

I. GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

Overview

Against the backdrop of rising and volatile oil prices, coupled with exchange rate shifts, OECD-wide growth slowed in the course of 2004. Performance, however, diverged across countries. Momentum slackened less in the United States, the United Kingdom and France than in Japan, Germany and Italy, where activity decelerated markedly, even contracting for a time. Elsewhere, growth generally proved quite robust.

Performance recently diverged anew...

While the pace of activity picked up in early 2005, it seems to have been moderating anew since. It is only later this year that OECD-wide growth is projected to strengthen modestly and to become more balanced, helped by sustained buoyancy in the rest of the world and an underlying assumption of oil prices not rising any further as well as responding by oil-producing non-OECD economies coming on stream. The OECD countries ahead in the cycle are seen to grow broadly on trend and the others to catch up, albeit incrementally and only partially in the case of some of the less resilient euro area economies. Where the cycle has lagged, investment is projected to strengthen on the back of ample profits, stronger balance sheets, easy credit and rising capacity utilisation rates. Unemployment, however, is not expected to decline rapidly (Table I.1).

... but momentum should start broadening later in 2005, though at a rather low pace

Table I.1. The expansion should gradually regain momentum

<i>OECD area, unless noted otherwise</i>									
Average							2004	2005	2006
1992-2001	2002	2003	2004	2005	2006	q4	q4	q4	
Per cent									
Real GDP growth¹	2.7	1.6	2.1	3.4	2.6	2.8	2.8	2.8	2.9
United States	3.4	1.9	3.0	4.4	3.6	3.3	3.9	3.5	3.3
Euro area	1.9	0.9	0.6	1.8	1.2	2.0	1.6	1.4	2.4
Japan	1.1	-0.3	1.5	2.6	1.5	1.7	0.9	2.2	1.9
Output gap²	-0.7	-1.3	-1.6	-0.7	-0.7	-0.5			
Unemployment rate³	6.8	6.8	6.9	6.7	6.7	6.4	6.7	6.6	6.3
Inflation⁴	3.8	2.6	2.2	2.0	1.9	1.9	2.4	1.7	1.9
Fiscal balance⁵	-2.6	-3.2	-3.7	-3.3	-3.2	-3.0			

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. GDP deflator. Year-on-year increase; last three columns show the increase over a year earlier.

5. Per cent of GDP.

Source: OECD Economic Outlook 77 database.

Some serious imbalances persist

Many of the risks surrounding this baseline projection stem from enduring external and internal imbalances, in the form of widening current account gaps and persistent large fiscal deficits, while some classes of assets may be richly valued, in a context of abundant liquidity. Some of the imbalances could be in the process of turning around, with housing markets slowing in several countries and some credit spreads having recently begun to tick up. While the imbalances may well unwind relatively smoothly, serious turbulences cannot be ruled out. Furthermore, in some countries, another risk is that business investment would disappoint, if firms anticipate that final demand weakness is set to persist.

More fiscal restraint is called for

Monetary stimulus has started or continued to be withdrawn in English-speaking OECD countries, where slack is shrinking or essentially gone, and in North America the return towards neutral interest rate levels is expected to continue. In contrast, sizable and persisting margins of slack combined with declining core inflation with little upside risk now warrant an easing of the monetary stance in the euro area. In Japan, mild deflation endures and any move suggesting an early change in the monetary stance would seem premature. On the fiscal side, underlying positions have deteriorated in many countries and consolidation is in order, even where the recovery is not that advanced, but especially in the countries where expansions are firmly established.

Absorbing the shocks

Performance in the face of adversity has been uneven

In the year and a half to early May 2005, the spot price of oil soared by about \$20, the largest increase in 25 years, with market participants widely expecting most of it to last (Figure I.1). In some OECD economies (including the euro area, Australia, Canada and Korea), this global shock was accompanied by exchange rate appreciation, which had an offsetting effect on inflation but an additional adverse impact on activity. In others, and most notably in the United States, the oil shock paralleled exchange rate weakening, which added somewhat to inflationary pressure and terms of trade loss but mitigated the output cost.¹ Some countries appear to have overcome these shocks at limited cost, in particular the United States, the United Kingdom and Canada and, outside the OECD, China.² Others – especially Japan and Germany, which were dependent on external demand that languished (Figure I.2) – appear to have had more difficulty coping with adversity.

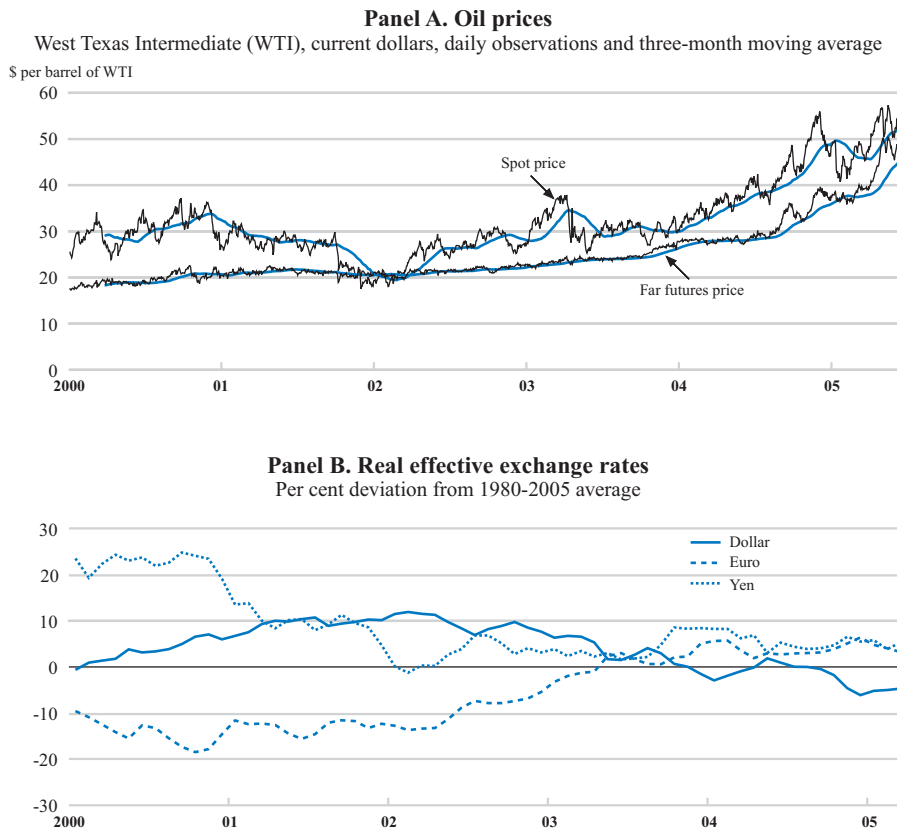
The US economy slowed from a rapid pace...

In the face of the oil shock, US growth has remained vigorous, despite some slowing. Job creation resumed in earnest, but it remained sub-par; nonetheless, because participation rates failed to pick up decisively, unemployment declined more than what experience in past cycles might have suggested (Box I.1). Output growth was supported by a still accommodating policy stance but also reflected some strong

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1. For an in-depth analysis of the oil market and of the economic impact of oil price fluctuations, see Brook, A-M., R. Price, D. Sutherland, N. Westerlund and C. André, "Oil price developments: drivers, economic consequences and policy responses", *OECD Economics Department Working Papers*, No. 412, 2004.
 2. In the case of the first three countries, greater resilience may be helped by the fact that they are themselves large producers of oil.

fundamentals. Non-residential fixed investment was buoyant, driven by spending on equipment and software and spurred by favourable financing conditions, healthier balance sheets and ample profits. It slowed in early 2005, but to some extent this may have reflected the expiration at the turn of the year of temporary accelerated depreciation provisions favouring capital spending.³ Household consumption expanded rapidly, despite some deceleration in the first quarter of 2005 associated with a drop in motor vehicle purchases. It has become less dependent on mortgage equity withdrawal and rests increasingly on employment growth. Against this backdrop and with shrinking slack, exchange-rate and commodity-price-driven cost-push pressures have been gathering strength. Core inflation has trended up, exceeding 2% for the consumer price measure (see Figure I.11 below). Core goods price inflation, which had turned positive in the course of 2004, has of late eased and remains well below core service price inflation. Inflation as measured by the core consumer expenditure deflator, however, has remained lower, at 1¾ per cent.

Figure I.1. Oil prices are high and volatile, while exchange rates have shifted



Source: Datastream and OECD Economic Outlook 77 database.

3. Indeed, spending on information processing equipment and software – which owing to its shorter economic life benefits less from this type of tax incentives – accelerated in the first quarter of 2005.

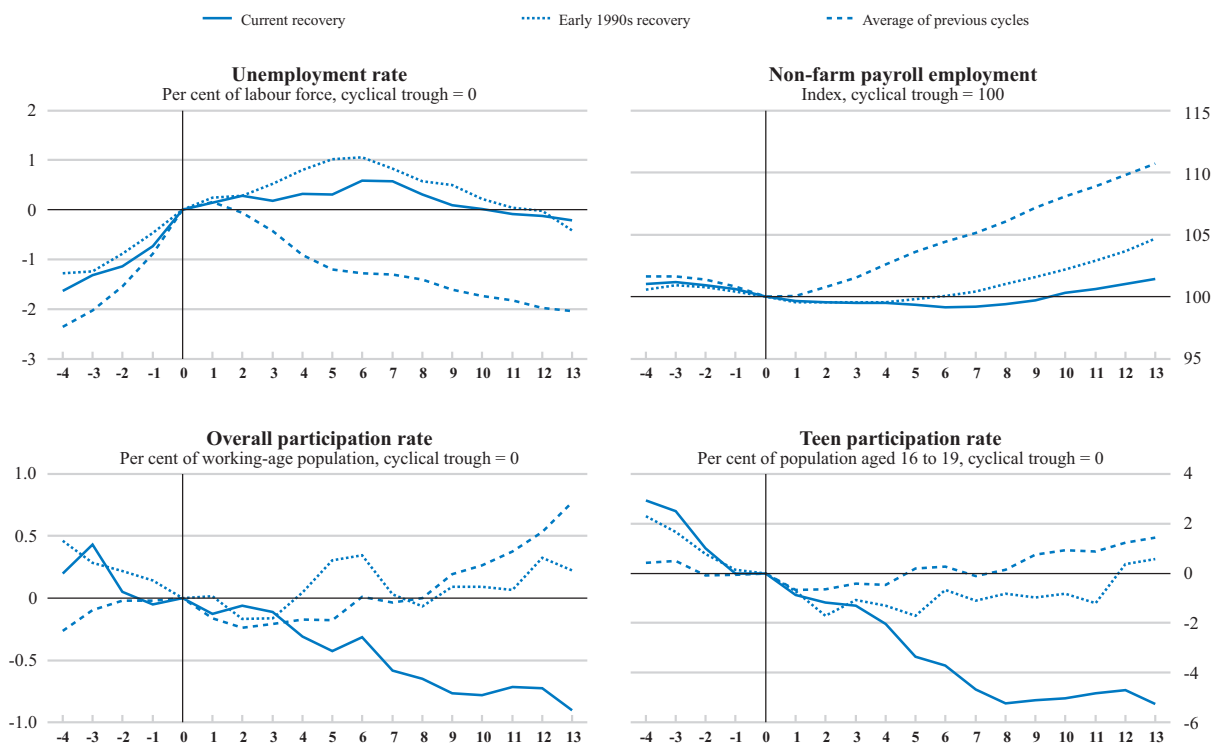
Box I.1. US employment, unemployment and labour force participation

The behaviour of the US labour market has been rather unusual in the current business cycle. Payroll employment continued to contract for almost two years after the recession had ended, twice as long as in the downturn of the early 1990s. Moreover, the subsequent recovery in employment has been subdued by historical standards. Meanwhile, the decline in the labour-force participation rate has been longer and more protracted than in earlier cycles. In contrast, the evolution of the unemployment rate has been less out of line with tradi-

tional patterns, easing from a cyclical peak of 6¼ per cent of the labour force in Spring 2003 to 5¼ per cent in the first quarter of 2005.

Surprisingly robust labour productivity accounts for the contrast between the recoveries in output and in job creation. Insofar as it is sustained, it should boost economic growth over the longer run. However, the persistently low labour-force participation rate may be a matter of concern, including for monetary policy. At issue is the extent to which it reflects cyclical

US unemployment declined more than job creation might have suggested



Note: Cyclical trough dates are given by the NBER chronology. The average of previous cycles includes major cycles from the 1960s to the 1980s. The last cyclical trough is 2001Q4.

Source: US Bureau of Labor Statistics.

... whilst growth in the euro area at large slackened...

The euro area's belated recovery has been crimped by the oil and exchange rate shocks. Economic slack increased in the second half of 2004, to over 1½ per cent of GDP, a shortfall in demand over one percentage point larger than in the rest of the OECD area. The pace of employment creation compared somewhat more favourably to that observed elsewhere but only barely sufficed to stabilise the unemployment rate, which remains close to 9% of the labour force, with a cyclical component of

Box I.1. US employment, unemployment and labour force participation (cont.)

rather than structural factors, and thus how much slack remains in the labour market and how close the economy is to potential. If the participation rate does eventually rebound, new hires will put less upward pressure on wages insofar as they draw in workers from outside the labour force.

At least four sets of forces impinge directly on participation rates, which may denote different cyclical behaviour or changes in some underlying trends:

- The participation rate of the 16 to 19 years-olds has plunged by about 8 percentage points in this cycle, twice as much as in the early 1990s downturn. This partly reflects increases in school enrolment,¹ which may have both a structural dimension (insofar as perceived returns to schooling rose) and a cyclical aspect.
- Participation rates for prime-age workers have also declined over the past few years. A major reason may be greater incentives for the low-skilled to take up disability rather than unemployment benefits. This is a long-standing trend,² but over time disability application rates are estimated to have become substantially more responsive to adverse cyclical shocks, not least because of a gradual increase in the replacement rate associated with this benefit for low-skilled workers.³
- Working in the opposite direction is a trend increase in the participation rate of older workers (aged 55 and over), by about 6 percentage points since the mid-1990s, possibly reflecting improvements in health but also, more recently, the bursting of the

equity market bubble. This group being four times as numerous as that of the 16-19 year-olds, the increase in their participation rate has more than offset the decline in teen participation. On the other hand, the ageing of the baby-boom generation shifts individuals from the prime-age into the older-worker groups, whose average participation rate remains much lower, subtracting an estimated 0.1 percentage point per annum from the overall participation rate.⁴

- There is also evidence that the underlying pace at which women join the labour force may have slackened.⁵

In addition, the extent of the ongoing business restructuring might be greater than in the past and the associated shifts in the occupational structure of employment may translate into longer spells out of the labour force, not least for workers to invest in new skills allowing them to pursue more demanded occupations.⁶ Rapidly rising non-wage labour costs, especially those related to health care, may be pushing in the same direction.⁷

The net effect of these various factors on participation is hard to evaluate, and its decomposition between trend and cycle even more so, especially when recalling that the labour market conditions prevailing around the turn of the millennium were themselves fairly unusual. That said, the projection in this *Economic Outlook* is for some pick-up in the cyclical component of the overall participation rate, which given the projected pace of job creation will contribute to limiting the decline in the unemployment rate.⁸

