0.5	-0.6
Euro area	-0.2	0.1	-0.7	-0.1	-0.9	-1	-1.2

Source: OECD calculations.

Box 3.1. Explaining the dynamics of structural unemployment

A large body of empirical research has studied the impact of structural features on aggregate unemployment, stressing the need for fundamental labour market reforms to deal with high and persistent unemployment. An analysis of the determinants of structural unemployment conducted for the *OECD Jobs Strategy* (Bassanini and Duval, 2006) showed that the level of unemployment benefits, the tax wedge and stringent product market regulation are robustly associated with unemployment rates (and also with participation). Changes in policies explain almost two-thirds of non-cyclical unemployment changes in the long run, on average, in OECD countries. Moreover, the precise impact of a given policy reform depends on the institutional context, tending to be larger when implemented in an overall more employment-friendly environment.

More recent OECD work has investigated the impact of a similar selection of structural variables directly on NAIRUs rather than on unemployment rates in order to better correct for the cycle (Gianella *et al.*, 2008). More precisely, the change in the estimated NAIRU is regressed on the current and lagged changes in a selection of institutional variables for a sample of 19 OECD economies over the period 1978 to 2003. The study confirms that, among the standard indicators of labour and product market rigidities, the level of the tax wedge, the replacement rate and the level of product market regulation have a strong influence on the structural unemployment rate.[1] For some countries union density is also found to play a role in explaining the dynamics of the NAIRU. Overall, the elasticities with respect to the main policy variables considered are of a similar order of magnitude as those found by Bassanini and Duval, albeit slightly lower: on average, it is estimated that a 10-percentage point reduction in the tax wedge, a 10% reduction in unemployment benefits and a decline in product market regulation by two standard deviations would be associated with a drop in the NAIRU by respectively 1.7, 0.3 and 0.6 percentage points. For countries where it is significant, a 10-percentage point reduction in union density would imply a decrease of 0.35 percentage points of the NAIRU.

1. Data on minimum wage regulations, for the countries where they exist, are unfortunately not available over a sufficiently long time period. A proxy for the user cost of capital is also added to the equation, but not considered here given the focus on structural reforms.

Structural reforms could continue to boost potential output…

A sustained pace of policy reform will be required to achieve a similar decline in the structural unemployment rate in future years. Nonetheless, the level of the structural unemployment suggests that there is significant room for further decreases in the NAIRU, especially in the euro area. If the pace of policy reforms were sustained, their positive contribution to potential growth would be of the order of 0.1 percentage point *per annum* in the euro area and 0.02 percentage point in the United States.

… also* via *increased labour force participation and productivity…

The effects of structural reforms on potential growth may extend beyond lower structural unemployment. For example, by encouraging more working-age people to look for jobs they could increase the participation rate of older workers. The effective retirement age has, however, already been raised quite substantially in many countries and it will take considerable reform efforts just to have the same contribution from this factor to potential growth in the future as in the recent past. The same probably applies to product market reforms which have increased competitive pressures in network and distribution industries in particular, but where the available evidence suggests that the pace of progress has been relatively stable. Finally, the downward trend in hours worked has already shown signs of inflection in many countries.

... provided the pace of reform is maintained

Summing up, sustaining the contribution from structural reform to potential growth into the future will require a determined effort. Even if this effort can be made, however, the energy and credit shocks are likely to imply a slowdown in growth, possibly on the order of 0.3 percentage point *per annum* in the euro area and the United States. To the extent that the contribution from structural reform falls, it will accentuate the effects of adverse shocks on potential growth.

Problems in assessing the cyclical situation

Business cycle indicators are often subject to significant revisions

Ideally, estimates of an economy's position in the business cycle should be available on a timely basis and subject to minimal revision so that early outturn estimates already provide a reliable picture of the "true" state of the economy. In practice, real-time estimates of output and unemployment gaps depend not only on estimates of potential output or the NAIRU, but equally on, respectively, current data on GDP growth or unemployment levels. Early vintages of these series are frequently and sometimes substantially revised over time, implying that output or unemployment gap estimates based on early data releases can be misleading, and sometimes quite significantly so.

Uncertainty over actual GDP is the main source of gap revisions

Annual revisions to gap estimates exceeding half a percentage point are not unusual, even several years after the initial estimate is published, though the magnitude tends to decline gradually over time. Historically, in two-thirds of the OECD countries examined, and all of the G10 economies except Italy and Sweden, revisions to data for actual GDP appear to have been a more important source of gap revisions than revisions to potential GDP over the past one or two decades (Table 3.3).

