ARTICLE

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Recession and recovery in the OECD

SUMMARY

During the last year the global economy has experienced its most severe recession since the Great Depression. This article compares the UK experience with that of OECD member countries – a group of the major industrialised economies. While important economies such as Japan and Germany saw a larger fall in output, the depth of the UK recession was larger than the OECD average. Recent data shows the global economy beginning to emerge from recession, but the projections are for a weak and fragile recovery as households, businesses and governments continue to pay off debts and rebuild their balance sheets. In fact, the major economies could be susceptible to a further downturn resulting in a double-dip recession. The second part of this article looks at the factors underlying recent growth forecasts made by the OECD and the IMF.

Introduction

Gross Domestic Product (GDP) in the UK has now fallen for 5 successive quarters. The cumulative loss in output of 5.5 per cent makes this the most severe recession since records began. Although the latest data shows that the pace of decline moderated in the second quarter of 2009, the number still disappointed for two reasons.

First, several of the business surveys had been more upbeat in April and May, pointing to a return to growth in these months. Some commentators, following these results, had even called the end of recession would be confirmed in the official Q2 data. Although the consensus was that this was premature, there had been a feeling that the downturn would have slowed further than it did. Data revisions though have done this slightly with quarter on quarter growth now showing a 0.6 per cent contraction compared to a preliminary estimate of a 0.8 per cent contraction.

Secondly, many of the major industrialised countries exited recession in the second quarter. Positive growth was recorded in Japan, Germany and France. And in the US, although output continued to fall, the quarterly contraction of 0.25 per cent was far more modest than in the UK. Therefore, official data pointed to a more prolonged fall in output in the UK.

The Organisation for Economic Cooperation and Development (OECD) is a group of 30 wealthy nations from around the world, including the North American Free Trade Association (NAFTA) and Japan, although membership is biased towards Europe. The first focus of this article is to compare the experiences of the UK with other OECD countries in what has been the first truly global recession since the early 1980s.

However, to a large extent the focus has now moved on. Even in countries where growth is yet to return, such as the UK, attention is turning to the speed and strength of the recovery. Although independent forecasts expect the UK to resume growing in the third quarter, general opinion is that the recovery will be fragile. And should the economy be subject to a further shock or loss of confidence then a double-dip recession cannot be ruled out.

An escape from recession in the second half of 2009 followed by weak growth in 2010 is a general pattern in the growth forecasts of most OECD countries. It is a reflection that many sectors of the economy (households, firms, financial sector and government) are still de-leveraging – that is they are running down their debts and trying to rebuild their balance sheets. While this continues it is unlikely there will be a strong pick up in either consumer spending or firm investment. Rapidly growing public sector debt has also limited the room for further fiscal stimulus. Most countries are now talking about fiscal restraint rather than expansion.

Monetary policy has been loosened considerably. Interest rates have been cut to almost zero, and being unable to lower rates any further, central banks have undertaken programmes of quantitative easing – a technical term for direct cash injections into the banking system. For those who can obtain it credit is cheap, but the credit system is still impaired. Banks are still unwinding their losses from toxic assets. And while they do so a cautious approach to lending will be adopted in order to protect balance sheets.

As economies 'technically' move out of recession, attention will turn to the labour market. Due to significant costs in adjusting the workforce (hiring and firing costs), it is usual for unemployment to lag output movements, so it is expected that unemployment will keep rising, for several quarters at least, after output passes a turning point. It could well be a jobless recovery in 2010 if firms are reluctant to start hiring again until they are confident a sustained improvement in business conditions. Naturally the depressed jobs market will feed back into demand and dampen growth.

These factors have been reflected in the economic outlooks of both the OECD and the International Monetary Fund (IMF). Therefore, the second focus of this article is to look ahead as the global economy starts picking up – identifying some of the issues behind the projections. There are a number of important issues and developments in the global economy that are important to the UK, not covered in this article, but these will be picked up in two future ELMR articles.