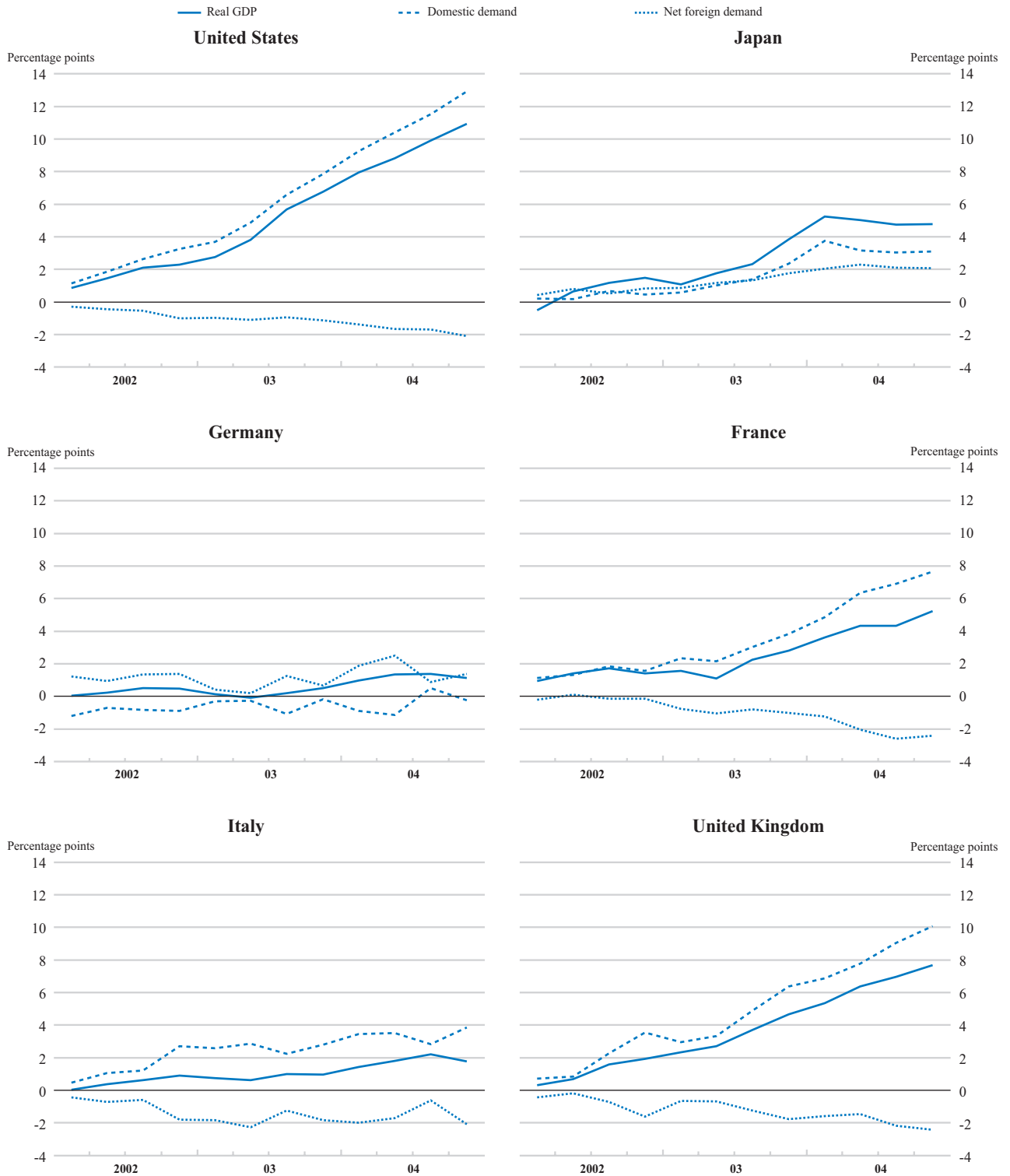
1. See Coffin, D., "Understanding the decline in the labor force participation of teenagers", *mimeo*, November 2004. The participation rates of 20-24 year-olds also dropped, but less starkly.
2. Between the mid-1980s (when the stringency of the screening governing access to disability benefits was reduced) and 2001, the rise in the share of non-elderly adults receiving Social Security disability insurance benefits reduced the unemployment rate by half a percentage point (Autor, D. and Duggan, M. "The rise in disability rolls and the decline in unemployment", *Quarterly Journal of Economics*, Vol. 118, No. 1, 2003).
3. As a result of the fact that the benefit is indexed on the average wage and that the dispersion of earnings rose during that period. In addition, the real value of the accompanying medical benefits also increased over time – an important factor in a context where a growing share of low-skilled workers do not enjoy company-paid health insurance.
4. See Congressional Budget Office, *CBO's Projections of the Labor Force*, September 2004.
5. See Congressional Budget Office, *ibidem*.
6. See for instance Schweitzer, M., "Economic restructuring and the slow recovery of employment", Federal Reserve Bank of Cleveland, *mimeo*, December 2004. The evidence in this area remains somewhat inconclusive, however.
7. See K. Baicker, K. and A. Chandra, "The labor market effects of rising health insurance premiums", *NBER Working Papers*, No. 11160, 2005.
8. Similar questions arise in other OECD countries, for instance in the United Kingdom, see Schweitzer, M. and D. Tinsley, "The UK labour force participation rate: business cycle and trend influences", *Bank of England Working Papers*, No. 228, 2004.

around $\frac{3}{4}$ percentage point.⁴ Rising energy prices almost uninterruptedly kept headline inflation a few decimal points above the 2% mark but measures of underlying inflation remained below that threshold and have recently eased further.

4. In Germany, job creation reflected the take-off of publicly-sponsored "mini-jobs" of self-employment schemes, which drew a number of people back into the labour force, more than new full-time private sector hires. See Caliendo, M., R. Hujer and S. Thomsen, "The employment effects of job creation schemes in Germany: a microeconomic evaluation", *IZA Discussion Papers*, No. 1512, 2005.

Figure I.2. **Dependence on external demand has varied across economies**

Cumulated contributions to growth from 2002Q1 onwards



Source : OECD Economic Outlook 77 database.

... although with stark differences across countries

Developments across euro area members diverged, however. Growth proved fairly resilient in France and more clearly so in Spain and several smaller economies. This contrasted starkly with Germany and especially Italy, where over the past two quarters activity has been contracting at an annualised rate of close to 2%. Paradoxically, real GDP and total domestic demand continued to follow similar paths in France and in the United Kingdom, whereas divergence amongst the largest members of the common currency area tended to increase (Figure I.2 above). Private consumption held up well in France in the course of 2004, partly thanks to a decline in the household saving rate, which may have been facilitated by sizeable housing wealth gains. In Germany, where for many years house prices have been falling steadily, the saving rate increased and consumption was weaker, against the backdrop of a lacklustre labour market (see Box I.2). As a consequence, domestic demand stagnated, and the modest growth in real GDP in 2004 was fully accounted for by foreign trade, reflecting a sharp acceleration of exports, driven to a significant degree by market share gains. This was accompanied by a further widening of the current account surplus, to over 3½ per cent of GDP (coming from a deficit of 1½ per cent of GDP in 2000). In Italy instead, the drag exerted by anaemic domestic demand was compounded by eroding competitiveness, associated *inter alia* with insufficient service sector deregulation. Indeed, over the past five years, Italy's cumulative loss of competitiveness has approached 25% (Figure I.3).⁵

The recovery paused in Japan in 2004

The Japanese economy decelerated fairly abruptly in the spring of 2004 and contracted slightly in the second and third quarters.⁶ This partly illustrated the dependence of the recovery on exports to China, where investment demand slowed, and on the high-tech cycle, which on some measures for semi-conductor equipment turned in the course of 2004, leaving Japanese firms with excess inventories. The deceleration also reflected domestic demand weakness. Fixed business investment slowed sharply and to a lesser extent so did household consumption. Despite the resumption of positive net job creation and a significant decline in unemployment, average nominal wages continued to falter, owing to the rising share in total employment of part-time employees, whose all-in compensation is much lower (not least because they receive very small if any bonuses). Activity and domestic demand were flat in the fourth quarter but accelerated sharply in early 2005, with both household consumption and private non-residential investment up substantially. Headline inflation turned positive in late 2004, but this reflected rising energy prices coupled with a jump in fresh food prices, so that core inflation remained in negative territory. In early 2005, sharp drops in rice prices and utility fees helped push the overall price level down again.

Growth picked up in most other OECD economies...

Growth picked up in 2004 in most of the other OECD economies, including in the four new European Union (EU) members (Poland, Hungary, the Czech Republic and the Slovak Republic), the smaller Northern European countries, Korea, Mexico and Turkey, despite some weakening during the second half of the year in several cases. In Australia, however, activity decelerated markedly, partly related to a surge in imports coupled with a contraction in exports, resulting in a widening of the current account deficit to 6¼ per cent of GDP for the year as a whole.

5. For further analysis on the resilience of euro area economies, see the forthcoming *OECD Survey of the Euro Area*, Paris, 2005.

6. It should be borne in mind that the Japanese national accounts underwent a comprehensive revision in December 2004, with the introduction of chain linking, which reduced annual real GDP growth estimates by around one percentage point.

Box I.2. How can the weakness in German consumption be explained?

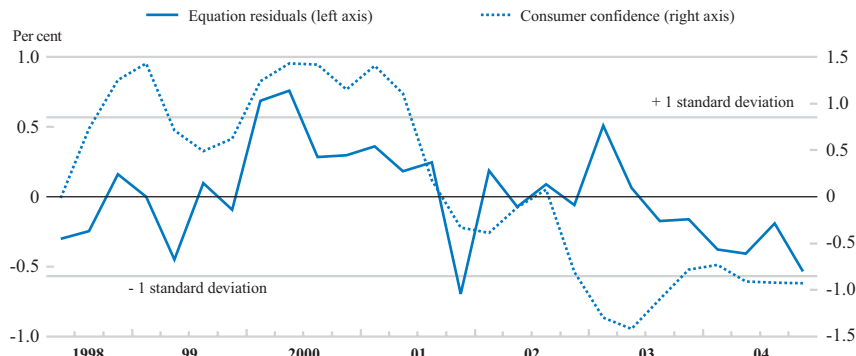
Over the past three years, the volume of private consumption in Germany declined cumulatively by 1½ per cent, whilst the household saving rate rose by almost ¾ percentage point.¹ To some extent, lacklustre consumption reflected subdued income growth, with real GDP expanding by only 1% over the same period. However, private consumption held up somewhat better in other euro area countries that also experienced weak real GDP growth, such as the Netherlands and Italy.

Against this background, a simple error-correction model was estimated to assess whether the usual determinants of private consumption could explain German households' behaviour. More specifically, this equation – estimated on quarterly data spanning the past 25 years – includes real disposable income, real short-term interest rates, inflation² and a proxy for real wealth³ on the right hand side.⁴ The inclusion of the unemployment rate, be it in level or in first-difference terms, was attempted, but, somewhat surprisingly, it failed to enter significantly. The residuals of the overall equation, which includes both the

long-run relationship and the short-run dynamics, are plotted below.

Looking at the past seven years, the residuals are distinctly pro-cyclical and are correlated with consumer confidence, suggesting a limited degree of consumption smoothing and a lack of consumer resilience when the cycle is at a low ebb. Over the past two years, the residuals are not that large, but they clearly trend down, showing that the aforementioned fundamentals may not fully explain consumers' lack of stamina, and that confidence effects may have played a role. Indeed, in a context of far-reaching economic restructuring and balance sheet repair, which has translated into labour shedding and sluggish real wage growth, households are likely to worry more about possible future job or income losses, which would tend to push up precautionary saving and thereby depress demand further.⁵ In addition, the psychological reverberations of the 2001 and 2003 pension system reforms, as well as of the recent labour market reforms – which are not captured in the above standard variables – may help explain greater precautionary saving.

The usual drivers do not fully account for consumer anaemia

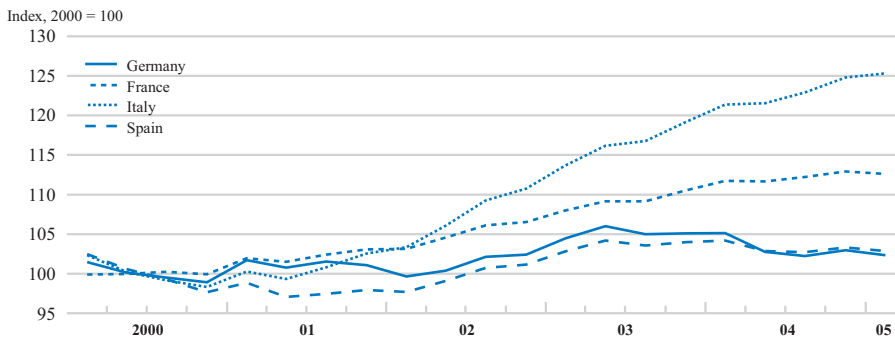


Note: Consumer confidence has been normalised at the average for the period starting in 1985 and is presented in units of standard deviation.

Source: OECD Economic Outlook 77 database and Datastream.

1. Consumption and GDP volumes are adjusted for working days.
2. The private consumption deflator is used as the measure of inflation as well as to deflate the variables expressed in real terms.
3. The DAX stock market index was used. Housing wealth exceeds equity holdings, but no good quarterly time series is available for this variable. In any event, studies conducted on annual data do not show housing wealth to affect consumption very significantly compared with other countries (see *e.g.* Catte, P., N. Girouard, R. Price and C. André, "The contribution of housing markets to cyclical resilience", *OECD Economic Studies*, No. 38, 2004).
4. Dummies for reunification and for a few outliers were added in as well.
5. Concerns have also been expressed that the deterioration in public finances may have heightened expectations of future tax increases (see the overview chapter of the Bundesbank's August 2004 *Monthly Report*). The presence of such effects was tested here by introducing changes in non-interest government spending on the right-hand side of the equation, but the results were inconclusive (the variable entered with the hypothesised negative sign and significantly but it did not markedly improve the fit of the overall equation).

Figure I.3. Competitiveness trends diverge across euro area members



Note: The competitiveness indicator is relative unit labour cost in the manufacturing sector corrected for changes in nominal effective exchange rates.

Source: OECD Economic Outlook 77 database.

Non-OECD economies continued to be an important source of dynamism in world trade in goods and services, accounting for two fifths of the expansion in total volumes in 2004, well above their share in total trade. However, in net terms, OECD trade with the rest of the world was a drain on OECD-wide growth, as China's current account surplus widened and the respending of the extra oil revenue by producers displayed the usual lag. In China, real GDP grew by 9.5% for the full year, a pace maintained in the first quarter of 2005. The balance between investment, which had been overheating, and consumption improved. Despite a major positive terms-of-trade shock coupled with increasing fiscal stimulus, Russia slowed in the course of the year, largely as a result of a deterioration in the business climate. Nevertheless, growth for 2004 as a whole still topped 7%. Brazil recorded its fastest expansion in a decade, with real GDP rising by over 5%, although with some deceleration in the second half of the year. In Africa and the Middle East, growth was spurred by a significant appreciation of the terms of trade, and the additional export revenue has started to be recycled into greater demand for imports.

... whilst on the whole remaining robust in the rest of the world

Maintaining or regaining momentum

In a number of OECD countries, survey data have softened lately (Figure I.4), even as some of the incoming hard data pointed upwards.⁷ On balance, the near-term indicator-based model forecasts, which incorporate both types of information, suggest that in the second quarter of 2005 growth should hold up in the United States and the United Kingdom, whilst slowing in Japan, following the rebound in the first

Incoming data send mixed signals...

7. In the US case, the marked climb-down of the manufacturing purchasing manager index can be interpreted as a correction following some overshooting, as its output and new order components in particular move back in line with actual activity. More generally, the data flow around the turn of a leap year is typically noisy, as shifts in working days are not fully captured in standard deseasonalisation procedures.

Box I.3. Policy and other assumptions underlying the central projections¹

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, the projection for federal government current receipts assumes that there will be no further tax initiatives pending the report of the President’s Advisory Panel on Federal Tax Reform, due in July 2005, and that the increased exemption for the alternative minimum tax, currently scheduled to expire at the end of 2005, will be extended for another year. On the spending side, the projection incorporates the significant restraint in non-defence discretionary spending underpinning the President’s 2006 budget proposal as well as the \$80 billion supplemental appropriations request transmitted to Congress in February 2005, mostly for operations in Iraq and Afghanistan. It also assumes limited further funding of these operations beyond the current supplemental request.
- For Japan, the projection takes into account the 2004 pension reform, which increases contributions by individuals and employers in every year from fiscal year (FY) 2004 to FY 2017, as well as the recent broadening of the direct and indirect tax bases and the partial abolition of the income tax cut introduced in 1999. A Supplementary budget for FY 2004, mainly focused on disaster recovery, is also incorporated.
- In the European Union, the projection for Germany takes into account the cuts in income taxes and tax expenditures taking effect in 2005, the health care and pension reforms measures that are being phased in as well as the measures taken to contain the public sector wage bill. For France, the projection incorporates the phased increases in public sector wages announced in December 2004 and March 2005 and it is assumed that measures to keep public employment and health care outlays in check will have some success. For Italy, it is assumed that the announced caps on public spending will be broadly adhered to in 2005-06, and that personal income tax cuts are cov-

ered by further savings measures. For the United Kingdom, the projection rests on the premise that the government’s nominal expenditures plans are broadly realised, but that the elasticity of revenue will be somewhat weaker than budgeted.

Policy-controlled interest rates are set in line with the stated objectives of the relevant monetary authorities with respect to inflation and activity:

- In the United States, the federal funds target rate, which since mid-2004 has been raised in 25 basis point steps from 1 to 3%, is assumed to continue to increase incrementally and to reach 4¾ per cent around mid-2006.
- In the euro area, the main refinancing rate, which has remained at 2% since it was lowered by ½ percentage point in June 2003, is assumed to be cut by 50 basis points in mid-2005 and to start rising one year later, reaching 2¼ per cent in late 2006. The policy rate has already been raised by 125 basis points in the United Kingdom from its July 2003 low, to 4¾ per cent, and no further increase is built into the projection.
- In Japan, the policy-controlled rate is assumed to remain at zero through the end of 2006.