Table 3.3. **Mean absolute revision between different vintages of data**

	Output gap[1]	Actual real GDP[1]	Potential real GDP[1]
United States	0.46	0.61	0.43
Japan	1.09	0.82	0.35
Euro Area	0.26	0.20	0.14
Germany	0.41	0.43	0.35
France	0.36	0.35	0.15
Italy	0.35	0.22	0.34
United Kingdom	0.38	0.42	0.22
Canada	0.37	0.50	0.26

Note: The sample period is 1994 to 2003 for all countries but the euro area where it is 1997 to 2003. Concretely, revision between vintage published in year t+1 and t+4 in the spring issue of the *OECD Economic Outlook.*

1. Expressed as the log difference.

Source: Pain and Koske (2008).

Forecasts of business cycle indicators are even more uncertain

The accuracy with which a business cycle indicator can be projected is an important criterion for its usefulness in policy setting,[7] as changes in the stance of macroeconomic policy affect the aggregate economy only with a certain time lag. Recent OECD research (Pain and Koske, 2008) shows that the uncertainty attached to estimates of the cyclical position is significantly magnified when turning to forecasts, even those at relatively short-term horizons: while the quality of current year projections of business cycle measures -- though not unproblematic -- is generally acceptable, this contrasts with year-ahead projections of often questionable information content (Box 3.2).

Business cycle indicators play a key policy role

Indicators of the current and projected cyclical position of the economy play an important role in monetary and fiscal analysis and surveillance. In the current situation, and as discussed above, potential growth may fall in response to energy and finance related shocks, which have added to the usual uncertainty about the cyclical position.

Overestimating potential growth may mean understating price pressures...

As business cycle indicators are often an important input in inflation projections, uncertainty with respect to these variables results in greater uncertainty around inflation forecasts (Box 3.3), complicating monetary policy setting. Even though monetary policy decisions may be based on an extensive array of potential indicators of inflationary pressures,[8] reductions in growth potential would need to be incorporated into the central bank policy response function. To the degree that falls in potential remain unnoticed, they may lead to an underestimation of current and future inflationary pressure, with the attendant risk of monetary policy becoming inappropriately accommodating.

... and an upward shift in inflation expectations would be costly to correct

Given the evidence that the responsiveness of inflation to domestic demand pressures has decreased,[9] a reduction in potential may only become visible in rising inflation with significant lags. With a lowered response of inflation to supply-demand imbalances, an inflation overshoot will be more costly to correct through monetary policy. If undesirably high inflation outcomes were accompanied by an upward shift in inflation expectations, central banks could even find themselves in the unenviable position of having to increase interest rates in an attempt to stop the upward drift of inflation expectations (and inflation) in conditions of weak economic activity and increasing unemployment.

7 . In this respect, estimation methods that also directly provide information about the precision, and hence the uncertainty, attached to estimates are useful.

8 . Central banks differ in the weight they ascribe to these other indicators, but they would normally include a range of different statistical and exclusion-based measures of underlying (or “core”) inflation; commodity and import prices; capacity utilisation, as well as credit and possibly monetary aggregates.

9 . This is probably at least partially driven by an increasing importance of the global business cycle, as well as possibly connected to an enlarged role for prices of commodities and manufacturing imports (see OECD, 2007).

Box 3.2. General business cycle measurements problems

Work undertaken recently by the OECD (Pain and Koske, 2008) looks at forecasts, "now-casts", and first-vintage-data based calculations of business cycle measures, comparing them with the "true" underlying business situation as calculated from later vintages of data.

