

## EDITORIAL

### STILL BUOYANT OVERALL, BUT VULNERABLE

Since we published our last *Outlook*, the world economy has once more confirmed its ability to withstand shocks and maintain momentum. Asia has forged ahead, with China enjoying double-digit expansion and India growing very rapidly as well. After years of deflationary weakness, Japan has embarked on a new path, with personal consumption and labour income joining exports and business investment as the main drivers of growth. In the United States, hurricanes had a damaging but only transient impact on activity, which was already bouncing back early in 2006. In Continental Europe, activity weakened again late last year, partly reacting to rising oil prices, but accelerated in early 2006.

Looking forward, business and consumer surveys suggest growth prospects across the OECD may be converging in the very near term. The euro area would grow slightly above trend over the next few months, as would Japan and the United States. After several aborted upswings, the likelihood of a broader-based recovery, extending to consumer demand, now taking hold in Germany, is at its highest level since the late 1990s. Indeed, business surveys now suggest that confidence in domestic demand-driven sectors such as construction and retail trade is well above average, while it is progressively building up in services.

Later in the year cyclical developments are likely to diverge, however. In the United States, past monetary tightening has created the conditions for a soft landing, while in Europe above-trend growth would allow for a very gradual resorption of economic slack. In a context where uncertainty prevails about the political feasibility and scope of economic reforms, the recovery of investment in Europe would remain rather subdued, while the upswing in consumer demand will be somewhat dented by a sizeable VAT hike in Germany. By end-2007, economic slack will have been more than eliminated in Japan and North America but ample excess supply would still persist in Europe, continuing to exert disinflationary pressure.

In this scenario, based on oil prices stabilising around \$70 per barrel, inflation prospects would remain relatively benign. Inflation in Japan would reach 1% early next year and stabilise thereafter, while euro area inflation – abstracting from the German VAT hike – would ease to below the 2% threshold at approximately the same horizon. In the United States, however, where inflation peaked at a much higher level late last year, disinflation would take a bit longer.

If anything, the risks surrounding this scenario have increased as regards current account imbalances, long-term interest rates and house prices, while the inflation and activity outlook could be significantly affected by abrupt changes in oil and commodity prices.

In recent years, current account imbalances have tended to widen. This has been the case in Europe's single currency area, where, in 2007, Germany's surplus would approach 4½ per cent of GDP and Spain's deficit 10%. More obviously, it has been the case globally, with current account surpluses in China and Japan headed for 5½ to 6% of GDP in 2007, while the US deficit would exceed 7½ per cent.

It has been said time and again that such imbalances are unsustainable in the long run and may not only reflect the free movement of capital towards the best investment opportunities worldwide, but also to a large extent underlying failures in the area of fiscal, structural and exchange rate policies. A brutal unfolding of such imbalances would hurt the world economy, with perhaps the largest output losses concentrated in the least “resilient” regions, not least the euro area. The stronger if somewhat belated commitment from the international community to put in place policies to reduce the risk and cost of an abrupt unwinding of current account imbalances is therefore welcome. As documented in this *Economic Outlook*, it is unclear, however, whether the needed changes in domestic policies required to avert worst-case scenarios would come into place in the foreseeable future.

The risks posed by high and in places inflated house prices to financial and economic stability should not be overlooked either, although the recent cooling off in the UK and Australian housing markets suggests that they may be manageable from a macroeconomic perspective with good chances for a soft landing. Nonetheless, real house prices have recently kept growing rapidly, or even accelerated in many countries, while the ongoing upswing was already the largest of its kind since the 1970s. The risk of housing being overpriced may rise as long-term interest rates move up. Econometric analysis reported in this *Outlook* suggests that, should house prices continue to rise in 2006 at the speed they did last year and long-run rates to increase as they have in recent months, several large countries (United States, France, Spain) would be at risk of a downturn in house prices.

OECD countries may also have to grapple with the complex consequences of globalisation on “imported inflation”. On the one hand, the integration in international trade of low-cost manufacturing economies such as China has undoubtedly had a welcome disinflationary influence, evaluated here at 0.3 percentage point a year for the euro area over the past five years and at 0.1 percentage point for the United States. On the other hand, the possibility that globalisation has not just brought about a level shift in oil and commodity prices, but rather a prolonged upward trend, is now becoming less of an intellectual curiosity and more of a practical concern for policymakers. Indeed, experience over the past three years suggests that commodity price pressures may significantly outweigh the disinflationary influence of low-cost manufacturing imports. This may be even more so going forward if protectionist pressures were to intensify.

Uncertainties about the underlying forces driving the recent increases in oil and commodity prices may complicate the task of central bankers since there is a risk that we may be facing a more permanent inflation shock rather than an ephemeral blip and that earlier rises may not yet have been fully passed through to the retail level.