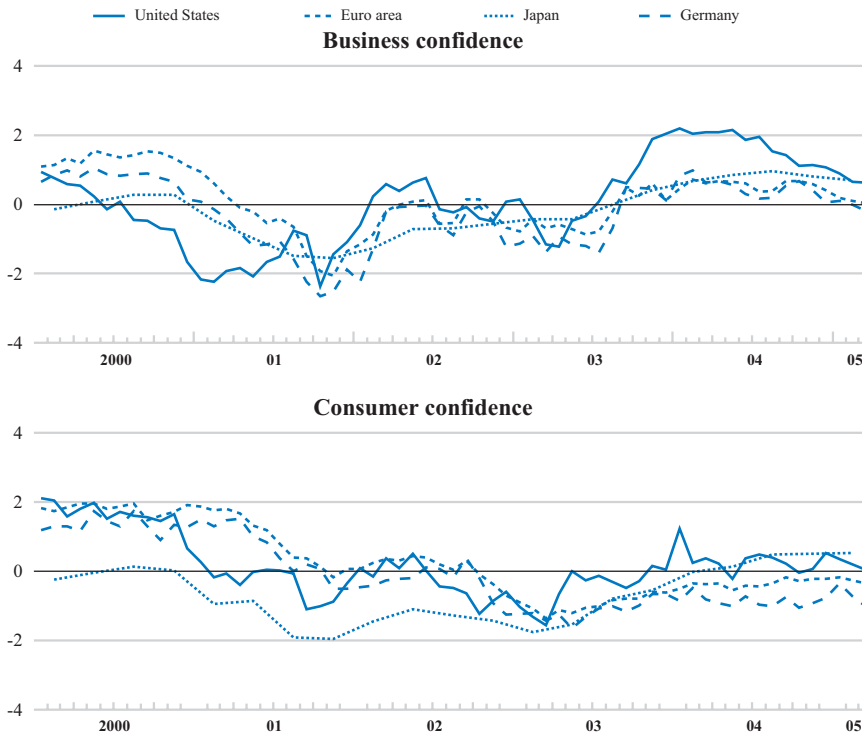
The projections assume unchanged exchange rates from those prevailing on 6 May 2005, at one US dollar equals ¥ 104.5 and € 0.779 (or equivalently, one euro equals \$1.28). For Turkey, the exchange rate is assumed to depreciate in line with the projected inflation differential *vis-à-vis* the United States.

Notwithstanding the recent commitment by the Organisation of the Petroleum Exporting Countries to raise the cartel’s daily output ceiling, oil prices are higher than six months ago. As a working hypothesis, the price of Brent crude is assumed to decline linearly from \$51 per barrel in the second quarter of 2005 to \$48 at the end of 2006. This is broadly in line with the assumption underpinning the OECD’s medium-run baseline scenario that the price of oil will gradually revert towards its long-term equilibrium level, as risk premia and other temporary factors abate. The posited decline is also consistent, by and large, with what recent far-futures quotes have suggested. Commodity price inflation is assumed to begin easing in the course of the projection period.

The cut-off date for information used in the projections is 20 May 2005.

1. Details of assumptions for individual countries are provided in Chapter II, “Developments in individual OECD countries”.

Figure I.4. Confidence has sagged



Note: Business confidence: United States, overall purchasing manager index; Japan, business conditions future tendency; the euro area and Germany, business surveys future production tendency. Consumer confidence is the overall balance. Monthly data except for Japan (quarterly data). All series have been normalised at the average for the period starting in 1985 and are presented in units of standard deviation. Source: OECD, *Main Economic Indicators*.

quarter (Table I.2). However, for Germany, these forecasts highlight that the bounce witnessed in the first quarter was largely a technical blip following the contraction recorded in the previous quarter, masking a much more gradual turnaround. For France, the forecasts point to a significant slowdown, while they suggest continued weakness in Italy.

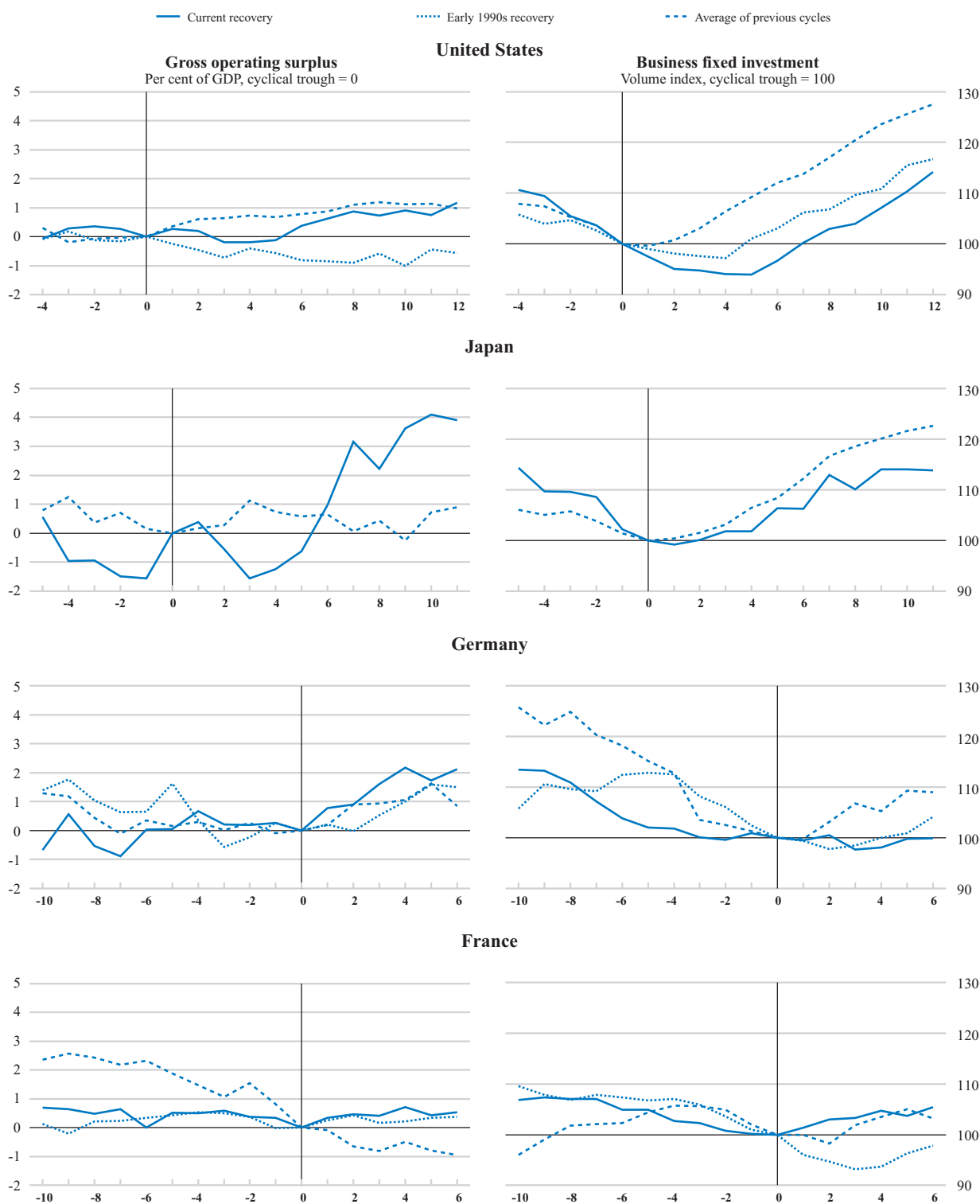
In response to these developments, policies have become less accommodative in the United States, the United Kingdom and some smaller economies. Monetary policy actively supported the global recovery in its initial stages, accompanied in some cases by substantial fiscal stimulus, but several central banks have since begun to raise policy-controlled interest rates from the exceptionally low levels reached in the course of the downturn. The US Federal Reserve in particular is set to continue to bring its policy rates up towards neutrality (Box I.3). In contrast, no monetary tightening is assumed in Japan in the near term, and easing is built in for the euro area. At the same time, the fiscal stance for the OECD area at large is broadly neutral over the projection period.

Against this background, domestic demand should decelerate in the course of this year and next in those countries where most of the cyclical slack has already been absorbed (including the United States, the United Kingdom and Canada). Deceleration will be led by private consumption, while fixed investment may

... and in some countries policy stimulus is waning...

... but some convergence in performance is projected

Figure I.5. Profits have generally picked up more than investment



Note: A cyclical trough is usually defined as a trough in the level of real GDP. For the United States the NBER chronology is used. The average of previous cycles includes major cycles from the 1960s to the 1980s (late 1970s to 1990s for Japan). The last cyclical trough is 2001Q4 for the United States, 2002Q1 for Japan and 2003Q2 for the European countries.

Source: OECD, Quarterly National Accounts and Economic Outlook 77 database, Japanese Economic and Social Research Institute and Ministry of Finance.

Table I.2. Incoming data point to near-term weakness in some countries

*Real GDP growth, per cent, quarter-on-quarter*¹

	Outcomes				Outcome / Estimate	Estimates ²	
	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005Q1	2005Q2	2005Q3
United States	1.1	0.8	1.0	0.9	0.9 ³	0.9 (+/- 0.5)	0.8 (+/- 0.6)
Japan	1.4	-0.2	-0.3	0.0	1.3	0.2 (+/- 0.5)	0.5 (+/- 0.7)
Euro area	0.7	0.4	0.3	0.1	0.4	0.2 (+/- 0.3)	0.3 (+/- 0.4)
Germany	0.5	0.4	0.0	-0.2	1.0	0.2 (+/- 0.5)	0.3 (+/- 0.6)
France	0.7	0.7	0.1	0.6	0.2	0.1 (+/- 0.4)	0.2 (+/- 0.4)
Italy	0.5	0.4	0.4	-0.4	-0.5	0.0 (+/- 0.4)	0.1 (+/- 0.4)
United Kingdom	0.7	1.0	0.6	0.7	0.6	0.5 (+/- 0.3)	0.6 (+/- 0.3)
Six largest OECD economies	1.0	0.6	0.5	0.5	0.8	0.5 (+/- 0.3)	0.6 (+/- 0.3)

1. Based on GDP releases and high-frequency indicators published by 20 May 2005. Seasonally and in some cases also working-day adjusted. Aggregation for the six largest OECD economies uses 2000 purchasing-power-parity weights.

2. These estimates are indicative of near-term GDP developments but do not necessarily coincide with the OECD projections. The one-standard-error range associated with the estimates is indicated in parentheses. Typically, OECD projections lie within that range.

3. The official advance estimate of 0.8 has been superseded by subsequent information, in particular as concerns imports.

Source: OECD Economic Outlook 77 database and OECD calculations.

continue to expand fairly robustly. In a number of countries where the cycle is less advanced (notably in Germany and France), business investment is expected to drive the recovery. The foreseen acceleration or continued strength of non-residential investment follows several years of negative or low net capital formation, and capital spending has lagged profits in most of the larger economies (Figure I.5). As a result, capacity utilisation rates in the manufacturing sector are reverting towards their long-term averages even in the slow-growing countries (Figure I.6).⁸ The projected buoyancy of investment is also facilitated by the balance sheet repairs undertaken in the wake of the 2000-02 equity market correction, the subsequent rebound in equity prices, flush cash flows and readily available and relatively cheap credit.

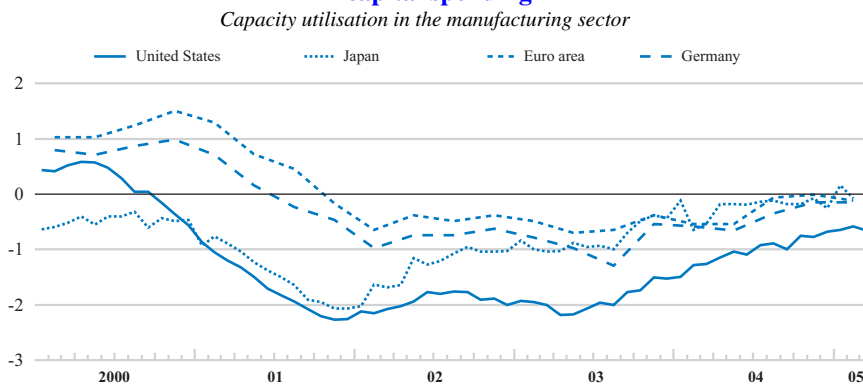
In a context of rising interest rates, and with a virtually closed output gap, growth is projected to remain around potential in the United States. In the process, labour productivity growth – which has fallen back towards its longer-run average (Figure I.7) – is likely to remain more moderate, and unit labour costs are set to pick up. Inflation, however, will continue to be damped – like in other OECD countries – by the ongoing offshoring trend, and more generally by the integration of China, India and other emerging markets into the world economy (including the recent removal of quotas on textiles and clothing).⁹ As a result, much of the cost pressure is

The US output gap is closing...

8. Capacity utilisation rates in manufacturing, however, are not perfectly correlated with economy-wide output or employment gaps.

9. See the section on offshoring, jobs and structural policies in the first chapter of the *OECD Economic Outlook* No. 75, June 2004. The take-off of these large emerging economies also puts upward pressure on commodity prices, but the impact on inflation is at least partly offset by the downward pressure exerted on wages.

Figure I.6. **Capacity utilisation rates foreshadow some acceleration in capital spending**



Note: All series have been normalised at the average for the period starting in 1985 and are presented in units of standard deviation.

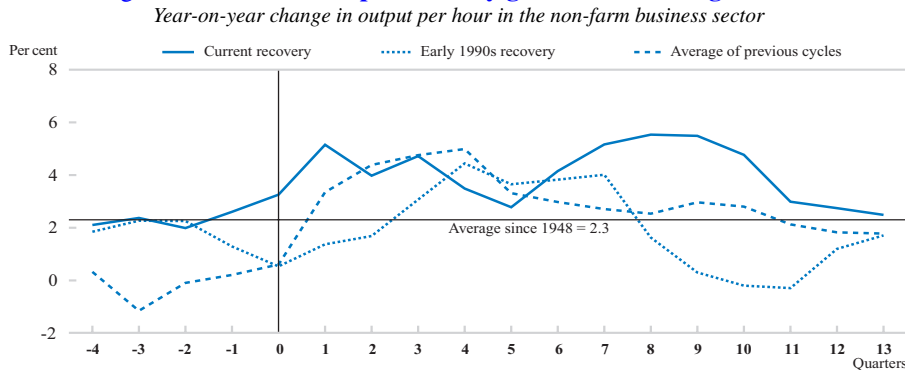
Source: OECD, *Main Economic Indicators*.

expected to be absorbed by profit margins, leaving core inflation still fairly subdued. As the impact of past exchange rate depreciation filters through, exports should accelerate and imports slow somewhat, although not sufficiently to stabilise the trade balance. With net investment income turning into a drag, as net foreign liabilities cumulate and exchange-rate induced valuation effects abate, the current account is projected to deteriorate further, to a new historical trough of 6¾ per cent of GDP in 2006.

... whilst slack is set to persist in the euro area

Activity in the euro area as a whole is projected to move back towards potential starting around late 2005, but the acceleration will not be sufficient for labour and product market slack to be absorbed by the end of 2006. As noted, business fixed investment is expected to drive the pick-up in activity, in particular in Germany, where following five years of investment contraction the profit share in national income is at a record high and credit standards are no longer being tightened. Although capital formation is gathering pace, the euro area-wide unemployment rate will not decline much

Figure I.7. **US labour productivity growth is reverting to trend**



Note: Time = 0 in the chart refers to the cyclical trough as defined by the National Bureau of Economic Research (NBER). The last trough is 2001Q4.

Source: US Bureau of Labor Statistics.

before next year. Against this backdrop, and as recent energy price increases fall out of the index, headline inflation is projected to ease somewhat. Looking further ahead (see Appendix I.1), potential and actual growth are likely to fall well short of the ambitious pace envisioned at the onset of the decade, when the so-called Lisbon Agenda was set out, in part because of delays in introducing some of the associated policy measures, not least as concerns the completion of a single market for goods and services.¹⁰

In Japan, growth has regained momentum, on the back of strong profits and a slowly recovering labour market. Business investment is projected to continue to expand vigorously, though at a more sustainable pace than in 2003-04 or the first quarter of 2005 (the strength of which partly reflected the postponement of spending on construction that was delayed by the late 2004 typhoons). The mix of new hires is improving, with a rising share of full-time contracts, implying that wage growth could become positive by 2006, contributing to a pick-up in household consumption. On the external side, the current account surplus is projected to widen to over 4% of GDP.