The precision of gap estimates based on real-time data

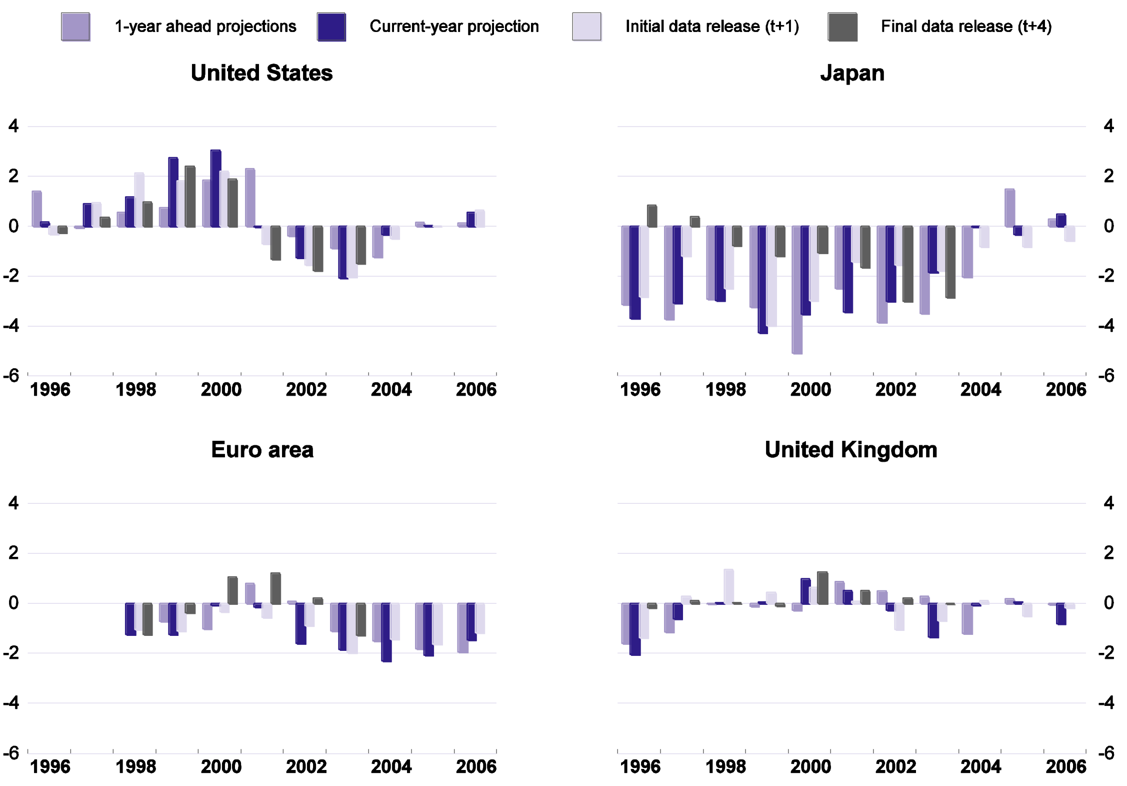
As discussed in the main text, given frequent and sometimes substantial revisions of data over time, estimates of the cycle based on early vintages of data provide only imperfect information about the underlying state of the economy. However, while the initial outturn estimates of the output and unemployment gap are imprecise, initial estimates in a particular year are generally highly correlated with subsequent estimates for that year. Initial estimates are also good predictors of the sign of the gap: for 80% of the available observations, the sign of the initial outturn estimate of the output gap in a particular year is the same as that of the revised estimate made three years later.

The accuracy of current-year and one-year-ahead projections of the output and unemployment gaps

Making use of projections from successive spring issues of the *OECD Economic Outlook*, the OECD work also examines the quality of current year and one-year-ahead projections of different gap measurements. The current-year projections of gap measures (projections for year *t* made in year *t*) appear to be reasonably good predictors of the initial (projections for year *t* made in year *t+1*) and final outturn (projections for year *t* made in year *t+4*) estimates (figure below). The projections are generally highly correlated with the outturn estimates and the sign of the gap, as well as its direction of change. Nonetheless, the current-year projections of the different gap measures are statistically biased for most countries.

In contrast to the current year projections, the one-year-ahead projections (for year *t* made in year *t-1*) appear to be rather bad predictors of the initial and final outturn estimates (see figure). The correlations between the projections and the outturn estimates are often very low and not significantly different from zero. Moreover, both the sign and the direction of change of the gap are wrongly predicted in many cases.