This article, by focussing on the OECD, pays little attention to the growing impact of emerging market economies, China and India in particular. The latest global financial crisis has led many to believe that the US consumer cannot and will not continue to be the sole engine of global growth, a role they will now share with the emerging economies of the Far East. Over reliance on the US consumer was seen as one the causes of the large global imbalances that built up over the preceding decade, and were ultimately the source of global financial crisis as surpluses from oil exporting and emerging market countries flowed into western financial markets. Therefore one article will look at the impact of these growing imbalances and the associated credit boom in the UK during the period of 'The Great Moderation'. A second article will look at the changing patterns of global growth, particularly the effect of emerging Asia on the UK economy.

Tracking the recession in the OECD

Recession trackers, which compare the path of the UK economy in the current with previous recessions, have been widely used to provide a context relative to previous experiences of severe downturns such as the recessions in the early 1980s and early 1990s.

The same tool can be used to compare the UK recession with that elsewhere among the major industrialised countries making up the membership of the OECD.

Figure 1 plots the path of the UK recession relative to the US, Japan and the Euro Area. The tracker works by creating an output index equal to 100 in Q1 2008, which then subsequently reflects the quarter on quarter GDP growth in each country. This means that the recession in each country is monitored from the same starting point and it is easy to see the cumulative output loss in each case.

The UK recession has generally followed the same pattern of the Euro Area. Between Q1 2008 and Q1 2009 output fell by about 4.9 per cent. However, while GDP in the UK fell by a further 0.6 per cent in Q2 2009, only a 0.1 per cent fall was recorded in the Euro Area as a number of major economies moved out of recession. Given the significant trade links between the UK and the Euro Area it is not surprising that experiences in the recession have been similar. Cumulative output losses in the US have been milder with output dropping by a total 3.5 per cent between Q1 2008 and Q2 2009. Japan though has suffered more pain. Output shrunk by 8.4 per cent in the four quarters leading up to Q1 2009, but there was a positive rebound of 0.9 per cent in Q2 2009.

Figure 2 is a similar tracker but compares the UK to the major economies in the Euro zone. Again the UK experience appears to be fairly 'middle of the road', experiencing a larger fall in output than France and Spain, but doing relatively better than Italy and Germany. Both the French and German economies exited recession in Q2 2009 as the same growth of 0.3 per cent was recorded.

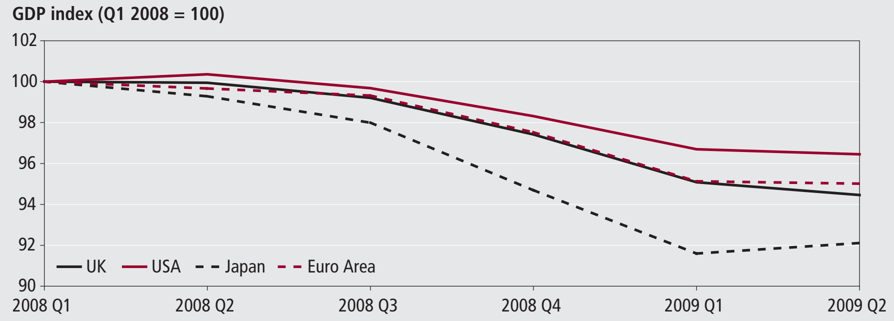
The first column in **Table 1** records, in order of size, the cumulative loss of output in each of the 30 OECD member countries during the recession. For those that exited recession in the second quarter of 2009 the output loss is measured between Q1 2008 and Q1 2009. Those economies marked with a * were still contracting right up to the end of the sample period, and here cumulative output losses were measured between Q1 2008 and Q2 2009.

As Table 1 shows, the largest output losses have been recorded in the more emergent economies of Turkey and Mexico. The Mexican economy has also suffered a jolt from the outbreak of swine flu, compounding the effect of the global credit crunch. Relatively large output losses were experienced in Ireland and Iceland – both small countries with a high exposure to losses in the banking sector.