Growth has resumed in Japan

Table I.3. World trade growth should be sustained

	2003	2004	2005	2006
Percentage change over previous period				
Goods and services trade volume				
World trade ¹	5.1	9.4	7.4	9.4
<i>of which:</i> OECD	3.1	8.1	5.8	7.8
NAFTA	2.7	9.0	7.1	7.4
OECD Asia-Pacific	8.0	13.1	6.7	9.0
OECD Europe	2.1	6.3	4.9	7.7
Non-OECD Asia	11.5	13.7	11.1	13.3
Other non-OECD	8.0	10.4	11.3	12.2
OECD exports	2.5	8.0	5.1	8.0
OECD imports	3.7	8.2	6.5	7.6
Trade prices²				
OECD exports	11.5	8.8	5.0	0.6
OECD imports	10.6	8.9	5.4	0.6
Non-OECD exports	6.0	10.6	8.0	2.9
Non-OECD imports	6.6	8.3	6.7	3.3
Current account balances				
Per cent of GDP				
United States	-4.8	-5.7	-6.4	-6.7
Japan	3.1	3.6	3.6	4.1
Euro area	0.4	0.6	0.1	0.3
OECD	-1.1	-1.2	-1.7	-1.7
\$ billion				
United States	-531	-666	-800	-879
Japan	135	170	177	203
Euro area	31	59	14	36
OECD	-336	-409	-600	-630
Non-OECD	254	371	461	430
World	-83	-39	-139	-200

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.

Source: OECD Economic Outlook 77 database.

10. Faster labour market reform would also help. See OECD, *Going for Growth*, Paris, 2005.

*Momentum elsewhere
should by and large be
preserved*

In most other OECD economies, growth is projected to generally remain fairly robust. Elsewhere, a limited deceleration is seen in China, Russia and Brazil, but from a rapid pace. In China in particular, investment should expand at a more sustainable rate. World trade growth, which held up well despite the oil price shock, is projected to pick up (Table I.3).¹¹ It will be fuelled to some extent by the acceleration of the imports of many of the major oil-producing nations, especially Russia and the Africa and Middle East region. In the latter, some three fifths of the additional oil export revenue since the start of 2004 is assumed to be re-spent by end-2006, generating import volume growth of 15% in 2005 and close to 20% in 2006. Within the OECD area, this recycling of revenues will benefit European countries most, as they trade more intensively with the major oil-producing economies. All told, import demand growth from the major oil producers will add almost 2 percentage points to the export market growth faced by the European OECD countries in 2005-06, as against 1 percentage point for the Asia-Pacific ones and $\frac{3}{4}$ percentage point for North America plus Mexico. Within Europe, the effects could be larger still for some countries, notably Turkey and Greece, but also Italy, France, Finland and the Central European economies.

Enduring risks and tensions

*Uncertainties surround
the baseline projection*

Most of the downside risks have been there for some time and not all of them are bound to unwind painfully. There may be some upside risks too, although they would seem to carry a lower probability. Some of the risks are interdependent, offsetting or compounding each other. For example, the widening current account deficit in the United States and some other OECD economies (United Kingdom, Australia and some euro area countries) is partly related to housing market features and developments, insofar as housing wealth gains tend to lower household and national saving. The housing market's apparent overextension in some countries is in turn related to the still low level of long-term interest rates, although judgement on the existence or absence of bubbles, be it in the real estate or other markets, is always difficult.¹²

*Long-term interest rates
and spreads remain low*

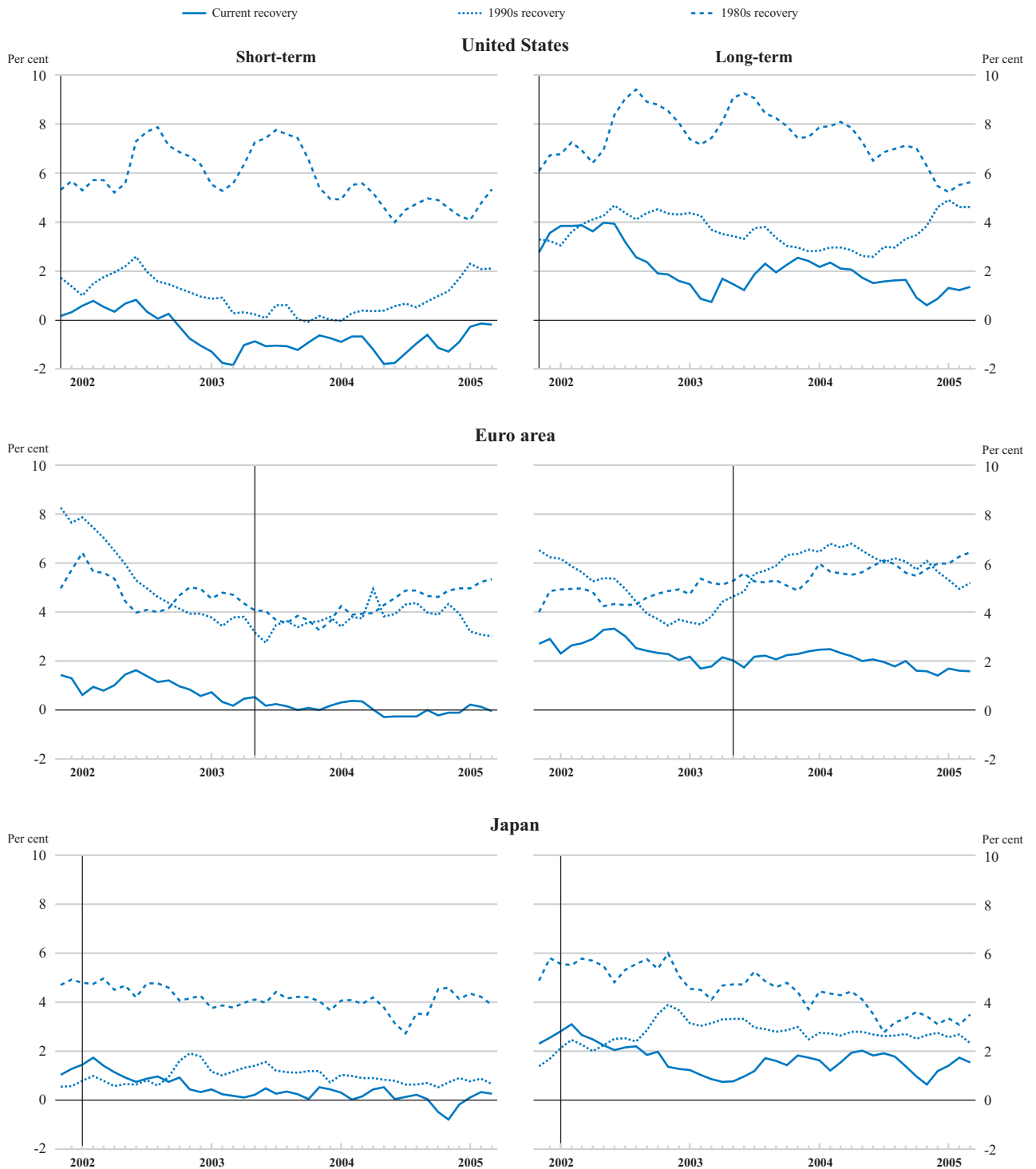
Long-term interest rates remain low in historical perspective (Figure I.8). In real terms, US benchmark government bond yields are distinctly below the levels prevailing during the previous two decades, even though broadly speaking the fiscal deficit is as large and persistent as during the 1980s. To some extent, this might reflect better anchored inflation expectations, making for a lower inflation risk premium. In the euro area and Japan, nominal yields are even lower, partly reflecting more modest growth prospects, but also, in the case of Japan, the central bank's commitment to quantitative easing until deflation has been overcome. At the same time, spreads for corporate bonds and emerging-market paper alike remain on the low side despite the recent up-ticks (Figure I.9), pointing to limited market discrimination across classes of risk notwithstanding improvements in fundamentals.¹³ One factor keeping a lid on US benchmark interest rates may be the steady stream of purchases by Asian central

11. Further out, sustaining a rapid expansion of trade requires that progress be made in the Doha Round negotiations.

12. See for instance Gurkaynak, R., "Econometric tests of asset price bubbles: taking stock", US Federal Reserve, *Finance and Economics Discussion Series*, No. 4, 2005.

13. See Sløk, T. and M. Kennedy, "Factors driving risk premia", *OECD Economics Department Working Papers*, No. 385, 2004. Equity prices, however, are not conspicuously overvalued, in that price-earnings ratios do not exceed long-run averages (in the United States) or are even below (in the euro area at large and Japan).

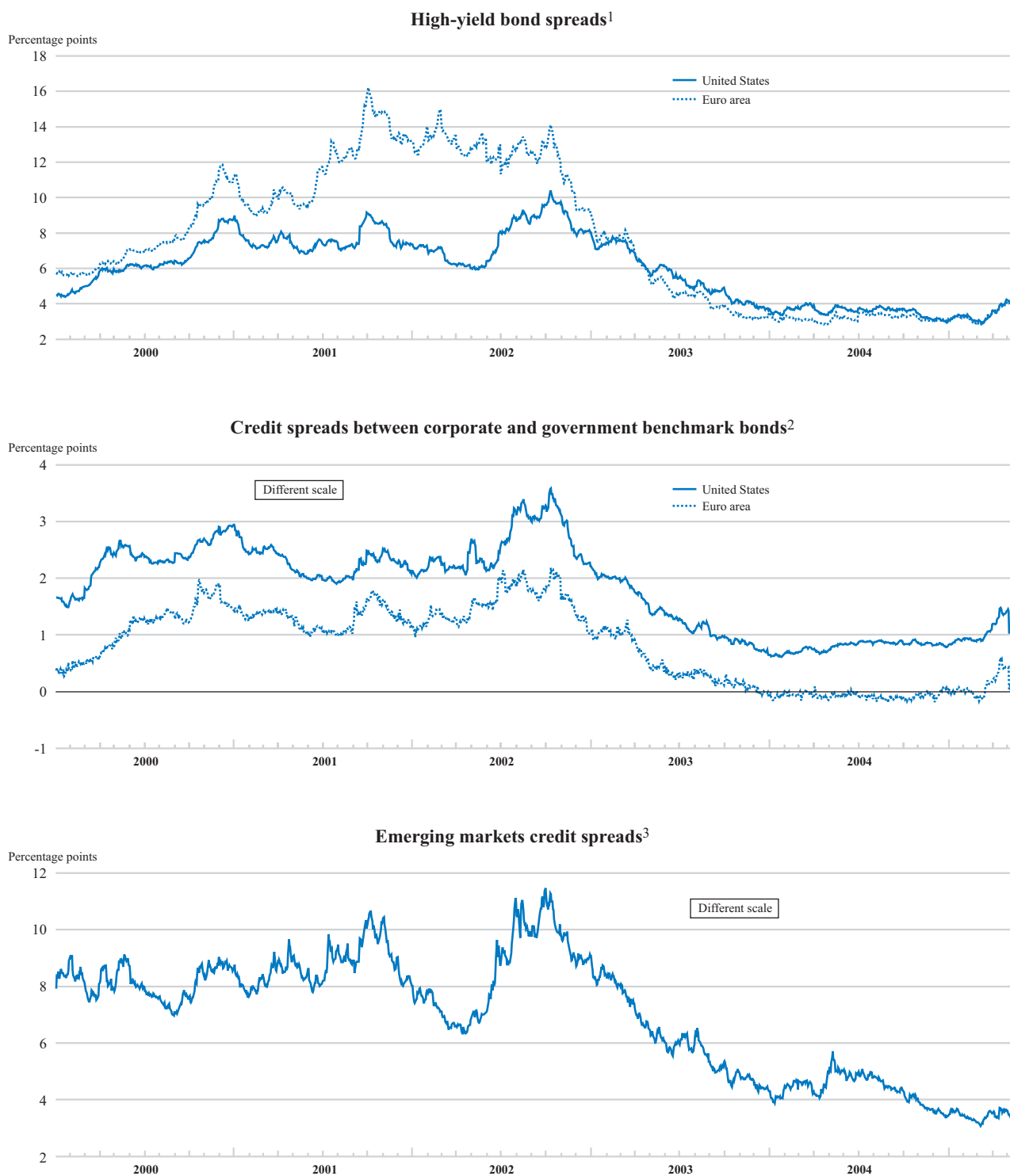
Figure I.8. Real interest rates are lower than in earlier cycles



Note: Short-term refers to 3-month money market rates and long-term to 10-year government bond yields. They have been deflated using the consumer price index (harmonised index for the euro area). Cyclical trough dates are taken from the NBER chronology for the United States, from the ESRI chronology for Japan and estimated by the OECD for the euro area. For Japan, the 1980s and 1990s recoveries refer to the average of two cycles in each of these decades. The last cyclical trough is November 2001 for the United States, January 2002 for Japan and May 2003 for the euro area.

Source : OECD, *Main Economic Indicators*.

Figure I.9. Spreads remain relatively compressed



1. Spreads of high yield bonds (Merrill Lynch indices) over government bond yields (10-year benchmark bonds).
 2. United States: Lehman Baa corporate index; Euro area: Lehman euro Baa. Government bond yields are for 10-year benchmark bonds.
 3. Spreads of JP Morgan Emerging Market Bonds Index (EMBI+) yields over US government bond yields.
 Source: Datastream.

banks, whose foreign exchange reserves are predominantly invested in US government securities.¹⁴ Another factor working in the same direction, both in the United States and in other OECD economies, could be an increased demand for bonds from pension funds and insurance companies in response to accounting changes and improved asset-liability management, in an environment where there is a dearth of very long-run bonds.¹⁵ Abundant liquidity has been fuelling a general hunt for yield – witness the proliferation of hedge funds and of carry trades and the greater eagerness to sell protection from asset price changes. While such symptoms are a cause for concern, a sharper-than-assumed ratcheting up of long rates might be absorbed without too much disruption if it were to occur in the context of a stronger-than-projected recovery.

With price-to-rent ratios reaching record highs, housing markets may be overextended in a number of countries, even if demographic and other fundamentals can explain a sizeable portion if not all of the appreciation witnessed in recent years.¹⁶ Indeed, signs of speculative demand can be spotted in a number of cases, in the form of seemingly exuberant expectations of further appreciation and of a rising share of buy-to-let purchases. In the United States in particular, the popularity of interest-only mortgages, the take-off of negative amortisation loans (the shortfall being added to the outstanding mortgage balance) and the spreading of low introductory “teaser” rates warrant concern. Several countries – including the Netherlands, Australia, and more recently the United Kingdom – have already entered an adjustment phase, illustrating that a mere stabilisation of nominal prices can translate into a significant slowdown in overall private consumption. The potency of the transmission mechanism from the housing market to household spending, however, depends on the institutional features of the mortgage market, and in many OECD countries it is not as rapid and strong as in these three cases.¹⁷ Moreover, in countries with a national monetary policy, the central bank should be in a position to offset, at least to some extent, the impact on aggregate demand of an unexpectedly hard landing of the housing market.

Housing market reversals could lie ahead

External imbalances have been gradually worsening and are projected to widen further over the projection period, raising questions as to how and when adjustment might take place. By definition, current-account adjustment in one country or region will have to be offset by parallel adjustments elsewhere. Despite this symmetry, concerns that these imbalances are unsustainable tend to focus on deficits, and under the circumstances on the US deficit. The latter is set to approach \$900 billion in 2006, with its main counterpart surpluses in Japan, China, dynamic Asian economies and oil producing countries. So far, the US deficit has been readily financed, and more and more so by Asian central banks (Figure I.10). At the same time, US external indebtedness has not risen in line with the accumulation of deficits over recent years because dollar depreciation has boosted the dollar value of the foreign assets held by

External imbalances are worsening

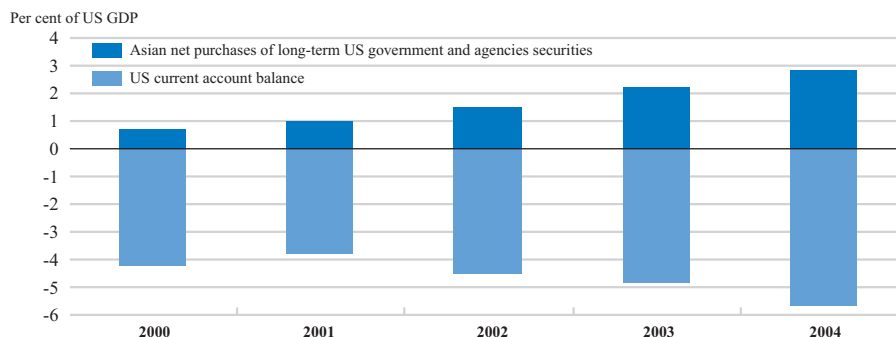
14. Estimates of their impact range from 40 to 200 basis points (Roubini, N. and B. Setser, “Will the Bretton Woods 2 regime unravel soon? The risk of a hard landing in 2005-2006”, *mimeo*, February 2005). That said, more recently some central banks have slowed their rates of accumulation.