Output gaps: different vintages of data and projections



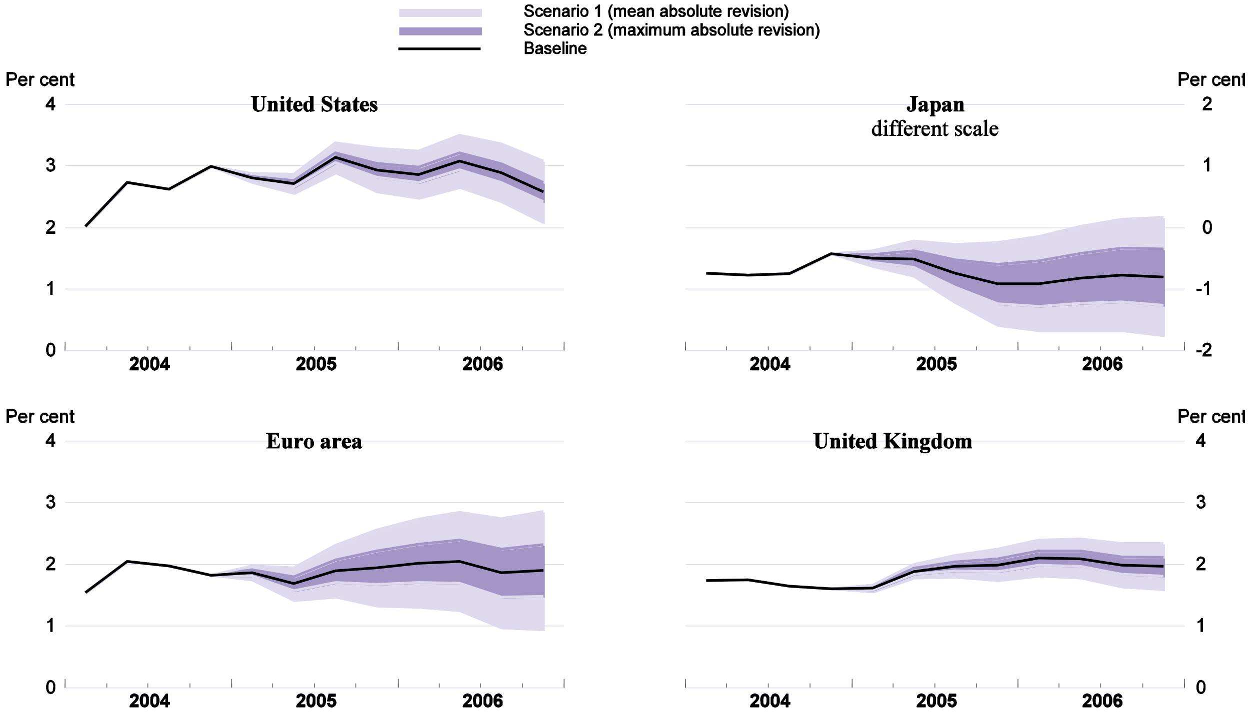
Source: Pain and Koske (2008).

Box 3.3. The impact of uncertainty about business cycle indicators on inflation projections

Uncertainty about output gaps has consequences for the reliability of inflation projections that use estimates of the short-run trade-off between inflation and activity. The figure below shows an estimate of the hypothetical error in inflation projections (starting from the first quarter of 2005) which would have been caused had output diverged constantly (and to the same side) from its true potential level by an amount corresponding to the observed mean absolute (respectively maximum absolute) revision for a given country's output gap.[1] The degree of such inflation forecast uncertainty varies considerably across countries, reflecting both different coefficient estimates of gaps in the country models of inflation, as well as different degrees of output gap uncertainty. For the United Kingdom and the United States the uncertainty around the inflation forecast created by output gap uncertainty is relatively low. It is notably higher for Japan and the euro area.[2] A high degree of uncertainty around the constructed euro area inflation projection reflects the high uncertainty around the projections for Germany and Italy, in part offset by the comparatively low uncertainty around the French forecast.[3]

The impact of output gap uncertainty on inflation forecasting

Percentage points



Source: Pain and Koske (2008).

1. The baseline scenario estimates consumer price inflation with a Phillips-curve model until the end of 2004, a dynamic forecast of inflation being generated to the end of 2006 employing actual values of all the exogenous variables. Two alternative scenarios are then estimated for inflation. In the first, the level of the gap for each of the economies was altered by the mean absolute revision observed during the period 1995 to 2006 between the current-year projection and the final outturn estimate at time *t+4*. In the second, the gap was altered by the maximum absolute revision observed over this period. This provides an estimate of the upper bound of the possible degree of uncertainty.

2. The euro area forecasts are obtained as a weighted average of the forecasts for Germany, France and Italy, employing 2005 consumption weights.

3. Low uncertainty around the French forecast results from a combination of low output gap uncertainty and a small output gap elasticity of inflation.

Output gap measures still have a useful role to play...

While greater uncertainty about potential would tend to reduce the policy weight given to output gap measures,[10] if underlying price pressures showed up in actual inflation data with an increasing lag, this would also imply a reduction in the information content of current inflation indicators (and potentially inflation projections to the degree that forecasting accuracy would be affected). Greater uncertainty about potential output thus need not imply giving more weight to indicators of current (and possibly projected) inflation relative to output gap measures when setting monetary policy.