Countries that have performed relatively

Figure 1

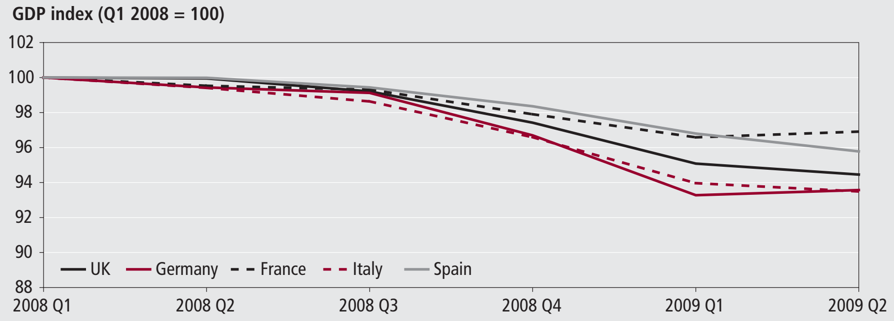
Tracking the recession in the UK, US, Japan and Euro Area



Source: OECD Statbase

Figure 2

Tracking the recession in the UK, Germany, France, Italy and Spain



Source: OECD Statbase

Table 1
Output growth in the OECD

Per cent

Cumulative output losses in the recession Q1 2008–		Cumulative output gains Q1 1998 to Q1 2008	
Turkey	–13.92	Slovak Republic	62.79
Mexico*	–9.43	Luxembourg	62.73
Finland*	–8.96	Iceland	62.63
Iceland*	–8.96	Turkey	53.15
Ireland	–8.40	Poland	50.91
Japan	–8.40	Hungary	46.68
Hungary*	–7.50	Czech Republic	45.64
Germany	–6.72	Spain	43.35
Italy*	–6.51	Australia	40.75
Sweden	–6.47	Finland	40.36
Slovak Republic	–5.71	New Zealand	39.63
United Kingdom*	–5.54	Sweden	36.44
Luxembourg	–5.44	Canada	35.06
OECD – Europe	–5.14	NAFTA	32.83
Netherlands*	–5.06	United States	32.30
European Union*	–5.00	United Kingdom	31.94
Euro Area*	–4.99	OECD – Total	30.23
G7*	–4.78	Netherlands	29.04
OECD – Total	–4.70	OECD – Europe	28.90
Czech Republic	–4.45	Austria	28.88
Korea	–4.32	European Union	27.34
Austria*	–4.28	G7	26.23
Denmark	–4.26	Belgium	25.01
Spain*	–4.22	France	24.75
NAFTA*	–4.05	Euro Area	24.56
Portugal	–3.96	Switzerland	23.15
United States*	–3.55	Norway	22.91
France	–3.42	Portugal	19.46
Belgium*	–3.35	Denmark	18.37
Canada*	–3.15	Germany	17.18
New Zealand	–2.72	Japan	15.87
Norway*	–1.95	Italy	14.63
Switzerland*	–1.89	Greece	NA
Greece	0.31	Ireland	NA
Australia	0.34	Korea	NA
Poland	1.71	Mexico	NA

Note:

* See main text.

Source: OECD Statbase

well, such as Poland, Greece, Australia, Switzerland and Norway, all have the common trait of being late entrants into recession. In fact the majority of these countries recorded respectable growth in 2008, and it is only latterly in 2009 that output has contracted. Norway and Australia are more unique among the OECD member states in being significant exporters of raw materials. The boom in global commodity prices in 2008 certainly helped these nations avoid a major downturn.

The UK is above average in terms of the severity of the recession it has faced, and output was still falling in the second quarter. Since the first quarter of 2008 total output has fallen by more than the Euro Area, the US, G7 and the OECD average. However, it is also notably that several major economies have performed worse – namely Japan, Germany and Italy.