15. Markets’ appetite for long-term bonds was illustrated by France’s recent successful issuance of a 50-year government bond.

16. On France, see Bessone, A.-J., B. Heitz and J. Boissinot, “Marché immobilier: voit-on une bulle?”, INSEE, *Note de Conjoncture*, March 2005. They find no evidence of overvaluation, but underline that data and econometric limitations warrant caution when interpreting the evidence. The Bank of England and the Bank of Spain have voiced concerns about housing market overheating.

17. In particular because it is more difficult for households to withdraw equity from their housing wealth (Catte, P., N. Girouard, R. Price and C. André, “The contribution of housing markets to cyclical resilience”, *OECD Economic Studies*, No. 38, 2004).

Figure I.10. Asia is financing a growing share of the US current account gap



Source: US Bureau of Economic Analysis and Treasury.

US residents. However, the losses concomitantly incurred by foreign investors on their dollar-denominated assets may not encourage them to hold a steadily increasing share of those assets in their portfolios. Indeed, it is clear that current trends cannot continue indefinitely, but the inflection point and modalities are hard to predict, although the likelihood that dollar depreciation would be one of the adjustment channels seems high.¹⁸ The proximate cause may be a large adverse credit event, a realisation that the desired currency composition of portfolios held by central banks and/or private financial institutions is shifting,¹⁹ an unexpectedly sharp rise in long-term interest rates, or yet some other factor. A sudden and large drop in the dollar would substantially damp the already modest expansion projected for the euro area and Japan, especially if accompanied by falls in bond, share and house prices, and all the more so given the structural features and narrow scope to use macroeconomic policy levers, which limit the resilience of US partner economies (Box I.4).

The investment accelerator may disappoint

Even in the absence of such an exchange rate or interest rate shock, the projected pick-up in activity in the euro area and Japan hinges on the strength of investment spending. As noted, the conditions for an acceleration in capital outlays do seem to be in place on the supply side. Nevertheless, businesses in these two regions might need more time to fully absorb past energy price increases and euro appreciation, and might remain cautious about final demand prospects, or choose to invest more in other regions of the world. If so, fixed investment might not pick up as forcefully as projected.

Even so, there are some upside risks

While downside risks loom large, some forces could work in the opposite direction. Although there are fears that they would rise further, oil prices could conceivably revert towards levels more in line with longer-run fundamentals and end up lower than assumed in the central projection. Furthermore, in some countries

18. As argued by Obstfeld, M. and K. Rogoff, "The unsustainable US current account position revisited", *NBER Working Papers*, No. 10869, 2004 and Blanchard, O., F. Giavazzi and F. Sa, "The US current account and the dollar", *NBER Working Papers*, No. 11137, 2005.

19. See Pringle, R. and N. Carver, "Trends in reserve management: results of a survey of central banks", *RBS Reserve Management Trends 2005*, Central Banking Publications, January 2005.

Box I.4. Channels for the adjustment of external imbalances

At some point in the future, the existing external imbalances will cease to widen and start to unwind. Adjustment may involve one or several mechanisms, among which dollar depreciation, fiscal consolidation in the United States or a cyclical catch-up in the countries where aggregate demand is lagging. It is less clear, however, how structural reforms outside the United States would affect current accounts.

Dollar depreciation

As a thought experiment as to what could happen if there were a steep fall in *ex ante* demand for dollar-denominated assets, the OECD's Interlink model has been used to simulate the impact of a sustained 30% drop in the value of the dollar (and all non-OECD currencies) against all other OECD currencies. Such a sharp adjustment is not a likely outcome but its implications throw some light on policy issues that could arise. Further detail on the assumptions and results is provided in Appendix I.2.

Dollar depreciation implies an inflationary impulse in the United States that is assumed to be met through a hike in short-term interest rates – by some 150 basis points in the near term but fading fairly rapidly thereafter. At the same time, the exchange rate shock is accompanied by declines in bond, share and house prices as a combined effect of higher short-term interest rates and increased risk premia. Against this background, US domestic demand and output are about 1% lower than baseline levels during the current and next couple of years, with the unemployment rate up by around ¾ percentage point.

Even though in this scenario the effective exchange rate of the euro appreciates by only 7% and despite the fact that the Eurosystem is assumed to react promptly and forcefully by moving all the way to the zero interest rate bound, euro area GDP is more than 1% below baseline levels during the current and next couple of years. While this impact is more severe than in the United States, it would be larger still if

higher risk premia in US bond, equity and housing markets were to spread to the euro area through contagion effects. Even without contagion, however, the unemployment rate would be ½ percentage point higher than in the baseline and with contagion it would not come back to current levels before 2008.

Output losses in Japan are marginally larger than in the euro area, reflecting a more sizeable shock to the effective exchange rate (+15%) as well as the fact that room for additional interest rate cuts is nil.

Fiscal consolidation and closing of output gaps

The unpleasant consequences of a dollar hard landing warrant a search for policies that could bring about a smoother transition to a more sustainable level of the US current account deficit. An obvious candidate would be fiscal consolidation in the United States, not least because it is desirable in its own right. However, its effects on the current account are quite uncertain.¹ Moreover, fiscal consolidation is also desirable in Japan and the euro area – both regions faced with higher public debt and larger ageing-related fiscal pressures than the United States – raising questions as to the contribution towards current-account rebalancing that could come from generalised moves towards more sustainable fiscal positions.

Higher growth outside the United States might also be seen as desirable in its own right and at the same time as another channel for current-account rebalancing. However, cyclical and structural effects need to be kept separate. A cyclical rise in domestic demand outside the United States would certainly help improve the US current account balance. But apart from the euro area, output gaps are generally small or even positive, which limits the influence of this mechanism in the current situation. Indeed, the medium-term reference scenario (see Appendix I.1) is based on the closing of output gaps over the period to 2010 and does not feature any significant narrowing of the US external deficit.

– notably the United States – the investment rebound might be stronger than projected, with capital formation catching up more rapidly with what was observed in past cycles.

Macro policies: reverting to neutrality and restoring sustainability

As noted, macroeconomic policy has been very accommodating during the downturn and well into the recovery. As and when cyclical slack is absorbed, monetary policy should adjust. With very few exceptions, fiscal policy has also been very loose. Public debt ratios are on the rise in a number of countries and the pressures associated with ageing populations are mounting, squeezing revenue and pushing up

As the cycle matures, policies should adjust

Box I.4. Channels for the adjustment of external imbalances (cont.)

Structural reform and trend growth

Structural reform leading to higher trend growth outside the United States would have ambiguous effects on the US external balance. In general, a country's external balance corresponds to the difference between saving and investment and it is often not clear how these will be affected by structural reform. Put differently, structural reform will affect both the demand and the supply side of an economy, with the net impact not obvious *a priori*. For example, productivity-enhancing reform could stimulate not just supply but also demand to the extent expectations of higher future productivity growth and associated higher share prices boost private consumption and investment. This was the mechanism at work during the information and communication technology-generated acceleration of productivity in the United States in the 1990s when, at times, demand appeared to expand more rapidly than supply. However, there may be doubts as to the strength of similar effects in Europe and Japan. Even so, recent OECD work suggests that liberalisation of product markets – normally associated with better productivity performance – would tend to weaken a country's external balance.²

By contrast, structural reforms in labour markets aimed at boosting employment could have the effect of strengthening a country's external balance. This is significant given

that labour market reform is a high policy priority in many countries outside the United States, not least in the euro area. Intuitively, reforms that lead to an increase in the effective supply of labour should lead to a fall in relative wages that boosts competitiveness and thereby the external balance.³

Welfare-enhancing structural reforms could also affect the external account without necessarily boosting trend income growth. For example, reforms to ensure a smoother functioning of financial markets and easier access to credit outside the United States could reduce saving relative to investment. Indeed, there is some evidence that financial market reforms negatively affect the external balance of the reforming country. By the same token, reform in the United States to correct overly strong incentives for private consumption as a result of housing taxation could also improve the US external balance.

Overall, the side-effects of structural reforms on external balances should not be their primary driver. Rather, they should be undertaken because they improve general welfare and enable economies to better withstand shocks. Indeed, even structural reforms that worsen international imbalances – as may be the case with labour market reform in Europe – could ultimately ease the unwinding of external imbalances by making non-US economies more resilient should current-account adjustment take place through other channels.

1. While there is empirical evidence that fiscal tightening may have less of a direct offset in lower private saving in the United States than in other OECD countries (see "Saving behaviour and the effectiveness of fiscal policy", *OECD Economic Outlook*, No. 76, December 2004), other quantifications suggest that only around 20% of a fiscal tightening in the United States is reflected in the external balance (Erceg, C., L. Guerrieri and C. Gust, "Expansionary fiscal shocks and the trade deficit", Federal Reserve Board, *International Finance Discussion Papers*, No. 825, 2005).
2. See M. Kennedy and T. Sløk, "Structural policy reforms and external imbalances", *OECD Economics Department Working Papers*, No. 415, 2005.
3. In principle, the return on capital will also improve, which could generate capital inflows that would tend to weaken the external balance.

pension and health care outlays. Hence, fiscal consolidation should not continue to be postponed, even where the recovery is lagging.

Gradual normalisation of the monetary stance

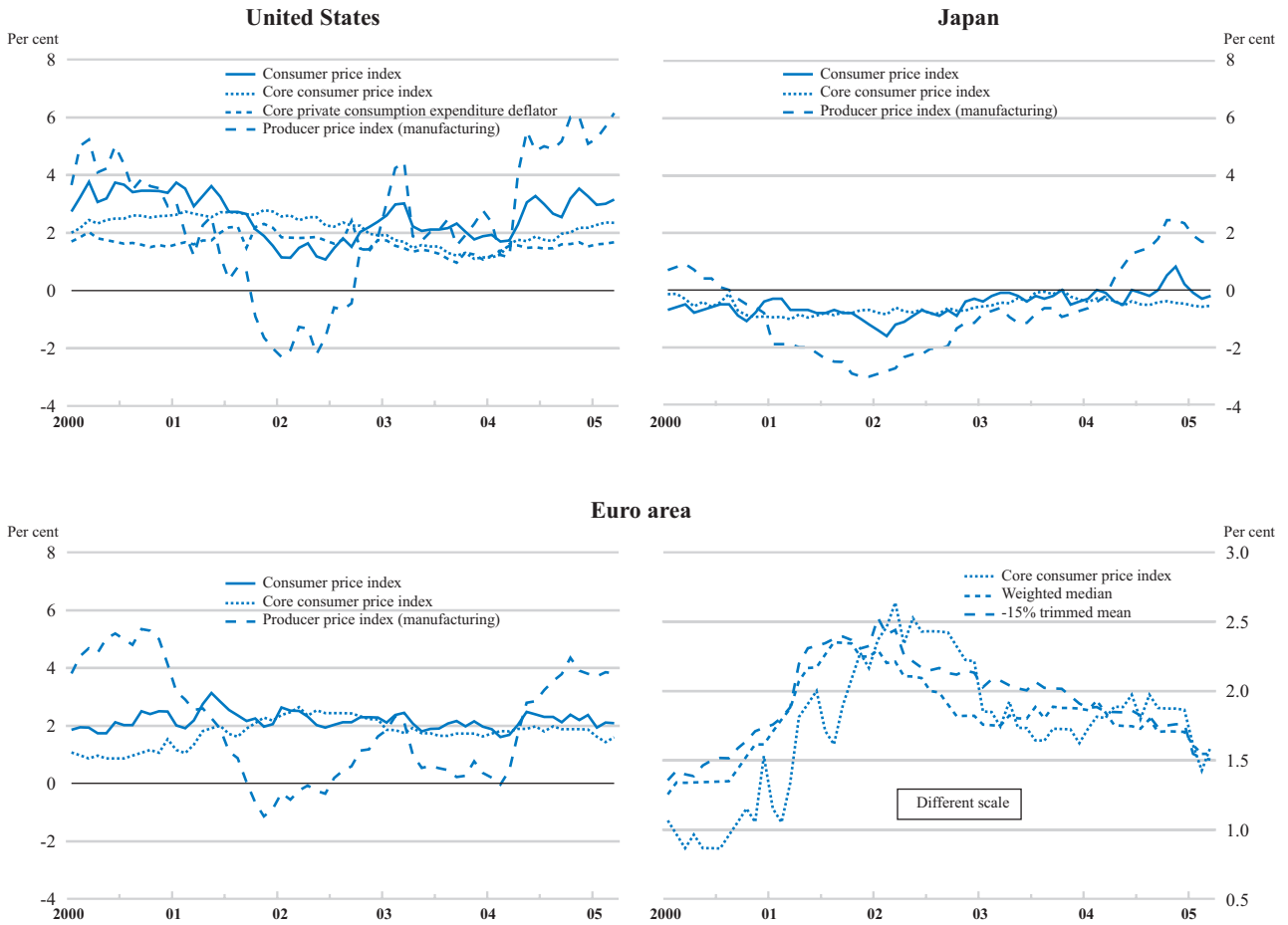
Central banks are removing stimulus or contemplating when to start

Despite accelerating producer prices, core consumer price inflation generally remains fairly subdued (Figure I.11).²⁰ Nonetheless, with output gaps closing or closed, several central banks have initiated and even in some cases completed a return to neutrality, notably in the United Kingdom, the United States, Canada,

20. For further discussion of how to interpret core inflation measures, see Chapter IV, "Measuring and assessing underlying inflation".

Figure I.11. Core inflation is still subdued

Year-on-year change



Note: The core consumer price index excludes food and energy.

Source : OECD, *Main Economic Indicators*, US Bureau of Economic Analysis and Statistical Office of the European Communities (Eurostat).

Australia, New Zealand and Switzerland, but also in some emerging markets such as Mexico and, outside the OECD area, China.²¹ In the euro area and Japan, however, a wait-and-see posture has continued to prevail, in view of significant slack that is either increasing or being absorbed only slowly.²²

21. Within the OECD, the new EU members stand out, however, with recent interest rate cuts.

22. A challenge faced by many central banks in this context is the uncertainty surrounding contemporaneous measures of slack, which are typically subject to sizeable subsequent revisions. See Orphanides, A. and S. van Norden “The reliability of inflation forecasts based on output gap estimates in real time”, Federal Reserve, *Finance and Economics Discussion Series*, No. 68, 2004, and Cotis, J-P., J. Elmeskov and A. Mourougane, “Estimates of potential output: benefits and pitfalls from a policy perspective”, in Reichlin, L. (ed.), *The Euro Area Business Cycle: Stylized Facts and Measurement Issues*, London: CEPR, 2005. In the United Kingdom, the Bank of England sees little, if any, slack, whereas Her Majesty’s Treasury estimates that some spare capacity remains. In Japan, the lack of capital stock data consistent with the new chain-linked national accounts hampers output gap estimation, which in any event is delicate in a context of entrenched deflation.

**Removal of US monetary
accommodation should
continue**

In the United States, inflationary pressures are palpable, as unit labour costs rise anew and dollar depreciation slowly feeds through. Going forward, inflation should nonetheless by and large remain within a desirable range, thanks to the buffer provided by existing ample profit margins, and as the Federal Reserve continues to adjust the fed funds rate (Figure I.12). The latter has been raised in 25 basis point steps by a cumulative 200 basis points since mid-2004, but still lies well below neutrality on any plausible definition of this concept.²³ Long-term household survey measures of inflation expectations have remained well anchored, even if indexed-bond proxies have drifted up somewhat. This stability has helped limit the second-round effects from the oil price and exchange rate shocks, but it is all the more important that further policy action validate the still serene expectations. As the policy rate moves up towards neutral or possibly even above, the predictability of the size and speed of further moves is likely to start diminishing at some point, which might contribute to pushing up long rates through a higher term premium.