... but uncertainty affects monetary policy choices

Greater uncertainty may affect the strength of monetary policy reactions to new information, depending on whether the costs of policy errors are symmetric or not. Asymmetric risks, such as those potentially resulting from either significant deflation risk or a danger of asset price bubble build-ups, could be seen as arguing for stronger monetary policy responses when greater uncertainty increases the likelihood of the more undesirable outcomes. This reasoning may, however, not hold in situations where policy errors in *both* directions carry significant risk of resulting in particularly bad outcomes (*e.g*. if the risk of deflation is mirrored by that of stagflation). When risks are of comparable magnitude on both sides, the presence of uncertainty ceases to require that monetary policy should necessarily respond more aggressively to a downturn.

Cyclically-adjusted fiscal indicators remain reliable…

Given the direct link from potential and unemployment gaps to measures of the structural budget balance, the uncertainties discussed above have direct relevant to the assessment of the fiscal position and stance.[11] In practice, however, errors in the cyclically-adjusted balance arising from erroneous business cycle indicators appear in most cases to be relatively moderate. Over the period 1995-2003, on average across 21 OECD economies, revisions to the level of the output gap accounted for revisions of around 0.4 percentage points of GDP in the cyclically-adjusted primary balance. Hence, gap revisions can explain some, but by no means the major part, of the *ex post* revisions made to structural budget estimates. A fiscal position that would be considered sound (or unsound) would generally be regarded as such under reasonable alternative scenarios (Figure 3.2).[12]

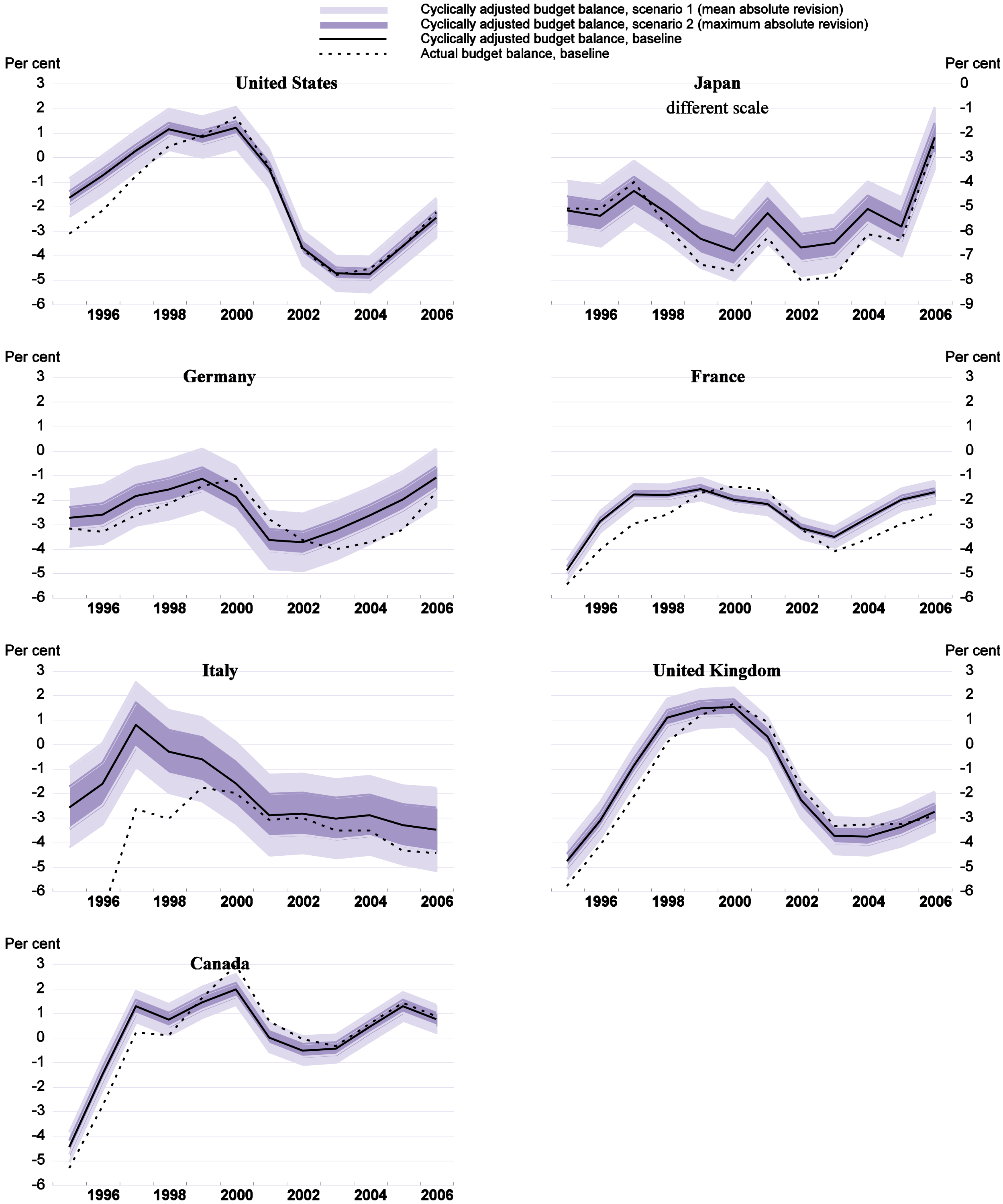
10 . Furthermore, a lower short-run trade-off between inflation and activity has the side-effect of complicating the measurement of output gaps.