Japan and Germany both have a large industrial base, and because a relatively high share of manufacturing output is traded internationally, this industry has been adversely affected by the synchronised fall into recession of the major economies and large slowdown in world trade. Recessions in the manufacturing sector also tend to be more severe because of the rapid disposal of inventories as firms lower expected future production. This is referred to as the 'stocks cycle' and can amplify the downturn in an economy. On the upside, recoveries tend to be sharper as well due to restocking. It is likely that an inventory bounce was a significant factor in these two economies returning to positive growth in the latest quarter.

The second column in Table 1 attempts to put these recent output losses in a longer term perspective. For most of the decade preceding the recession the global economy saw a period of rapid growth and unprecedented stability. That is not to say there weren't some sizeable shocks to economic activity – there was the Asian financial crisis, the bursting of the dot com bubble and the terrorist attacks of September 11th – but despite these output and inflation volatility fell to unprecedented levels. The entire period has been widely referred to as 'The Great Moderation'.

Even though there was a brief period of global recession in 2001-2002, and a soft patch in growth in late 2005, the UK managed to avoid a downturn altogether. Up until the second quarter of 2008 sixty-four successive quarters of positive growth were recorded – the longest peacetime expansion on record. Looking at the second column in Table 1 the UK performed better than the G7, Euro Area and European averages over this period.

History has shown that it is fairly typical for economies to experience a downturn after a long period of sustained growth. The nature of the cycle this time is somewhat different, in that inflation has largely been kept under control despite some very volatile commodity price movements. But it is clear that during the period of Great Moderation significant imbalances were allowed to build up in the global economy. In the UK the strong rise in house prices, consumer debt, the private equity boom and the sharply deteriorating trade balance were all signs of an unbalanced economy. The current recession is largely the consequence of these imbalances rewinding. A future article will explore this further with a particular emphasis on how the UK was affected by the rise in global imbalances.

Despite the severity of the current recession it has far from wiped out the gains made over the previous decade. It is also clear that previous low growth was not a buffer against the recession. For example, Japan, Germany and Italy have shown long periods of weak growth, but were also subject to among the largest output falls in the recession – and future growth projections aren't particularly rosy either. This highlights the importance of structural factors in driving longer-term or trend growth.

The economic outlook

The summer update of the OECD *Economic Outlook* provides forecasts of annual GDP growth in 2009 and 2010 for member countries. As **Table 2** shows, the UK is expected to contract by 4.3 per cent in 2009 with output flat in 2010. Although projected growth rates vary by country, there is unanimity in the general pattern. Most OECD members are expected to record a large fall in output in GDP during 2009 followed by zero or very modest growth in 2010. For some of the emergent OECD economies, such as Turkey, Mexico, and Korea, growth in 2010 is expected to rebound relatively strongly following large declines in 2009. For the majority of the more advanced countries, including the G7 members, growth is expected to be modest – regardless of previous growth or the depth of the recession. Output in the Euro Area is projected to be flat, with small growth in Germany, France and Italy offset by continued recession in Spain. Annual growth of 0.7 per cent and 0.9 per cent is forecast for Japan and the US respectively in 2010, which pulls up the expected G7 growth rate to 0.6 per cent. But it must also be accepted that there is considerable uncertainty surrounding these projections, with the balance of risks judged to be towards the downside.

Although there are signs that the major economies are coming out of recession with positive GDP growth in the second quarter in Japan, Germany, and France, with independent forecasters expecting the UK and US expected to follow in quarter three, any recovery is expected to be fragile for a number of reasons. There continues to be tight credit conditions as a result of the credit crunch following from the financial crisis and final consumption demand is weak due to the process of de-leveraging or shedding debt from the balance sheets of homes and businesses.

These are among the key assumptions underlying the latest forecasts for the global economy by the International Monetary Fund (IMF). The IMF predicts that global output will fall by around 1.0 per cent this year and grow by 3.0 per cent in 2010, which means that the world will be in recession once population growth is taken into account. One measure of the weakness of the recovery is the extent of the output gap prevalent in major economies. The output gap (the difference between actual and potential output) is between 5-7 per cent for major economies (and 8 per cent for Japan) in 2009 and 2010, making this the worst instance of excess capacity in the post-war period (see **Figure 3**).