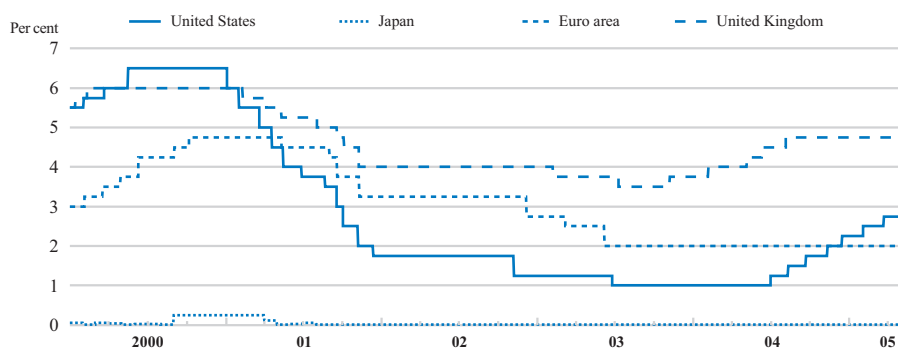
**In contrast, easing is
warranted in the euro area**

In the euro area, the key policy rate has been kept at 2% since mid-2003, with headline inflation hovering most of the time a notch above 2% but various core inflation measures running below the 2% mark. Insofar as the latter capture underlying inflation momentum, the outlook for price stability is fairly benign. Indeed, going forward, headline and core inflation look set to recede to 1½ per cent or below by 2006. At the same time, the euro area's sizeable negative output and unemployment gaps are currently widening and will only just begin to shrink, slowly, towards the end of 2005. With domestic demand sluggish, resilience feeble and possible upward pressures on the euro looming ahead, the balance of risks on growth and inflation is clearly tilted to the downside, calling for an early easing of monetary policy. Across the Channel, the Bank of England has kept its repo rate at 4¾ per cent since August 2004, a level close to if not already around neutrality, and consistent over the projection period with the authorities' inflation target.

**In Japan, no early change in
stance is desirable**

In Japan, the current policy of quantitative ease, which has kept short-term rates near zero, should continue as long as core inflation has not decisively crossed over into positive territory. In light of the progress achieved in dealing with non-performing

Figure I.12. Policy rates are being steered back towards neutrality in several economies



Source: US Federal Reserve Board, Bank of Japan, European Central Bank, Bank of England.

23. See Box I.4 in the *OECD Economic Outlook* No. 76, 2004.

loans and the seemingly dwindling appetite for excess liquidity on the part of banks, it has recently been suggested that it might be advisable to start bringing down the ¥ 30 to 35 trillion target range for banks' current accounts with the Bank of Japan, which would make it easier for banks to properly price risk. Such a move, however, would prematurely send a signal that deflation has been or is about to be overcome.

Resuming fiscal consolidation

In 2004, cyclically-adjusted fiscal deficits approached or exceeded 3% of GDP in six of the seven largest OECD economies, Canada standing out as an outlier, with a surplus of over 1% of GDP. Going forward, only very limited, if any, consolidation is in the pipeline, based on the measures enacted to date (Table I.4). Moreover, some recent policy initiatives, which are not factored into the projection, may go in the opposite direction. Yet, consolidation is urgently needed for longer-term reasons. Granted, the warranted pace of consolidation partly depends on cyclical conditions, but in many countries the underlying fiscal position is precarious and a change in course is required.

Underlying fiscal positions are weak

In the United States, the overall fiscal stance was essentially neutral in 2004, despite increases in defence spending, the extension of tax cuts and some temporary tax incentives for certain types of investment. Going forward, the budget tabled by the Administration in February 2005 projects a reduction in the federal deficit from 3.5% of GDP in FY 2005 to 1.3% in FY 2009, on the basis of more restraint for discretionary outlays (other than those related to homeland security) than has been achieved in decades. At the same time, large swathes of entitlement spending have an autonomous momentum of their own (Figure I.13). The present projections are based

Consolidation may prove elusive in the United States...

Table I.4. Fiscal deficits are high and debt ratios are rising

	2002	2003	2004	2005	2006
	Per cent of GDP / Potential GDP				
United States					
Actual balance	-3.8	-4.6	-4.3	-4.1	-3.9
Cyclically-adjusted balance	-3.2	-4.1	-4.2	-4.1	-4.0
Cyclically-adjusted primary balance	-1.2	-2.3	-2.4	-2.3	-2.0
Japan ¹					
Actual balance	-7.9	-7.7	-6.1	-6.1	-5.3
Cyclically-adjusted balance	-7.1	-7.0	-5.9	-6.0	-5.4
Cyclically-adjusted primary balance	-5.7	-5.6	-4.4	-4.3	-3.6
Euro area					
Actual balance	-2.5	-2.8	-2.7	-2.8	-2.7
Cyclically-adjusted balance	-2.5	-2.2	-2.0	-1.8	-1.8
Cyclically-adjusted primary balance	0.7	0.8	0.8	1.1	1.0
OECD ²					
Actual balance	-3.2	-3.7	-3.3	-3.2	-3.0
Cyclically-adjusted balance	-3.2	-3.4	-3.3	-3.1	-3.0
Cyclically-adjusted primary balance	-0.9	-1.4	-1.3	-1.2	-1.0

Note: Actual balances are in per cent of nominal GDP. Cyclically-adjusted balances are in per cent of potential GDP.

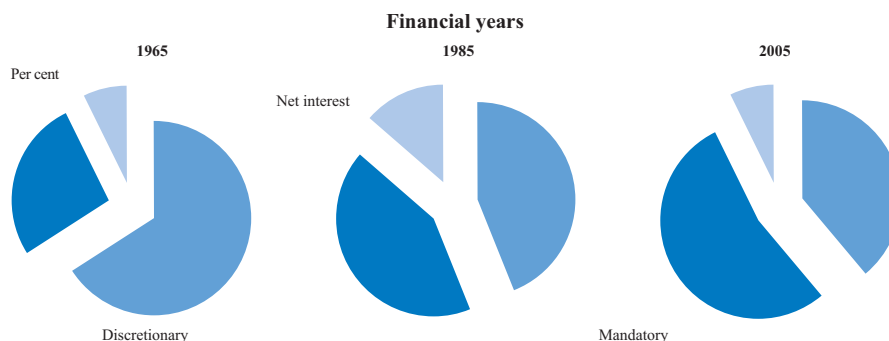
The primary cyclically-adjusted balance is the cyclically-adjusted balance less net debt interest payments.

1. Includes deferred tax payments on postal saving accounts amounting to 0.1 per cent of GDP in 2002.

2. Total OECD figures for the actual balance exclude Mexico and Turkey and those for the cyclically-adjusted balance further exclude the Czech Republic, Hungary, Korea, Luxembourg, Poland, the Slovak Republic and Switzerland.

Source: OECD Economic Outlook 77 database.

Figure I.13. The share of mandatory programmes in US Federal government spending is rising



Source: US Office of Management and Budget.

on the assumption that the exemption from the alternative minimum tax is carried forward, and that some limited additional funding for the operations in Iraq and Afghanistan will be required and imply that the federal government balance would barely improve by 2006, whilst the cyclically-adjusted general government deficit would remain around 4% of GDP. In the absence of new revenue-raising measures and of tax receipt windfalls, deviations from the spending path outlined by the Administration would further postpone the adjustment of a deficit that despite looming long-run pressures far exceeds its historical average.²⁴

... where two major fiscal initiatives have recently been launched...

Two major long-run initiatives have been launched in recent months on the fiscal front. The Administration has outlined a far-reaching reform of social security (*i.e.* the publicly-financed pension pillar), involving the creation of a new type of voluntary individual savings accounts, into which workers would be able to redirect up to four percentage points of the social security payroll tax. The diversion of part of today's social contributions to these new accounts would increase the general government's deficit in the coming years, but the impact on financial markets would depend, *inter alia*, on the extent of enrolment, on any concomitant adjustments to entitlements (which remain to be determined), on the provisions concerning the investment of the funds deposited in the new accounts and on the extent to which they focus on headline deficits.²⁵ Proposals for comprehensive tax reform are also under consideration, as the tax code has become horrendously complex and replete with exemptions and distortions. Base broadening and streamlining, however, ought to be carried out with a view to raising overall tax revenue. It is also important that any tax reform preserve or, better, enhance labour force participation incentives, and release resources now tied up in managing tax liabilities to more productive uses.

24. Simulations carried out by the US Congressional Budget Office (CBO) show public spending on pensions and even more so on health care jointly rising by close to 10 percentage points of GDP between now and 2050 under an intermediate scenario, with most of the increase to come after 2020, however (*The Long-Term Budget Outlook*, December 2003).

25. The CBO estimates that participation of all eligible workers would add about 1% of GDP to the budget deficit by 2015 (*An Analysis of the President's Budgetary Proposals for Fiscal Year 2006*, March 2005).

... as well as in the euro area...

In the euro area as well, only minimal fiscal consolidation is in the making, even on the conventional measure of changes in the cyclically-adjusted balances, which does not take into account some one-off measures that only temporarily improve the fiscal position (Box I.5).²⁶ As regards the policy framework, the fiscal rules enshrined in the Stability and Growth Pact were substantially amended in March 2005. Henceforth, more attention will be given, when assessing fiscal positions, to country-specific factors such as spending on research and development and innovation, contributions to the EU budget, expenses deemed to foster international solidarity (including some military outlays) or European unification (referring inter alia to transfers to former East Germany) and structural reforms entailing short-run costs but strengthening public finances over the longer run (*e.g.* the introduction of a funded pension pillar). Also, the excessive deficit procedure can now be suspended when growth languishes below trend, as opposed to the earlier condition of a “severe economic downturn”. In addition, more time will be granted for countries overshooting the 3% of GDP deficit mark to move back towards safer territory. These changes are likely to provide extra leeway to member countries where activity runs below potential and/or undertaking ambitious structural reforms. At the same time, a greater emphasis is to be placed on debt developments and sustainability, as well as on the reliability and timeliness of budgetary statistics. Moreover, the stated intention is to strengthen the Pact’s preventive arm through enhanced budgetary discipline in periods of relatively buoyant growth, which would help create the room needed to accommodate economic downturns. Furthermore, the benchmark of an annual adjustment of ½ per cent of GDP in underlying terms for countries needing to move towards balance is maintained. Implementation of this more sophisticated set of rules – which allows both the European Commission and the member countries to exercise greater judgement – will show how effective they are. Greater flexibility should not come at the expense of fiscal discipline. In any event, whatever the exact codification of any formal rules, the longer-run fiscal challenges are more daunting than ever, calling for much more effective and transparent national budgetary institutions in support of the revised Pact.

... although with stark differences between members

Fiscal positions and stances differ considerably across euro area members, with most of the smaller countries typically displaying more resolve to stick to the Pact’s maintained medium-run objective of close to balance or surplus (Figure I.14).²⁷ The underlying deficit – net of one-off measures – is not projected to improve much this year and next in Germany and France, and to largely stabilise in Italy as one-offs are phased out. The envisaged cuts in corporate tax rates (in Germany) or in personal income taxes (in Italy), irrespective of any longer-term merits on supply-side grounds, would also weigh on short-run outcomes. In the case of Italy, the fiscal challenge is compounded by the fact that growth will be far weaker than projected in the budget and this will be heightened by the expiration of a number of one-off measures which in recent times made for a better headline fiscal balance. In contrast, sustained tightening is in the cards in the Netherlands, amounting to 1½ percentage points of GDP over 2005-06. Two of the smaller countries, however, face serious difficulties, namely Greece, where the headline deficit reached 6% of GDP in 2004, and Portugal, where it is projected at 5% of GDP in 2005.

26. How much controlling in full for these measures would alter the time profile of the underlying position between 2004 and 2005 is a moot point, however: not all of them are known and some one-offs embellishing the 2004 accounts are no longer at work in 2005.

27. Under the new rules, however, the medium-run objective ranges from a deficit of 1% of GDP for low-debt or high-potential-growth countries to balance or surplus for high-debt or low-potential-growth countries, in cyclically-adjusted terms and net of temporary measures.

Box I.5. Seeing and believing

To analyse the evolution of countries' underlying fiscal positions, it is necessary to control for the effects of the cycle in economic activity. This "cyclically-adjusted" balance, however, may be affected by a number of other transient factors, including asset prices cycles,¹ one-off operations, creative accounting and classification errors.² In some cases, and with the benefit of hindsight, these have at times reached or exceeded 2 percentage points of GDP (e.g. Greece in at least six years since 1993, or Portugal in 2003 and 2004). In a growing number of countries, estimates taking some of these influences into account are produced and published.³ It is difficult, however, to pin down all of them, especially in real time and even for governments themselves. *A fortiori*, for projection purposes, it is even harder to quantify them. Even so, when they are identified, they should in principle be excluded from measures of the underlying fiscal position, although it may be desirable to distinguish between those factors that have a direct effect on the real economy and those that do not, depending on the use to which the underlying measure is being put.

The concept of "standardised budget balance", developed by the US Congressional Budget Office (CBO), is a prominent example of a measure attempting to remove both the impact of the cycle and that of other short-lived factors, which are not directly related to changes in fiscal policy and are unlikely to significantly affect private agents' real incomes in the short run. It excludes items such as swings in the collection of capital gains tax receipts, temporary changes in the timing of tax payments or government outlays, discrepancies between tax liabilities and payments (overpayments one year, compensated by higher refunds the following year), changes in the inflation component of the government's net interest payments (which effectively adjusts the value of outstanding public debt for the impact of inflation and hence does not alter real private incomes) and government asset sales. At various times in the past, and most notably around shocks and cyclical turning points (1974-75, 1978-81 and 1989-91), changes in the standardised budget balance have deviated from changes in the cyclically-adjusted balance by over one percentage point of GDP.⁴

No similarly sophisticated measure exists as yet across EU countries, where one-offs, creative accounting and misclassification problems have taken on a bewildering variety of shapes. For example, in the context of EU countries' most recent notification to Eurostat of their deficit and debt data, the submitted estimates for last year and/or for earlier years could not be validated for Greece (inconsistencies in the recording of EU bud-

get flows, improper accounting of expenditure on hospitals), Italy (treatment of payments to the Government by financial institutions acting as tax collectors, sectoral classification of government-owned entities, treatment of a securitisation operation, recording of transactions with the EU budget, inconsistencies between cash and accrual data) and Portugal (inconsistencies between cash and accrual data).⁵

Looking forward, another such example would be the one-time upfront payment to the Government that the French electricity company EdF is set to make in 2005 in the context of its partial privatisation, mainly as a counterpart of the transfer of its pension obligations to the State (which may amount to around ½ per cent of GDP). In Germany, 0.1 percentage point of GDP of the improvement in the cyclically-adjusted balance projected for 2005 is related to the repayment to state governments by state banks of past subsidies, which will be offset in the latter's balance sheets by new equity participations (which are recorded "below the line"). In addition, the capitalisation of claims by the pension funds for the civil servants of the former Post Office should reduce the government deficit in 2005 by about 0.2% of GDP. The tax amnesty that expired end-March 2005 will work in the same direction, although by a smaller amount. In the context of fiscal surveillance under the aegis of the Stability and Growth Pact, the European Commission has increasingly tried to control for these factors, but with mixed results, insofar as some of them only belatedly come to light, not least in the context of official audits following the election of a new majority.

Outside Europe, a recent example is a capital transfer in Japan from the corporate pension funds to the Government, which amounted to 0.1% of GDP in 2003 and at least 0.6% of GDP in 2004. This is duly noted in the SNA data released in March 2005 but should be taken into account when assessing the timing and speed of fiscal consolidation in Japan.

Changes in headline budget deficits may also be biased in the opposite direction, however. Some one-offs temporarily worsen the recorded fiscal position, but make for more favourable outcomes down the road. This was the case for example in 1999, when the Irish government paid a capital transfer of 1.8% of GDP to discharge future pension payments to the employees of the privatised telecommunication company. More recently, accounting adjustments to recognise spending that had been under-reported in earlier years worsened the 2004 general government balance for Spain by ¾ per cent of GDP.

1. See Girouard, N. and R. Price, "Asset price cycles, "one-off" factors and structural budget balances", *OECD Economics Department Working Papers*, No. 391, 2004.