11 . In addition to revisions of gap estimates, revisions to the cyclically-adjusted balance as a proportion of GDP can result from revisions to actual revenues and disbursements, as well as revisions to GDP. Quantitatively, GDP revisions play, however, only a minor role in driving revisions to the GDP shares of the cyclically-adjusted balance and of its components.

12 . Alternative scenarios for the cyclically-adjusted fiscal balance (as a share of GDP) are derived by varying the size of the change in the output and unemployment gaps. The baseline scenario is one that uses the change in the output and unemployment gaps published in the spring 2007 issue of the *Economic Outlook*. Two alternative scenarios are obtained by varying the change in the output and unemployment gaps by the mean absolute revision (respectively, the maximum absolute revision) observed during the 1995-2003 period. Mean and maximum absolute revisions are determined based on the differences between the projected current-year change in the gaps and the revised estimate of that change made four years later.

Figure 3.2. Gap uncertainty and the level of the cyclically adjusted budget balance

Percent of GDP



Note : Excludes receipts from sales of mobile phone licenses.

Source : Pain and Koske (2008).

As regards *changes* in the fiscal balance, both "now-casts", and first-vintage-data based calculations of the fiscal stance are fairly good predictors of the "true" fiscal stance.

… with exceptions...

Nevertheless, in some countries, revisions to the output and unemployment gap can at times be so large as to induce revisions to the cyclically-adjusted primary balance of more than 1% of GDP. In these cases, estimates of steady-state debt-to-GDP ratios could be seriously distorted by output gap uncertainties, which would also matter if a country is close to meeting or missing a relevant policy target.

... but policy errors could occur from negative supply shocks

More generally, the response of fiscal policy to output gap uncertainty would also depend on whether such errors are caused by demand or supply-side developments. Where errors in the output gap reflect unforeseen demand fluctuations, automatic stabilisers will have a useful role to play. In contrast, a negative supply shock will ultimately require a recalibration of fiscal policy settings. The shape of the necessary adjustment will depend on the nature of the supply shock.[13]

13 . Negative productivity shocks, by lowering real wages and profits, would be expected to lower government tax revenue, but also the government wage bill and social transfers, with any net effect on the fiscal balance likely to be small. In contrast, an increase in the equilibrium unemployment rate would worsen the fiscal position both through decreasing tax revenue and an increased need for transfers (*e.g*. unemployment benefits), implying a need for some off-setting of automatic stabilisers through fiscal tightening.

APPENDIX 3.A1
DERIVING ILLUSTRATIVE ESTIMATES OF THE IMPACT OF CHANGES IN FACTOR PRICES ON SUPPLY

A simple framework is used to gauge the impact of recent supply shocks

Recent developments in energy and capital markets have led to increases in the prices of production factors relative to output. A production function framework has been used to provide illustrative estimates of the impact of these changes on supply. The framework is simple because it looks at the implications of changes in factor prices on steady-state output without taking account of general-equilibrium feedbacks. This choice has been made because it enables the shocks to be calibrated directly on the basis of observed price changes. Nevertheless, the framework used here has the limitation that the real wage is assumed to remain steady in the face of shocks to real energy and capital costs. Related to this, any effects of a wider wedge between firms' real labour costs and workers' real wages on equilibrium unemployment are not taken into account.

The model is based on a well-established specification…

In the vein of a wide body of empirical research following the seminal work by Rasche and Tatom (1977) and Darby (1982) and recently illustrated by Duval and Vogel (2008), and as in the FRB/US model used by the US Federal Reserve (Brayton and Tinsley, 1996), the present framework uses a standard multi-factor Cobb-Douglas production function

$$Y = \prod_{i=1}^{n} F_i^{\alpha_i} \qquad [1]$$

where the factor shares α_i sum to one. If p_i denotes the price of factor *i* relative to output, profit maximisation implies that the elasticity of factor *i* to a change in its relative price is given by:

$$\frac{\Delta Fi / Fi}{\Delta Pi / Pi} = \frac{\partial F_i / \partial p_i}{F_i / p_i} = -\frac{1}{1-\alpha_i} \qquad [2]$$

As a result, steady-state output responds to a change in the relative factor price p_i with the elasticity:

$$\frac{\Delta Y / Y}{\Delta Pi / Pi} = \frac{\partial Y / \partial p_i}{Y / p_i} = -\frac{\alpha_i}{1-\alpha_i} \qquad [3]$$

The impacts of movements in relative factor prices on steady-state output are estimated by integrating the ordinary differential equation (3).