For economies already close to full employment, such as the United States, the possibility of a prolonged imported inflation shock, coupled with an upward drift in inflation expectations, may tilt the balance towards further tightening. For the euro area, where wages and unit labour costs are increasing slowly, the starting point is one where slack is substantial and thus a source of falling inflation. At the same time, if commodity price pressures persist and as evidence builds up that the recovery is firming, the need for monetary tightening should become clearer. Its actual pace, however, should be conditional on unambiguous signs that economic slack is shrinking, which hard data is not as yet confirming.

On the fiscal front, little action has been witnessed for some time now, even though the pressures associated with ageing populations are building up. So are those stemming from health and long-term care spending, documented in detail in this *Outlook's* special chapter, which are only partly linked to ageing and in some cases are even larger than pension-related pressures. Fiscal consolidation is urgent not just to restore public finance sustainability but also to recover, ahead of the next downswing, the room for manoeuvre that was squandered at the peak of the previous cycle when, in a number of Continental European countries, fiscal authorities exacerbated the upswing by both cutting taxes and increasing spending. In theory, fiscal policy is supposed to help mitigate the vagaries of the business cycle and smooth the tax burden across generations. It is also supposed to reallocate resources in a way that increases the well-being of societies. Alas, in many countries fiscal policy is doing exactly the opposite. Because it often exacerbates problems instead of alleviating them, fiscal policy increasingly turns out to be a problem rather than a useful instrument. Regaining control in the good times is thus urgently needed.

19 May 2006

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

Jean-Philippe Cotis  
Chief Economist

## Summary of projections

	2005	2006	2007	2005		2006			2007		Fourth quarter		
				Q4	Q1	Q2	Q3	Q4	Q1	Q2	2005	2006	2007
Per cent													
<b>Real GDP growth</b>													
United States	3.5	3.6	3.1	1.7	4.8	4.0	3.4	3.2	3.0	3.0	3.2	3.9	3.0
Japan	2.7	2.8	2.2	5.4	1.4	2.7	2.4	2.5	2.1	2.1	4.3	2.2	2.1
Euro area	1.4	2.2	2.1	1.4	2.5	2.2	2.3	2.2	1.7	2.3	1.8	2.3	2.2
Total OECD	2.8	3.1	2.9	2.7	3.4	3.3	3.0	2.9	2.7	2.9	3.0	3.1	2.9
<b>Inflation</b>													
United States	2.8	3.0	2.3	3.5	3.3	3.0	2.0	2.2	2.2	2.3	3.1	2.6	2.3
Japan	-1.3	-0.6	0.5	-1.9	-0.8	0.4	0.4	0.4	0.6	0.6	-1.7	0.1	0.6
Euro area	1.7	1.6	2.0	3.3	0.6	1.4	1.6	1.5	2.5	2.1	1.9	1.3	2.2
Total OECD	2.0	2.2	2.0	2.9	1.9	2.1	1.8	1.9	1.9	2.0	2.0	1.9	2.0
<b>Unemployment rate</b>													
United States	5.1	4.7	4.7	5.0	4.7	4.7	4.6	4.7	4.7	4.7	5.0	4.7	4.8
Japan	4.4	4.0	3.5	4.5	4.3	4.1	3.9	3.8	3.6	3.5	4.5	3.8	3.3
Euro area	8.6	8.2	7.9	8.4	8.2	8.2	8.1	8.2	8.1	8.0	8.4	8.2	7.8
Total OECD	6.5	6.2	6.0	6.4	6.2	6.2	6.1	6.1	6.1	6.0	6.4	6.1	5.9
<b>World trade growth</b>	7.5	9.3	9.1	8.9	10.4	7.8	8.5	8.9	9.3	9.4	8.3	8.9	9.4
<b>Current account balance</b>													
United States	-6.4	-7.2	-7.6										
Japan	3.6	4.3	5.5										
Euro area	-0.2	-0.4	-0.3										
Total OECD	-1.9	-2.1	-2.1										
<b>Cyclically-adjusted fiscal balance</b>													
United States	-3.7	-3.7	-3.9										
Japan	-4.9	-5.3	-5.2										
Euro area	-1.6	-1.6	-1.5										
Total OECD	-2.7	-2.8	-2.8										
<b>Short-term interest rate</b>													
United States	3.5	5.1	5.1	4.3	4.7	5.0	5.2	5.3	5.3	5.1	4.3	5.3	5.0
Japan	0.0	0.1	0.7	0.0	0.1	0.1	0.1	0.1	0.3	0.6	0.0	0.1	1.1
Euro area	2.2	2.7	3.4	2.3	2.6	2.6	2.7	2.9	3.2	3.4	2.3	2.9	3.7

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 4 May 2006; in particular 1\$ = 113.50 yen and 0.79 euros.

The cut-off date for other information used in the compilation of the projections is 17 May 2006.

Source: OECD Economic Outlook 79 database.