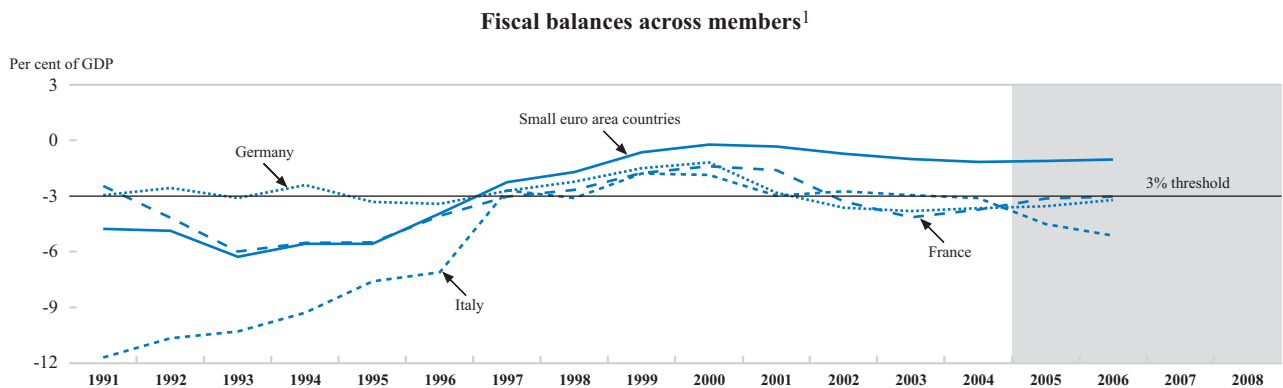
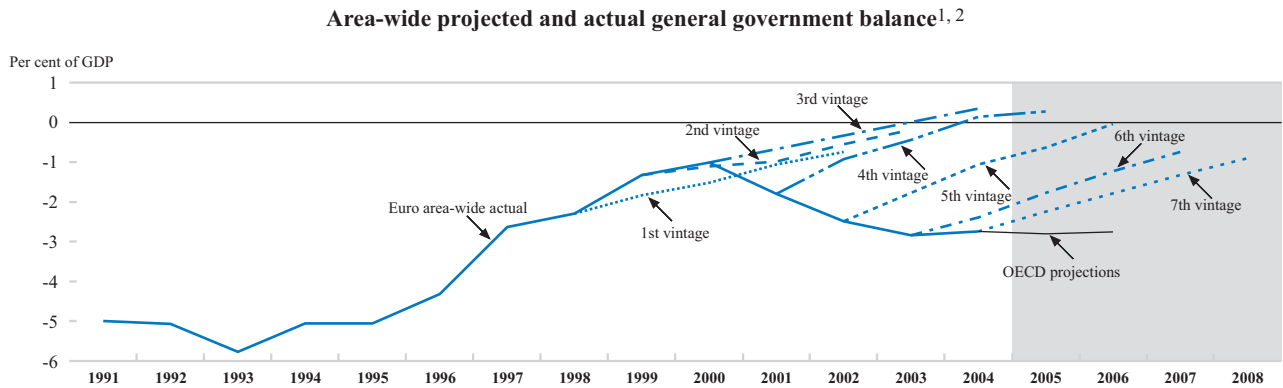
2. See Koen, V. and P. van den Noord, "Fiscal gimmickry in Europe: one-off measures and creative accounting", *OECD Economics Department Working Papers*, No. 417, 2005.

3. A number of EU countries now fairly transparently report the non-recurrent factors affecting the fiscal balance.

4. See CBO, *The Cyclically Adjusted and Standardized Budget Measures*, Washington DC, February 2005.

5. See Eurostat's 18 March 2005 news release.

Figure I.14. Recurrent fiscal slippage in the euro area



1. Excluding third generation mobile telephone licence proceeds.
 2. The various vintages of the Stability Programmes were released over the following periods: 1st 1998/99, 2nd 1999/2000, 3rd 2000/01, 4th 2001/02, 5th 2002/03, 6th 2003/04, 7th 2004/05.
 Source: Statistical Office of the European Communities (Eurostat) and OECD Economic Outlook 77 database.

In Japan, the underlying fiscal deficit, adjusted for the pension-related payment transfer described in Box I.5, improved somewhat in 2004, but the gross public debt ratio continued to rise, approaching a new high of 160% of GDP. Over the projection horizon, some further fiscal consolidation is foreseen, with the partial reversal of the tax cuts passed in 1999 and with incremental increases in social contributions. On the spending side, public investment and some other discretionary programmes are being cut further, but social outlays continue to grow rapidly. As a result, both the deficit and the debt ratio are projected to remain more than twice as high as in the OECD at large. In order to achieve the official target of a primary surplus in the early 2010s, measures to broaden the tax base need to be taken, with a rise in the value added tax rate to be considered once the expansion is more firmly established.²⁸

Gradual adjustment is under way in Japan

28. See the 2005 *OECD Economic Survey of Japan*. The rate of the value added (or consumption) tax currently stands at only 5%.

Appendix I.1

The medium-term reference scenario

Area-wide, potential growth is expected to ease to around 2½ per cent by 2010

The medium-term reference scenario is a largely supply-side driven extension of the current short-term projections to the end of 2010, based on a set of specific assumptions, as described in Box I.6 (see Tables I.5 to I.7). It therefore serves as a benchmark for the analysis of some of the tensions discussed in the main text, nota-

Table I.5. Medium-term reference scenario summary

	<i>Per cent</i>								
	Real GDP growth 2007-2010	Inflation rate ¹		Unemployment rate ²		Current balance ³		Long-term interest rate	
		2006	2010	2006	2010	2006	2010	2006	2010
Australia	3.6	2.7	2.1	5.2	5.0	-4.9	-3.0	6.6	6.2
Austria	2.7	1.7	1.4	5.5	4.9	0.3	1.1	3.6	5.5
Belgium	2.4	1.6	1.5	8.0	7.2	3.3	3.1	3.6	5.5
Canada	2.9	1.5	1.6	6.8	7.2	2.5	3.9	5.1	5.6
Czech Republic	3.0	2.5	1.7	8.2	8.5	-4.5	-2.0	5.2	6.0
Denmark	1.8	1.9	1.6	5.0	4.8	1.6	2.1	3.7	5.5
Finland	1.9	1.9	1.7	8.3	8.0	3.5	2.2	3.6	5.5
France	2.6	1.7	1.5	9.6	8.8	-0.6	0.4	3.6	5.5
Germany	2.2	0.8	1.6	9.1	7.7	4.9	4.9	3.5	5.5
Greece	3.6	3.3	1.9	10.5	9.8	-4.9	-4.2	3.6	5.5
Hungary	3.5	3.8	2.5	6.0	5.0	-6.4	-5.7	5.8	6.5
Iceland	3.3	3.2	2.2	2.3	2.4	-12.3	-12.0	8.7	5.7
Ireland	4.7	2.7	2.0	4.3	4.8	1.5	4.0	3.6	5.5
Italy	1.8	1.8	1.7	8.4	8.4	-2.3	-2.7	3.7	5.5
Japan	0.8	0.1	0.9	4.1	3.9	4.1	3.9	1.8	4.2
Korea	4.4	3.1	2.8	3.3	3.5	1.7	-0.8	5.3	6.2
Mexico	4.2	3.6	3.6	3.8	2.4	-2.0	-2.0	10.4	8.2
Netherlands	3.0	0.5	1.5	6.1	3.2	4.6	5.8	3.5	5.5
New Zealand	3.3	2.0	1.6	4.5	4.7	-6.3	-5.6	6.0	6.2
Norway	2.7 ⁴	2.5	2.0	3.8	4.1	14.7	14.5	4.6	5.6
Poland	5.2	2.5	2.1	17.3	15.1	-1.5	-2.3	5.9	5.2
Portugal	2.3	1.7	1.6	6.9	4.2	-8.9	-8.5	3.7	5.5
Slovak Republic	5.7	2.8	2.1	17.5	14.1	-5.3	-4.8	4.3	6.3
Spain	3.0	2.6	1.8	9.8	10.3	-6.7	-6.6	3.6	5.5
Sweden	2.3	1.9	1.9	4.7	4.7	6.5	5.2	4.4	6.1
Switzerland	1.7	0.9	0.7	3.5	2.2	12.5	13.2	2.5	3.6
Turkey	7.1	5.4	4.5	10.5	8.0	-4.5	-5.1	10.1	9.8
United Kingdom	2.6	2.1	1.9	5.2	5.3	-2.4	-1.7	4.8	5.9
United States	3.2	2.1	1.6	4.8	4.8	-6.7	-6.8	5.3	5.8
Euro area	2.5	1.6	1.6	8.7	7.9	0.3	0.6	3.6	5.5
Total of above OECD countries	2.8	1.8 ⁵	1.7 ⁵	6.4	5.9	-1.7	-1.8	4.5 ⁵	5.6 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 77 database.

Table I.6. 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	
	2006	2010	2006	2010	2006	2010	2006	2010
Australia	0.8	1.1	0	-4	17	13	..	..
Austria	-1.9	-1.3	38	37	64	64	61	61
Belgium	-1.2	-0.4	88	78	98	87	93	82
Canada	0.8	0.8	27	19	66	58	..	..
Czech Republic	-4.2	-3.6	..	..	..	..	..	..
Denmark	1.5	0.6	1	-3	46	43	39	36
Finland	1.1	0.7	-40	-38	57	58	48	50
France	-3.0	-2.1	44	46	74	76	66	68
Germany	-3.2	-2.2	64	65	73	73	69	70
Greece	-3.5	-3.2	..	..	106	95	106	95
Hungary	-4.1	-4.9	..	..	..	..	..	..
Iceland	1.1	-0.2	16	14	30	28	..	..
Ireland	-0.7	-0.5	..	..	30	25	30	25
Italy	-5.0	-4.2	99	103	122	126	109	114
Japan	-5.3	-5.6	82	99	163	180	..	..
Korea	2.9	2.8	-29	-34	27	22	..	..
Netherlands	-1.7	1.3	38	29	66	58	56	48
New Zealand	2.8	2.8	-12	-20	15	7	..	..
Norway	14.6	12.1	-140	-160	46	26	..	..
Poland	-4.0	-3.6	..	..	54	57	..	..
Portugal	-4.8	-3.3	..	..	82	88	71	78
Slovak Republic	-3.2	-2.4	..	..	..	..	..	..
Spain	0.6	0.6	29	21	50	42	44	36
Sweden	0.8	0.6	-6	-8	61	59	50	48
Switzerland	-0.8	-0.1	..	..	..	..	..	..
United Kingdom	-3.0	-2.7	40	44	48	52	46	50
United States	-3.9	-3.5	50	54	69	74	..	..
Euro area	-2.7	-1.8	58	57	79	78	72	71
Total of above OECD countries	-3.0	-2.6	50	53	80	83	..	..

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 2004, 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 77 database.

bly the fiscal and external imbalances. Growth in output for any country from 2007 onwards is assumed basically to reflect the growth of potential output and a closing of the output gap. Over the period, growth in potential for the OECD area as a whole is expected to slow slightly to just below 2½ per cent *per annum* in 2010, reflecting a decline in trend labour force growth which is partially offset by some acceleration in trend labour productivity.

Table I.7. 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	
		1998-2006	2007-2010	1998-2006	2007-2010	1998-2006	2007-2010	1998-2006	2007-2010	1998-2006	2007-2010	1998-2006	2007-2010
Australia	-1.3	3.6	3.3	1.8	2.2	1.7	1.0	0.3	0.0	1.3	0.9	0.1	0.1
Austria	-2.1	2.4	2.1	1.6	2.0	0.8	0.2	0.2	0.1	0.5	0.0	0.0	0.0
Belgium	-1.3	2.1	2.1	1.3	1.7	0.7	0.4	0.4	0.1	0.3	0.3	0.0	0.0
Canada	-0.2	3.1	2.8	1.5	2.0	1.6	0.8	0.4	0.0	1.2	0.8	0.0	0.0
Denmark	-0.1	2.0	1.7	1.9	1.8	0.1	-0.1	-0.1	0.0	0.1	0.0	0.1	0.0
Finland	0.6	2.7	2.1	2.1	2.3	0.6	-0.3	0.0	-0.4	0.3	0.1	0.3	0.0
France	-2.1	2.2	2.0	1.4	1.8	0.8	0.2	0.2	-0.1	0.4	0.3	0.2	0.0
Germany	-2.1	1.4	1.7	1.1	1.6	0.2	0.1	0.5	0.3	-0.2	-0.2	-0.1	0.0
Greece	-0.1	3.5	3.5	2.8	2.8	0.7	0.7	0.6	0.6	0.1	-0.1	-0.1	0.2
Iceland	1.3	3.8	3.6	2.1	2.5	1.6	1.1	0.0	0.0	1.5	1.0	0.1	0.1
Ireland	-0.5	6.8	4.6	3.8	3.6	2.9	0.9	0.7	0.2	1.7	0.7	0.5	0.1
Italy	-2.0	1.3	1.3	0.8	1.3	0.4	-0.1	0.3	0.2	-0.1	-0.3	0.2	0.0
Japan	0.3	1.2	0.9	1.3	1.5	-0.1	-0.6	0.3	0.2	-0.3	-0.7	-0.1	0.0
Netherlands	-4.2	2.4	1.9	1.0	1.3	1.4	0.6	0.7	0.3	0.5	0.3	0.2	0.0
New Zealand	0.0	3.3	3.3	1.5	2.1	1.8	1.2	0.3	0.2	1.2	1.0	0.3	0.0
Norway ³	0.8	2.7	2.9	1.8	2.2	0.9	0.7	0.1	0.1	0.8	0.6	0.0	0.0
Spain	-0.5	3.0	2.8	0.9	1.5	2.1	1.4	1.0	0.5	0.8	0.8	0.2	0.0
Sweden	0.3	2.5	2.4	2.2	2.2	0.3	0.2	-0.2	-0.1	0.5	0.3	0.1	0.0
Switzerland	-0.4	1.4	1.6	0.6	1.3	0.7	0.3	0.1	0.1	0.6	0.1	0.0	0.0
United Kingdom	0.0	2.7	2.5	1.9	2.1	0.7	0.4	0.0	0.0	0.6	0.4	0.2	0.0
United States	0.1	3.2	3.2	2.2	2.3	1.0	1.0	-0.4	-0.2	1.3	1.1	0.0	0.0
Euro area	-1.9	2.0	2.0	1.2	1.6	0.7	0.3	0.6	0.2	0.2	0.1	0.1	0.0
Total OECD	-0.5	2.5	2.4	1.7	1.9	0.7	0.5	0.1	0.0	0.8	0.6	0.0	0.0

1. Percentage point contributions to potential employment growth.

2. Estimates of the structural rate of unemployment are based on the concepts and methods described in "Revised OECD measures of structural unemployment", *Economic Outlook*, No. 68, 2000.

3. Excluding oil-sector.

Source: OECD Economic Outlook 77 database.

**Unemployment falls,
inflation remains moderate,
but fiscal deficits endure**

Since the OECD area as a whole is projected to operate slightly below potential in late 2006, the assumed closing of output gaps over the medium term implies growth in subsequent years which slightly exceeds estimated potential, at around 2¾ per cent. Area-wide unemployment falls gradually to an underlying structural rate of around 6% of the labour force and inflation remains stable at around 1¾ per cent. Fiscal balances for the area as a whole improve only marginally, reflecting continuing large structural deficits for the United States, Japan and the major European economies.

**Growth is robust in
the United States...**

Potential output for the United States is projected to grow at around 3¼ per cent over the medium term, with robust labour productivity growth offsetting the declining growth in the working-age population and the labour force. With output at or

Box I.6. Assumptions underlying the medium-term reference scenario

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

- Gaps between actual and potential output are eliminated by 2010 in all OECD countries.
- Unemployment returns to its estimated structural rate (the NAIRU) in all OECD countries by 2010.¹
- Most commodity prices and exchange rates remain broadly unchanged in real terms.
- Beyond the short term, world oil prices are assumed to decline from \$48 per barrel (Brent crude) at the end of 2006 to around \$42 per barrel by 2010.²
- Monetary policies are directed at keeping or bringing inflation in line with medium-term objectives.
- Fiscal policies are assumed to remain broadly unchanged (*i.e.* the cyclically-adjusted primary budget balance is held approximately unchanged from one year to the next),³ subject to Secretariat assessment of specific influences implicit in currently legislated tax and expenditure measures.

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. The concept and measurement of structural unemployment rates are discussed in more detail in Chapter V, “Revised OECD measures of structural unemployment”, *OECD Economic Outlook* No. 68, December 2000.
2. Consistent with the analysis in “Oil price developments: drivers, economic consequences and policies”, Chapter IV, *OECD Economic Outlook* No. 76, December 2004.
3. This implicitly assumes that the authorities take measures to offset underlying changes in primary structural balances.

close to potential throughout the period and oil prices falling steadily, inflation declines to around 1½ per cent in 2010 (see Box I.6). The general government deficit barely shrinks over the medium term and still amounts to 3½ per cent of GDP in 2010, translating into a continuing deterioration in public debt, with general gross government financial liabilities approaching 74% of GDP at the same horizon.

In the euro area, potential output growth, at 2% *per annum*, is much slower than in the United States, reflecting lower growth in both the working-age population and trend labour productivity. At the same time, the cyclical position in 2006 is much worse with a negative output gap of almost 2% of GDP, implying a larger contribution to growth from the closure of the gap, with GDP growth averaging 2½ per cent *per annum* over the period. Unemployment falls to a structural rate of slightly below 8% and inflation remains subdued at around 1½ per cent *per annum*. Over the period, the fiscal deficit for the euro area as a whole shrinks from around 2¾ per cent of GDP in 2006 to 1¾ per cent of GDP in 2010. For most euro area economies, reduced deficits reflect exclusively the cyclical contribution from the closing of the gap. Thus, on present policy settings, substantial structural deficits persist in France, Italy, Germany, Greece and Portugal and to a lesser extent Austria. With the exception of the United Kingdom, which also remains in significant deficit over the period, the fiscal positions of most of the other European Union (EU) countries move steadily towards balance or remain in surplus.