… using four production factors

Four factors ($n=4$) enter the production function: labour, non-residential business capital, dwellings and oil (including natural gas because its price is closely tied to that of oil). The model includes residential buildings in the capital stock because they produce housing services, in the form of market and imputed rents, which are part of GDP. Government capital is not included because the national accounts do not measure its contribution to output. The price of capital p_i which determines production choices is the real user cost of capital, which combines the real interest rate paid by the borrower and depreciation. The average depreciation rate of business capital depends critically on whether different categories of capital are weighted according to value following the conventional "capital stock" approach or to their efficiency profiles following the "capital services" approach (Schreyer, 2003).[14] Because both approaches have legitimate foundations and have been applied in empirical analysis (Beffy *et al.*, 2006; Schreyer and Webb, 2006), both are used here. For oil, the relative factor price is simply the local currency price of Brent as a ratio to the GDP deflator.[15] In the case of an oil shock, the present approach, which assumes constant factor shares, may involve some overestimation of the long-term reduction in the level of potential output. The reason is that, because new capital will be more energy-efficient, the oil and gas share is likely to trend down over time after an oil shock, gradually limiting the impact.

Included for consistency, housing capital does not drive the annual results

Because the scrapping rate of residential buildings is very low, this category of capital -- which has been retained in the analysis to be consistent with national account data -- has very little impact on the reported results. In all the reported simulations (in both the main text and the appendix), resetting the assumed change in mortgage rates to zero never changes the estimated impact on potential growth by more than 0.1 percentage points. At the same time, precisely because houses depreciate slowly, their cost of capital is very sensitive to the interest rate, implying that shocks to mortgage rates can have large effects on the steady-state level of the housing stock. Because these steady-state effects phase in only very slowly, they are probably negligible in practice compared with other long-term trends affecting housing supply including demography and urban planning.

14 . While the scrapping rate of capital does not appear explicitly in the services approach as it does in the stock approach, its level can be derived by relating the change in the volume of capital services to the level of investment. See for instance Beffy *et al.* (2006), Footnote 15.

15 . International Energy Agency (IEA) indices of real energy prices for end users might be considered as a potential alternative. The local currency price of Brent relative to the GDP deflator has been preferred for three reasons. First, the IEA indices do not cover services. In a framework based on an economy-wide production function, services, which make up significantly more than half of OECD output, have to be taken into account. Second, the economy-wide approach requires considering the price of oil when it enters the economy rather than when it reaches end users because value added in the transport and processing of oil is part of GDP. Third, price indices for end users include excise duties, retail margins and non-deductible value-added tax, three items which are not reckoned in the basic prices at which the oil shares are calculated. As such, price indices for end users are not well suited to the present study.

Estimated steady-state impacts are translated into annual effects

Steady-state effects are converted into annual impacts using the average scrapping rate of the stock of capital. This approach may be thought (but is not guaranteed) to provide a lower bound on the speed of adjustment, especially when the shock is large, because the renewal rate of capital is likely to accelerate in response to a large shift in factor prices. Part of the output adjustment in response to an oil shock also does not require the renewal of capital and can therefore occur faster. Furthermore, the structure of the model, where potential adjusts smoothly to its new long-term equilibrium path, by definition ignores the possibility that supply may contract by more in the near term.[16] On the other hand, energy-intensive capital often has service lives that are well above average. Because it depends on the renewal rate of capital, the estimated speed of convergence will differ between the capital stock and services approaches.

Calibrated on recent data…

The data are taken from various sources. Shares for business and housing capital are calculated on 2004 data (the most recent vintage that is unlikely to be revised) using the OECD National Accounts database. Nominal interest rates are taken from Datastream, the German Bundesbank and the Bank of France. Real interest rates are calculated as nominal rates minus a five-year moving average of the inflation rate of the GDP deflator. The yield on BBB-rated corporate bonds serves as proxy for the average interest rate charged to businesses for non-residential capital. Scrapping rates of the capital stock are taken from the OECD Economic Outlook 78 and 82 databases for the capital stock and services approaches, respectively. Housing capital is assumed to depreciate by 3% a year in the United States as estimated by Harding *et al.* (2007) and by 1.2% in the euro area as derived from the US rate and the information in the OECD Economic Outlook 78 medium-term database. The oil and gas share in production (which can equivalently be seen as the intensity of oil and gas usage in production) is taken from Blanchard and Galí (2007) for the United States and calculated using the *OECD Input-Output Tables* for the euro area. Brent prices are from Datastream and the GDP deflator from the OECD Economic Outlook 83 database.