One of the implications of this substantial output gap is a period of slow income growth and below trend income levels. Even though GDP stops falling and the recession is technically over, it could take several years for the economy to recover to the pre-crisis trend level of income. Therefore, the global recession may be over in a technical sense, but the level of income is lower than potential for some years. Of course, if the recovery is U-shaped (rather than the more optimistic V-shape where recovery is rapid), meaning output remains below trend for a longer period of time, then the process of restoring income levels to trend could take even longer.

As this recession is characterized by a financial crisis, the pace of recovery is likely to be slower than the usual dip in the business cycle. The IMF's latest World Economic Outlook estimates that it takes an average of seven years to recover after a financial crisis, meaning that it will take the UK until the middle of 2015 to reach its pre-crisis level of income given the recession began in the second quarter of 2008. **Figure 4** shows the evolution of output after previous financial crises reinforces this view whereby the level of income has remained below pre-crisis levels for the better part of a decade.

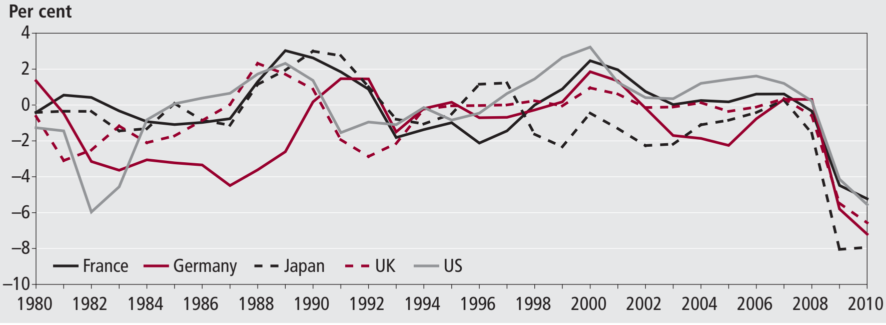
Table 2
Projections of OECD output growth for 2009 and 2010

Per cent

	2009	2010
Australia	–0.4	1.2
Austria	–4.3	–0.1
Belgium	–4.1	–0.5
Canada	–2.6	0.7
Czech Republic	–4.2	1.4
Denmark	–4.0	0.1
Finland	–4.7	0.8
France	–3.0	0.2
Germany	–6.1	0.2
Greece	–1.3	0.3
Hungary	–6.1	–2.2
Iceland	–7.0	–0.8
Ireland	–9.8	–1.5
Italy	–5.5	0.4
Japan	–6.8	0.7
Korea	–2.2	3.5
Luxembourg	–4.0	–0.4
Mexico	–8.0	2.8
Netherlands	–4.9	–0.4
New Zealand	–3.0	0.6
Norway	–1.0	0.8
Poland	–0.4	0.6
Portugal	–4.5	–0.5
Slovak Republic	–5.0	3.1
Spain	–4.2	–0.9
Sweden	–5.5	0.2
Switzerland	–2.7	–0.2
Turkey	–5.9	2.6
United Kingdom	–4.3	0.0
United States	–2.8	0.9
Euro area	–4.8	0.0
G7	–4.0	0.6

Source: OECD Statbase

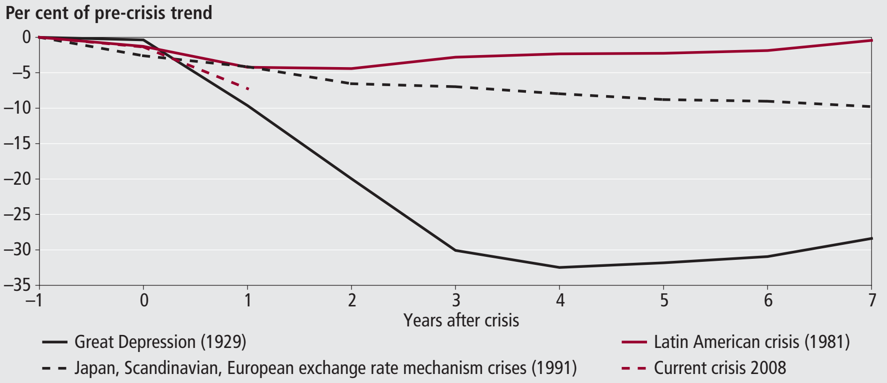
Figure 3
Output gap as a percentage of potential GDP



