

EDITORIAL

SMOOTH REBALANCING?

Until recently, the OECD area was enjoying a prolonged period of non-inflationary growth despite rising oil and commodity prices. Underlying these favourable trends, persistent wage moderation provided for both price stability and strongly rising profits as well as vigorous job creation in the main OECD regions.

This smooth performance has been somewhat disturbed recently, however. In the United States, signs of inflationary pressures and labour market tensions have recently built up while investment in housing has fallen sharply, following a long boom in residential construction. In the OECD area as a whole, however, there are still few signs of general overheating. Aggregate demand and supply broadly match, in contrast with the previous cyclical peak at the turn of the century when demand pressures were much stronger. While in the United States and Japan aggregate demand may be somewhat above trend, in the euro area substantial slack remains.

Rather than a major slowdown, what the world economy may be facing is a rebalancing of growth across OECD regions. Indeed, recent developments point to an unwinding of cyclical differences, with activity having slowed in the United States and Japan, and gathered speed in Europe. Looking ahead, and given what is seemingly a mild degree of initial excess demand in the United States and Japan, the slowdown in these countries should remain well-contained. In the euro area, recent hard data as well as business and consumer confidence suggest that a solid upswing may be underway. In addition, growth should remain buoyant in China, India, Russia and other emerging economies. All in all, Japan and the euro area would grow slightly above trend over the next two years while US growth would return progressively to potential in the course of 2007, following the recent steep deceleration in activity.

In its initial phase, however, this growth rebalancing would not be strong enough to prevent a mild and short-lived weakening in 2007 in the OECD area. As a matter of fact a variety of factors, including needed fiscal consolidation in Germany and Italy would weigh down on euro-area activity next year before it accelerates anew.

The projected “soft landing” in the United States implies that history would not repeat itself. In 2000, aggregate demand vastly exceeded potential supply, calling for a strong downward adjustment in activity. Today, the degree of overheating still looks modest despite some tensions in US labour markets, which should recede progressively. In fact, the increase in core inflation witnessed through last summer owed a lot to past hikes in oil and gasoline prices, which have now partly been reversed. Because of its high energy intensity, the American economy has been subjected to a stronger external inflationary shock than the OECD average and this has shown up in both headline and core inflation. Assuming a stabilisation in oil prices around their current levels, a mild economic slowdown may be enough to progressively restore price stability in the United States.

In Japan, the return to price stability is proving longer and less assured than expected. Looking at GDP deflators and consumer price inflation excluding food and energy, deflation is not over yet. Somewhat worryingly, nominal wage growth may be at risk of tapering off after only eighteen months in mildly positive territory. Although strong profits and export markets will continue to underpin Japanese growth, it also relies on at least moderate support from household spending.

In the euro area, activity has finally taken off, following a series of aborted recoveries. The recent fall in oil prices has driven headline inflation back below the 2% threshold and is welcome for growth as well. Notwithstanding the upcoming VAT hike in Germany, which should impart a mild stagflationary shock to the euro area in early 2007, the central scenario for the next two years is one of stable growth, somewhat above potential, and mild inflation, in a context where the shortfall of aggregate demand is being progressively worked off.

But sustainable growth in the OECD does not only hinge on the balance between aggregate demand and supply. It can also be affected by current account imbalances, or, in other words, by imbalances in the distribution of aggregate demand between its domestic and external components.

Clearly, achieving price and output stability requires macroeconomic policies to first balance aggregate supply and demand. But policies to this end find their limits when they generate unsustainable current account imbalances. To balance aggregate demand and supply earlier during this decade, US policy had to offset weakening external demand, resulting in part from anaemic domestic demand in Europe and Japan, by stronger demand at home. Besides an expansionary fiscal stance, accommodating monetary policy boosted domestic demand, not least through higher asset prices and wealth effects, one particularly strong channel of transmission running through housing markets. This housing channel contributed strongly to output stabilisation in the aftermath of the 2001 recession but also to the deterioration of the US current account deficit. Conversely, it now plays an important rebalancing role, both domestically and externally. A cooling housing market should therefore not necessarily be a cause for anxiety.

Although in recent years housing markets have played an important role in supporting economic activity, prices may now have reached unsustainable highs in certain countries (notably the United States, Denmark, France and Spain), at least according to OECD Secretariat estimates. When price corrections set in, housing markets may thus reduce the speed of economic expansion, even though the economy at large is not strongly overheating and macroeconomic policies are only mildly restrictive.

Within bounds, such corrections should not be a cause of concern. However, history suggests that sharp housing corrections can be hard to contain. It is especially so when, as a starting point, the economy is out of kilter, with both over-extended financial markets and clearly overheated product markets. Today, however, this is not the case, implying that a smoother adjustment may be in the offing for the US economy. Recent Australian and UK experience – admittedly helped by favourable circumstances – indeed suggests that for resilient economies landings can be smooth.

In this respect, it is comforting to note that in many countries, households seem well prepared to cope with the consequences of a downturn in housing markets, as documented in the special chapter appended to this *Outlook*. Household balance sheets are generally sound and debt-servicing burdens still moderate, although some low-income households may be overstretched.

