

# Commentary

BUFFIN PARTNERS INC.

ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

## OECD Issues Economic Outlook and Calls for Corrective Actions

The Paris-based Organization for Economic Cooperation and Development (OECD) projects a decline in GDP growth for its 34 member countries from 1.9% in 2011 to 1.6% in 2012, before recovering to 2.3% in 2013. Within the group of OECD countries, the United States is expected to experience a slow growth recovery, the euro area is expected to enter into a mild recession and Japan is expected to experience temporary faster growth because of reconstruction. The OECD's baseline scenario for its *Economic Outlook* assumes that policy-makers take appropriate actions to avoid each of four potential problems, namely, disorderly sovereign defaults, a sharp credit contraction, systemic bank failures, and excessive fiscal tightening. The OECD assumes, under its baseline scenario, that weak economic activity, low levels of inflation, and potential downside risks will be met with strong accommodative monetary policy. In a well-timed anticipatory assessment of actual events, the OECD stated "Central Banks should provide ample liquidity to calm tensions in financial markets and prepare contingency plans that could be implemented swiftly if needed." Two days after the release of the OECD's *Economic Outlook*, the US Federal Reserve, Bank of Canada, Bank of England, Bank of Japan, European Central Bank, and Swiss National Bank took coordinated action to provide access to low-rate emergency US dollar-denominated funds for banks in Europe. An accompanying statement explained that the purpose of these actions is to ease strains in financial markets and thereby mitigate the effects on the supply of credit and so help foster economic activity. The Federal Reserve also issued a statement that it had a range of tools at its disposal to provide short-term funding to US markets and was prepared to use them if needed.

The euro area crisis represents the greatest current risk to the world economy. Concerns about sovereign debt sustainability have resulted in a number of high-level meetings among leaders and finance ministers in Europe that dominate the media headlines. Confidence has eroded and skepticism has grown as to whether euro area policy makers can deal effectively with the challenges that they face. Certain countries that were previously believed to have relatively solid public finances are not immune from the effects of contagion that will further increase economic disruption. Pressures on bank funding and balance sheets are increasing the risk of a credit crisis. Another risk would arise from fiscal tightening policy in the United States that could tip the economy into recession. Monetary policy alone would not be effective to counter the risks of recession in the United States. Improved economic prospects depend on the implementation of a credible medium-term fiscal program in the United States.

Under present circumstances global economic prospects depend on a number of critical future events that are difficult to predict. An air of uncertainty surrounds any attempt to predict economic outcomes based on various alternative scenarios. Deleveraging in the financial and government sectors remains as a significant factor of concern. Imbalances in the euro area that reflect fiscal, financial and structural problems remain unresolved. Serious downside risks remain in the euro area including the possibility of a sovereign default and its consequent cross-border effects on creditors. This uncertainty has resulted in a loss of confidence in sovereign debt markets in general, and indeed in the continued viability of the euro area's monetary union itself.

Future negative economic events would most likely send the OECD area as a whole into recession. Such events would result in marked declines in economic activ-

ity in the United States and Japan, and prolong and deepen the recession in the euro area. Unemployment would rise still further. Emerging markets would not be immune, with global trade volumes falling significantly. By contrast, the OECD believes that an alternative upside scenario could arise if policy actions were successful in boosting confidence and no significant negative events occur. For an upside scenario to be plausible, substantial credible commitments would be required at the country level in both advanced and emerging market economies to pursue sustainable structural adjustments, to raise long-term growth rates, and promote global rebalancing. By improving confidence, lowering uncertainty and removing impediments to economic activity, implementation of such reforms could raise consumption, investment and employment.

The OECD warns that in view of the great uncertainty that policy makers now confront, they must be prepared to face the worst of potential economic outcomes. The OECD's strategic response recommendations for the worst case scenario include: stabilizing the financial sector; protecting the social safety net; further monetary policy easing; providing fiscal support where practical; and stronger fiscal frameworks to reassure markets that public finances can be brought under control. Finally the OECD recommends appropriate labor market policies to deal with the consequences of unemployment that is turning from cyclical to structural thereby constraining potential growth.

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