Source: IMF World Economic Outlook

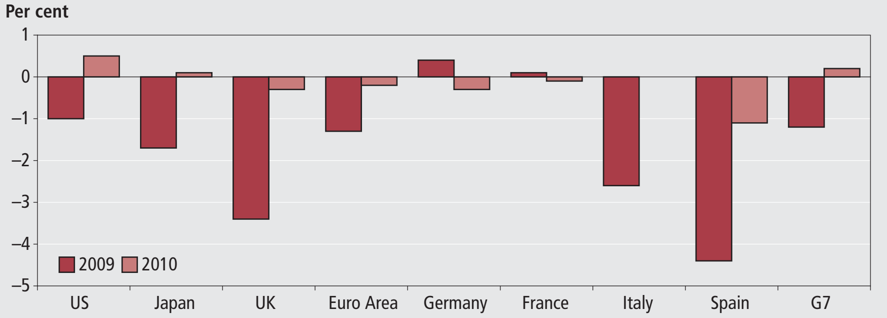
For specific countries the immediate prospect of recovery is not only dependent on the trajectory of the financial crisis but also the strength of demand. This is where economic fortunes appear to diverge quite noticeably for the countries which have had high levels of borrowing leading to highly indebted consumers. **Figure 5** shows OECD projections of personal consumption expenditure growth for 2009 and 2010. Although there has been a considerable slowdown everywhere, the countries which have experienced the sharpest falls are the UK and Spain, which have been subject to a large boom and correction in the housing market, and Italy where consumer confidence has fallen sharply due

Figure 4
Output evolution after financial crises in advanced economies



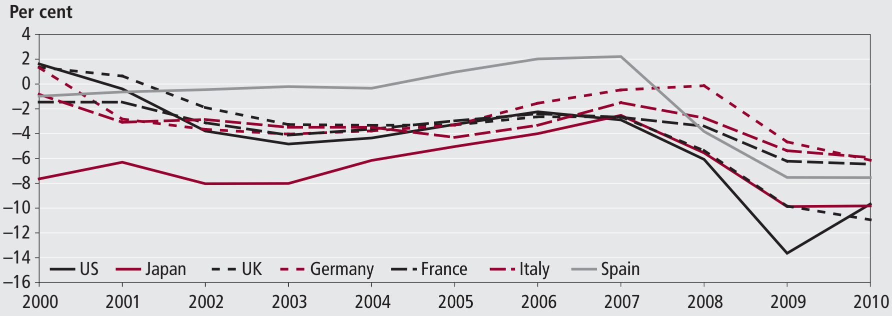
Source: IMF World Economic Outlook

Figure 5
Projections of annual growth in personal consumption expenditure



Source: OECD Statbase

Figure 6
General government balance as a percentage of GDP



Source: IMF World Economic Outlook

to the weakening labour market and credit restrictions. The Euro Area as a whole has had relatively stronger consumption growth, notably in France, Germany, and here the extent of household indebtedness is lower.

De-leveraging means that consumption as a driver will remain weak, particularly in those countries where housing bubbles were the most significant. British households and firms are repaying debt and saving instead. The savings rate in the UK has increased four-fold since the start of the crisis to around 5.6 per cent of disposable income. Though this increased rate of saving and reducing consumer borrowing are necessary to shed debt and rebuild household balance sheets, the implication is that consumption will remain weak while this process of de-leveraging occurs.