… the main model suggests significant oil shock effects…

When the scrapping rate of existing capital is estimated using the conventional stock approach, the oil shock is reckoned to dent potential growth by 0.21 percentage points a year in the United States and 0.06 percentage points in the euro area in the first years of adjustment (Table 3.4). The capital stock approach can be considered as providing a central estimate of the relevant scrapping rate. On the one hand, energy-intensive capital typically has longer service lives than other types of non-residential capital and is therefore likely to have a scrapping rate below the average for the stock approach. On the other hand, in the wake of a large shift in real oil prices, energy-intensive capital could well be upgraded and replaced more rapidly than past average scrapping rates would indicate.

16. A model with vintage capital would capture this effect.

Table 3.4. **Detailed illustrative estimates of the impact of real energy and capital cost increases**

	Capital stock approach		Capital services approach	
	United States	Euro area	United States	Euro area
Oil price shock	*Per cent*			
Oil and gas share	3.2	2.1	3.2	2.1
Real oil price increase relative to the previous 20 years	240	170	240	170
Impact on steady-state output	-4.1	-2.1	-4.1	-2.1
	Percentage points			
Medium-term impact on potential growth	-0.21	-0.06	-0.51	-0.20
Shock to real interest rates from the 2007 turmoil	*Per cent*			
Capital share	39	49	39	49
of which: housing	10	9	10	9
non-residential business capital	30	40	30	40
User cost of homes	8	4	8	4
User cost of business capital	12	8	21	17
	Percentage points			
Change in real mortgage rates	0.5	0.4	0.5	0.4
Change in real rates charged to businesses	0.4	0.6	0.4	0.6
	Per cent			
Resulting change in business capital cost	3	7	21	17
Resulting change in residential capital cost	7	10	7	10
Impact on steady-state output	-2.1	-5.9	-1.5	-3.3
	Percentage points			
Medium-term impact on potential growth	-0.1	-0.2	-0.1	-0.3
Medium-term impact of both shocks on potential growth	-0.3	-0.3	-0.7	-0.5

Source: OECD calculations.

… while capital stock adjustment could be even faster

As a (possibly extreme) alternative, if the scrapping rate is estimated using the capital services approach, which gives more weight to short-lived equipment such as information and communication technology, convergence will be estimated to be much faster. In the capital services framework, the illustrative steady-state estimates of the oil shock translate into initial annual reductions of potential growth of 0.51 percentage points in the United States and 0.20 percentage points in the euro area. However, even following a large oil shock, energy-intensive facilities (for instance refineries, power plants, cement works and buildings) are unlikely to be replaced at the very high rates of 13-16% *per annum* that are implied by the capital services approach.[17] The renewal rate of capital taken from the

17 . The scrapping rate is very high in the capital services framework because this approach puts a strong weight on capital that is replaced quickly such as information technology equipment and software.

capital services framework is therefore most likely to lead to overestimating the speed at which installed equipment adjusts to the shift in the real price of oil.[18]

The estimated effects of financial turmoil are also significant

The effects of the 2007 rise in real interest rates are also significant, reducing potential growth by an estimated 0.1 percentage points in the United States and 0.2-0.3 percentage points in the euro area. The impact is larger in the euro area because businesses have been confronted with a greater rise in real interest rates and the capital share in value added is higher. In practice, however, businesses may finance themselves in international markets and the cost of capital relevant for the decision on capital intensity may not correspond to the real interest rate on firms' domestic financial markets. The implication would be that the effects of the shock would be similar across the OECD area.

18 . Some models incorporate much faster adjustment speeds because the response to an oil shock can happen in part by cutting energy consumption before updating capital. For instance, potential output absorbs two-thirds of an oil shock within two years in the FRB/US model used by the Federal Reserve (Brayton *et al*., 1997). In the framework used here, such a rapid adjustment speed would reduce potential growth by 2.3 percentage points in 2008 and 1.1 percentage points in 2009. On the other hand, as newly installed capital is more energy-efficient than what it replaces, a partial rebound in potential output is likely to follow the initial contraction.

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