With housing headwinds already affecting the US economy and at risk of materialising elsewhere, it would help the world economy that domestic and household spending fully revive where they have been lagging behind. This challenge may be progressively met in economies such as Germany and Japan, but the outlook for household spending remains somewhat fragile and these countries' current account surpluses would continue to build up, exceeding 5% of GDP by 2008. The projection also implies that the

widening of the Chinese surplus would slow. As a counterpart to these trends, and a novel feature of this *Outlook*, the US current account imbalances would stop worsening, albeit partly owing to the recent fall in energy prices.

Against this backdrop, central banks face different challenges. In the United States, bringing inflation back to around the 2% mark may require maintaining the current restrictive stance for some time. In the euro area, where the recovery is expected to last, moving towards a measure of monetary restraint may be justified as insurance against the risk of inflation pressure down the line. In Japan, further monetary tightening should wait until a fully-fledged exit from deflation finally materialises.

On the fiscal and structural reform front, not enough is being done in large OECD countries. Although governments today seem much less inclined to spend away tax windfalls than in the past, they generally are not taking advantage of the good overall economic outlook to reduce underlying deficits, with the notable exception of Germany. Besides, social security, health system and labour market reforms do not seem to feature high on political agendas, and protectionist pressures seem to be mounting.

Ideally, OECD countries would seek growth-oriented policy mixes, where solid fiscal consolidation and structural reforms elicit in turn more accommodating monetary conditions and stronger investment. Regrettably, however, best practice seems some way off.

24 November 2006

Handwritten signature of Jean-Philippe Cotis in black ink, consisting of the initials 'JP' followed by the name 'Cotis' in a cursive script.

Jean-Philippe Cotis
Chief Economist

Summary of projections

	2006	2007	2008	2007		2008				Fourth quarter			
				Q2	Q3	Q4	Q1	Q2	Q3	Q4	2006	2007	2008
Per cent													
Real GDP growth													
United States	3.3	2.4	2.7	2.7	2.8	2.8	2.8	2.6	2.6	2.6	3.0	2.6	2.7
Japan	2.8	2.0	2.0	2.1	2.1	2.1	2.0	2.0	1.9	1.9	2.2	2.1	1.9
Euro area	2.6	2.2	2.3	2.2	2.3	2.2	2.3	2.4	2.5	2.6	2.9	2.2	2.5
Total OECD	3.2	2.5	2.7	2.7	2.8	2.7	2.7	2.7	2.7	2.8	3.0	2.7	2.7
Inflation													
United States	2.9	2.6	2.6	2.7	2.7	2.6	2.8	2.4	2.4	2.3	2.5	2.8	2.5
Japan	-1.0	0.2	0.6	0.1	0.3	0.4	0.8	0.8	0.9	0.9	-0.4	0.3	0.8
Euro area	1.8	2.0	2.0	2.0	2.0	2.2	1.8	2.0	2.0	2.1	1.5	2.1	2.0
Total OECD	2.2	2.2	2.1	2.1	2.2	2.3	2.1	2.0	2.1	2.1	2.1	2.2	2.1
Unemployment rate													
United States	4.6	4.8	5.1	4.8	4.8	4.9	5.0	5.1	5.1	5.2	4.5	4.9	5.2
Japan	4.2	3.9	3.6	3.9	3.8	3.7	3.6	3.6	3.5	3.5	4.2	3.7	3.5
Euro area	7.9	7.4	7.1	7.5	7.4	7.3	7.2	7.1	7.0	6.9	7.6	7.3	6.9
Total OECD	6.0	5.8	5.7	5.8	5.8	5.8	5.8	5.7	5.7	5.7	5.9	5.8	5.7
World trade growth	9.6	7.7	8.4	8.2	8.2	8.3	8.5	8.6	8.6	8.6	8.5	8.2	8.6
Current account balance													
United States	-6.6	-6.5	-6.6										
Japan	3.8	4.5	5.3										
Euro area	-0.3	-0.1	-0.1										
Total OECD	-2.0	-1.9	-1.8										
Cyclically-adjusted fiscal balance													
United States	-2.4	-2.8	-2.9										
Japan	-4.6	-4.2	-4.1										
Euro area	-1.5	-1.1	-1.2										
Total OECD	-2.1	-2.1	-2.2										
Short-term interest rate													
United States	5.2	5.3	5.0	5.3	5.3	5.2	5.1	5.1	5.0	4.9	5.3	5.2	4.9
Japan	0.2	0.4	0.9	0.3	0.4	0.5	0.7	0.8	0.9	1.2	0.4	0.5	1.2
Euro area	3.1	3.8	4.0	3.8	3.8	3.9	4.0	4.1	4.1	4.1	3.5	3.9	4.1

Note: Real GDP growth, inflation (measured by the increase in the GDP deflator) 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. The unemployment rate is in per cent of the labour force while the current account balance is in per cent of GDP. The cyclically-adjusted fiscal balance is in per cent of potential GDP. 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 November 2006; in particular 1\$ = 118.10 yen and 0.78 euros;

The cut-off date for other information used in the compilation of the projections is 20 November 2006.

Source: OECD Economic Outlook 80 database.