In a recession, public demand can take the place of private demand. **Figure 6** shows the sharp deterioration in the general government balance in all major economies, either through automatic stabilizers or discretionary fiscal spending. The eventual withdrawal of the stimuli, for example the reversal of the VAT cut in Britain in January 2010, will require private demand to take its place or else risk a fall in aggregate demand.

A consequence of public spending is the increase in government debt. Government debt as a share of GDP will increase to 79 per cent this year and 86 per cent next year in the Euro Area. The UK's debt-to-GDP ratio will increase to 84 per cent in 2010, while Spain's will increase to 61 per cent, Germany to 81 per cent and France to 86 per cent, all considerably above the 40 per cent ceiling in the Maastricht Treaty. This increase in government debt will in turn require austerity measures such as raising taxes and cutting spending, putting more pressure on a fragile and prolonged period of recovery. Premature tightening can worsen a recession as has been seen in Japan in the late 1990s as well as in the Great Depression where the recession ended in 1933 but was followed by a second recession in 1937.

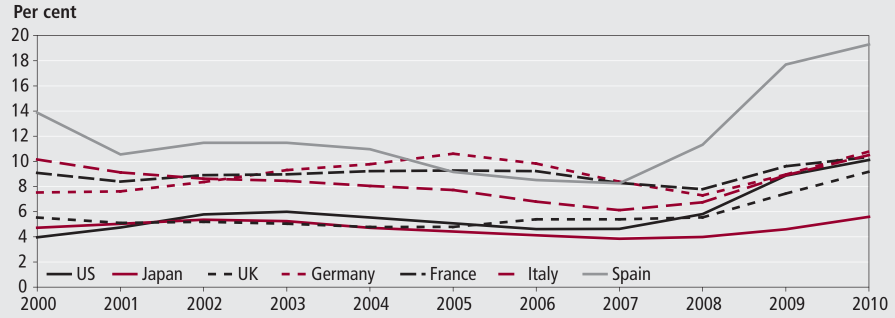
The severity of the recession has driven up unemployment. The unemployment rate in all major economies is expected to rise sharply next year since joblessness follows the real economy with a lag (see **Figure 7**). In the Euro Area, the unemployment rate is predicted to exceed 12 per cent, while the US and the UK face unemployment of around 10 per cent. Spain, one of the worst affected economies, is to experience a jump in the unemployment rate from 11 per cent in 2008 to 18 per cent and nearly 20 per cent in 2009 and 2010, respectively. Rising unemployment along with sluggish wage growth will further dampen consumption since uncertainty in incomes will induce precautionary savings rather than spending.

How sustainable is the recovery?

Although the UK, USA, and perhaps Spain will follow Japan, Germany and France out of recession in this or the next quarter, there is also the prospect of these economies falling back again into recession. De-stocking had been so fierce that re-stocking has bumped up industrial production leading to growth in industrial output in the Euro Area. However, restocking will not have a permanent affect on output and as fixed investment continues to fall sharply weakness in the third quarter could continue. This is particularly significant in Germany and France with large industrial bases. As industry constitutes a third of GDP in those economies, an upturn in industrial output would generate growth. But, by the same token, the downturn may well drag growth down again.

Second, export growth for Germany has resumed at 7 per cent (fastest rate in 3 years) and it has had a current account surplus of around 3 per cent of GDP because imports have fallen more quickly due to a low consumption base. Exports of capital goods

Figure 7
Unemployment rate



Source: IMF World Economic Outlook

are driven by infrastructure spending in the fiscal stimulus spending of America and China. Once those funds end, then export growth may well taper off.

Third, consumption growth looks weak in the recovered economies of Germany and France, more so in the former due to a savings rate exceeding 10 per cent and an economy geared at exports. Where consumption is growing is related to fiscal policy such as the car scrappage scheme in France which has driven household consumption upward by 0.4 per cent. Other countries like Spain and Ireland have to de-leverage or shed debt, offering little in support of consumption growth in the Euro Area. And in Italy low labour productivity growth is likely to suppress income growth and consumption.

Fourth, global re-balancing will involve Germany which had the second highest trade surplus in the world only after China before the crisis. As Americans save, there will be global re-balancing in that consumption will decline and the trade deficit fall which will be matched by shrinking surpluses elsewhere. Without the boost from exports and fiscal stimulus spending, exports will not be much of an engine for sustained recovery.

Fifth, Germany and France both have short-time workers which has staved off unemployment and maintained incomes, particularly as wage compression reins in costs. If final demand does not increase, then these schemes cannot be maintained and a squeeze on income will follow.

Although the Euro Area and Germany in particular have suffered greater contractions in GDP than America and its banks are estimated by the European Central Bank (ECB) to have 800 billion euros of toxic assets, the rebound from recession is sharper than in the US and the UK, both of which contracted in the second quarter.

There are, however, also factors that would point to a sustainable recovery. Although external demand from emerging economies like China are unlikely to fully offset the fall in consumption in the United States, its growth rate of 7.1 per cent in the first half of the year will boost global growth as the third largest economy in the world. World trade had been predicted to shrink for the first time since World War II this year. But, the injection of funds into trade finance (letters of credit from exporting countries to reassure importers) by the G20 has revitalized world trade and the pace of growth in global exports and imports is at its highest since 2003, albeit from a low level. Finally, although the credit crunch has not concluded, there are signs of stabilization in the banking system. Some US banks are seeking to exit from government schemes as are British ones. The combination of improvements in the financial sector and a source of demand could together support a sustained recovery. This is particularly the case for countries like the UK and USA where weak currencies could bolster net exports both through exporting more competitive goods and services but also through import substitution whereby cheaper non-traded goods/services are substituted for more expensive traded ones. This, of course, is not an option for Spain as the single currency will prevent it from making such adjustments.

Conclusion

The global recovery looks to be on the horizon, but there are a number of reasons as to why it may be too early to call an end to the severest post-War recession. Continued write-downs by banks and weak final private demand due to households and firms de-leveraging their balance sheets point to a fragile resumption of growth. Financial crises, in particular, are associated with prolonged periods of below-trend levels of output with levels of income not expected to recover for at least 7 years.

For the UK and USA, the financial crisis has caused a severe credit crunch while households and firms shed debt. However, with weakening currencies (the US dollar is at a 13 month low against the euro and sterling is also declining against both the dollar and euro), global demand might cushion some of the impact.

This is not an option for Spain. Although its banks have been less affected by the financial crisis, the housing bubble and level of indebtedness have plunged Spain into a recession with unemployment projected to reach 20 per cent by next year. Without net exports as a driver of growth and high levels of government debt, Spanish demand will need to come from consumers which will make for a weak recovery. Italian banks also avoided large write-downs, but weak consumer demands means the economy is over-dependent on external demand for growth.

In contrast, Germany and France in the Euro Area and Japan have emerged from recession. Although their banks were also affected by the financial crisis, the larger industrial sectors in their economies allowed for a faster recovery than the UK. However, the same inventory cycle could pull these economies into an uneven W-shaped recovery. Also, these countries have savings ratios of above 10 per cent, which means that de-leveraging is not necessary which could point to quicker recovery in consumption. However, by the same token, the lower rates of consumption mean that the pace of growth will not be as fast as when exports and external demand boosted countries like Germany and Japan before the crisis.

Finally, the resumption of world trade and the stronger than expected growth in Asia, particularly China, does offer a source of demand in the global economy. As public sector spending will be hamstrung by rising debts and private consumption is likely to remain weak, external demand by consumers and Asian governments spending on infrastructure will offer a source of growth, particularly for economies with competitive currencies.

Although there is already global re-balancing happening, notably with the US current account deficit halving from 6 per cent to 3 per cent of GDP and Chinese consumption rising from 36 per cent to 41 per cent of GDP, the ensuing structure of global demand and production may well be more sustainable. A more stable global economic structure would benefit all countries during what is likely to be a lengthy recovery period.

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