... but more modest in Europe, where fiscal deficits persist as well

Potential output growth in Japan is projected to weaken from 1% to around ¾ per cent, with a decline in labour force more than offsetting a rise in productivity growth. With Japan operating at about potential in 2006, GDP growth is projected to slow down over the medium-term horizon. Inflation is projected to return into positive territory, rising to close to 1% by 2010. In spite of some short-term improve-

Inflation moves back into positive territory in Japan

ment, the public deficit in Japan is projected to deteriorate slightly over the medium term, to around 5.6% of GDP in 2010 pushing the public sector debt ratio to around 180% of GDP. Indeed, the legislated annual increases in social security contributions that are taking effect throughout the projection period are offset by rising social spending on account of an ageing population.

Current accounts do not adjust

Given the recovery in GDP growth in the OECD area, world trade is projected to grow at around 9% *per annum*. This rate is slightly above the historical average of the 1990s, consistent with the assumption of sustained robust growth in China and Dynamic Asia. At broadly unchanged real exchange rates and in the absence of major cyclical fluctuations in individual countries, scant overall adjustment in the current external imbalances between regions is in the making. The euro area current account surplus remains around ½ per cent of GDP. The US current account deficit remains at around 6¾ per cent of GDP, owing to persistent public dissaving and little further adjustment in private sector saving and investment balances. Japan maintains a large surplus of around 4% of GDP.

Appendix I.2

Dollar hard landing scenarios: calibration and simulation

This appendix provides details and background information on the two illustrative dollar depreciation scenarios referred to in Box I.4 of the main text, one involving no cross-Atlantic financial contagion and the other based on the premise that higher long-term US interest rates do spill over onto the euro area. They are run using the OECD's Interlink model. For this purpose, the nominal effective exchange rate of the dollar is assumed to plunge by 30% against all OECD currencies, but to remain unchanged *vis-à-vis* the Chinese renminbi and other non-OECD currencies. Accordingly, the euro would appreciate by 7% in nominal effective terms, and the yen by 15%. In such a situation, interest rates as well as equity and house prices would be important transmission channels. Accordingly, the exchange rate shock is assumed to be accompanied by a significant adverse shock to US domestic demand, which considerably contributes to speeding up the adjustment of the US current account.

The OECD's medium-term baseline scenario, which runs to 2010, is used as a reference point in the simulations (see Appendix I.1). The magnitude of the posited exchange rate shock is large, though not unprecedented. Its uniformity *vis-à-vis* all other OECD currencies may be deemed unrealistic, since the Canadian dollar or the British pound for example might be expected, under the circumstances, to depreciate against the euro (exacerbating the predicament faced by euro area policymakers). It should be borne in mind, however, that this is merely a technical assumption, as is the unchanged parity with the non-OECD Asian currencies. Indeed, the simulations are a *ceteris paribus* thought experiment, intended to trace out certain important effects, rather than an attempt to flesh out probable future developments. The same obviously holds for the assumed central bank interest rate moves, which may not accord with Taylor rule or other classical reaction functions, and should not be construed as best guesses of what their decisions would most likely be.

Asset price responses

US short-term interest rates are assumed to rise initially by 150 basis points to contain the impact of exchange rate depreciation on inflation but to return to baseline soon, as inflation abates and activity falls below potential. Assuming that, once the shock has hit, financial markets perfectly anticipate future policy rates, term-structure considerations suggest that US long-term interest rates rise by less than short-term rates in the first year and then decline, albeit at a slower pace than policy rates (Table I.8).

The future path of US policy rates is only one factor impacting long-term interest rates. Two other relevant forces are a general, cross-border increase in uncertainty, pushing up risk premia globally. At the same time, some portfolio rebalancing may be set in motion, away from US-dollar denominated assets, leading to an extra risk premium on the latter. The sharp exchange rate change is therefore assumed to be accompanied by a sizeable, 200 basis points jump in the risk premium on US dollar-denominated assets.

As it becomes clear that the dollar has stabilised, such a premium would presumably fade. In the event, US long-term interest rates are assumed to revert to base-

Table I.8. Asset price assumptions

Units are percentage points, shock minus control

	2005	2006	2007	2008	2009	2010
United States						
Short-term interest rate	1.5	1.1	0.7	0.3	0.0	0.0
Term-structure effect ¹	0.4	0.2	0.1	0.0	0.0	0.0
Risk premium	2.0	2.0	2.0	1.5	0.5	0.0
Long-term interest rate	2.4	2.2	2.1	1.5	0.5	0.0
Equity prices ²	-10.0	-9.0	-7.0	-5.5	-3.5	-2.0
House prices	-10.0	-9.0	-7.0	-5.5	-3.5	-2.0
Euro area						
Short-term interest rate	-1.7	-1.7	-1.7	-1.5	-1.0	-0.5
Term-structure effect ¹	-0.8	-0.6	-0.5	-0.3	-0.2	0.0
Without contagion						
Long-term interest rate	-0.8	-0.6	-0.5	-0.3	-0.2	0.0
Equity prices ³	0.0	0.0	0.0	0.0	0.0	0.0
House prices	0.0	0.0	0.0	0.0	0.0	0.0
With contagion						
Long-term interest rate	1.2	1.1	1.0	0.8	0.3	0.0
Equity prices	-5.0	-4.5	-3.5	-3.0	-2.0	-1.0
House prices	-5.0	-4.5	-3.5	-3.0	-2.0	-1.0

1. Consistent with the geometric average of the path of short rates over a ten-year horizon.

2. Using the dividend discount model and assuming dividends are cut from \$5 to \$3 until 2011.

3. Assumes that interest rate effect is offset by a cut in dividends as the economy weakens.

Source: OECD calculations.

line by 2010. Not taken into account here is the possibility that the endogenous deterioration of the fiscal position could push up long-term interest rates further²⁹.

Two important caveats apply, however. First, in light of its mandate and of the short-lived nature of the inflation spike (see the simulation results below), the Federal Reserve might not react by raising its policy rate as sharply as posited here, in particular if the inflation response to exchange rate depreciation were judged to be more limited than captured in the model based on past experience.³⁰ Second, the risk premium on US dollar-denominated assets could be significantly smaller should market participants consider that risk is actually reduced once the dollar slide has occurred.

Based on term-structure arguments, and in the absence of contagion, euro-area long-term interest rates would fall over the simulation horizon. In the scenario involving contagion from US to euro-area long rates, it is assumed that the latter follow the former to a large extent. It is further assumed that financial markets in Japan

29. On some estimates, a 1 percentage point of GDP increase in the expected fiscal deficit could raise long rates by 20 to 40 basis points (Laubach, T., "New evidence on interest rate effects of budget deficits and debt", Federal Reserve, *Finance and Economics Discussion Series*, No. 2003-12, 2003).

30. The pass-through to US inflation may be lower than apparent in the simulation. There is some evidence that the pass-through has declined over time (see for instance Marazzi, M., N. Sheets, R. Vigfusson *et al.*, "Exchange rate pass-through to U.S. import prices: some new evidence", Federal Reserve, *International Finance Discussion Papers*, No. 833, 2005).

remain disconnected, as they have been for some time, although the economy is affected via the trade and valuation channels (see below).

The jump in long-term interest rates, which causes bond prices to plummet, would negatively affect the value of other assets. For the present simulations, the dividend discount model was used to calculate a path for the implied change in equity prices, assuming, for the United States, an initial dividend yield of 5%, a potential real growth rate of 3% and a real long-term interest rate of 4%. The implied equity price fall reflects the interest rate rise plus an assumed cut in the dividend yield to 3%, as firms try to restore the health of their balance sheets.³¹ The dividend yield is not restored until after 2010, at which time equity prices are back to baseline. For the euro area, it is assumed that in the absence of contagion, the effect on equity prices of lower interest rates is offset by dividend cuts as the economy weakens, whereas with contagion, equity prices would decline by about half as much as in the United States.

The rise in US interest rates would also hit house prices, which are assumed to decline on impact by 10% in the United States, in nominal terms.³² In the euro area, they are assumed to remain unchanged in the absence of contagion and to fall by half as much as in the United States in the case of contagion.³³

Finally, the exchange rate shock entails capital gains and losses on net foreign asset positions, a channel that has gained importance with the rapid rise in gross cross-holdings of assets and liabilities. These effects improve the US net foreign debt position, since the value of US residents' assets denominated in foreign currency exceeds that of their foreign-currency denominated liabilities. In the case of the euro area and Japan, the opposite holds.³⁴

Detailed results

On this basis, the first scenario, without financial contagion, has the following features, in terms of deviations from baseline (Table I.9 and Figure I.15):

- US activity initially falls by about 1¼ per cent, reopening the output gap, as the stimulus to exports from currency depreciation is more than offset by a sizeable contraction in domestic demand. Inflation initially spikes up by over 2%, but the output gap combined with monetary tightening bring it back towards its desired path fairly swiftly. As policy rates revert and asset prices recover, the output gap is gradually unwound. The current account improves by almost 3 percentage points of GDP already by the second year.³⁵ This is

31. Quite possibly, the initial drop in equity prices might be larger under such circumstances, as the equity risk premium would probably shoot up.

32. Historically, nominal US-wide average house prices – as measured by the index published by the Office of Federal Housing Enterprise Oversight – never declined significantly since 1975, although they were almost flat in 1989-91, at a time when the consumer price index was rising far more rapidly than now, implying a decline in real terms by some 7% in the two years to the third quarter of 1991. Earlier, between the beginning of 1979 and the end of 1982, real house prices fell by 14%. The 10% decline in nominal house prices posited in the simulations here translates into a decline in real house prices similar to the one recorded 15 years ago.

33. Some euro area countries – most prominently Germany, but also France (in the early 1990s) – have experienced significant declines in nominal and real house prices in the past.

34. For some broad-brush empirical estimates, see Blanchard, O., F. Giavazzi and F. Sa, “The US current account and the dollar”, *NBER Working Papers*, No. 11137, 2005 and Gourinchas, P.-O. and H. Rey, “International financial adjustment”, *NBER Working Papers*, No. 11155, 2005.

35. This is broadly in line with the typical result in the literature that a 10% depreciation improves the current account by 1% of GDP. See, for example, Obstfeld, M. and K. Rogoff, “The unsustainable US current account position revisited”, *NBER Working Papers*, No. 10869, 2004 and Blanchard *et al.*, *op. cit.*

Table I.9. Simulation results

Deviation from baseline levels

	<i>No contagion</i>				<i>Contagion</i>			
	2005	2006	2007	2010	2005	2006	2007	2010
United States								
Real GDP (%)	-1.2	-1.0	-1.0	-0.2	-1.3	-1.0	-1.0	-0.3
Output gap (pp)	-1.2	-0.9	-0.9	0.0	-1.3	-1.0	-1.0	0.0
Unemployment rate (pp)	0.6	0.8	0.8	0.1	0.6	0.7	0.8	0.1
Inflation (pp)	2.2	0.5	0.2	0.1	2.2	0.4	0.2	0.1
Current account (% of GDP)	0.7	2.9	2.9	2.8	0.7	2.8	2.8	2.8
Nominal effective exchange rate (%)	-30	-30	-30	-30	-30	-30	-30	-30
Euro area								
Real GDP (%)	-1.0	-1.5	-1.2	0.0	-1.3	-2.0	-1.6	-0.2
Output gap (pp)	-1.0	-1.5	-1.2	-0.1	-1.3	-1.9	-1.6	-0.4
Unemployment rate (pp)	0.2	0.5	0.5	0.2	0.3	0.7	0.7	0.2
Inflation (pp)	-0.3	-0.7	-0.6	-0.1	-0.3	-0.8	-0.8	-0.4
Current account (% of GDP)	-1.3	-2.1	-2.5	-2.4	-1.2	-2.0	-2.3	-2.2
Nominal effective exchange rate (%)	7	7	7	7	7	7	7	7
Japan								
Real GDP (%)	-1.4	-1.5	-1.4	-0.5	-1.4	-1.6	-1.4	-0.6
Output gap (pp)	-1.3	-1.5	-1.3	-0.5	-1.3	-1.5	-1.3	-0.5
Unemployment rate (pp)	0.1	0.2	0.2	0.1	0.1	0.2	0.2	0.1
Inflation (pp)	-0.1	-1.6	-0.8	-0.4	-0.1	-1.7	-0.8	-0.4
Current account (% of GDP)	-0.7	-1.9	-2.0	-2.5	-0.8	-1.9	-2.0	-2.7
Nominal effective exchange rate (%)	15	15	15	15	15	15	15	15

Source: OECD calculations.

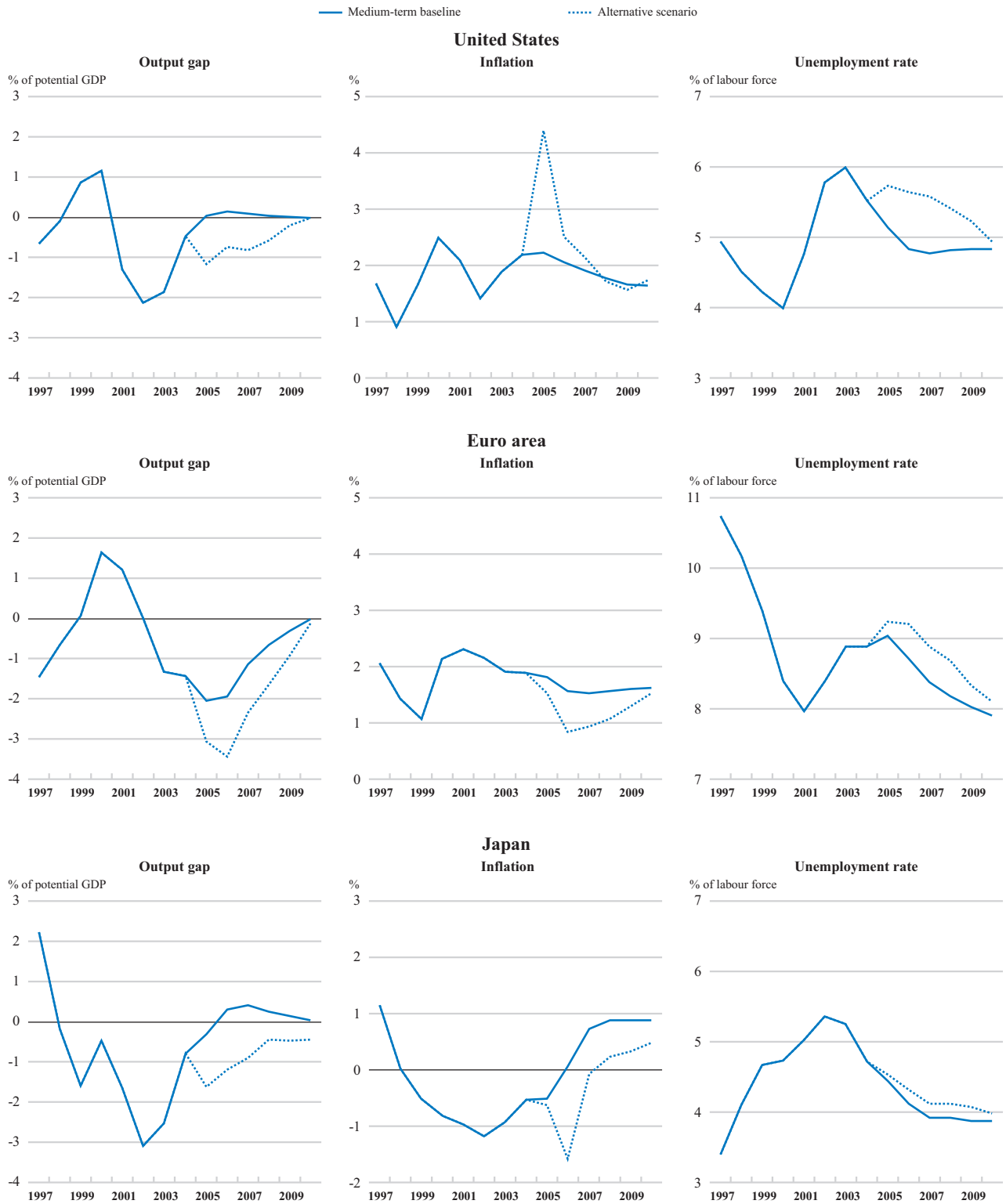
much more than in simulations focusing on an exchange rate shock in isolation,³⁶ owing to the sizeable concomitant demand shock built in here, which by itself underpins about half of the overall current account correction.

- The effect of the shock on the other economies depends on their exposure to the fall in US demand and on the room available to the domestic authorities to take offsetting action. In the euro area, already low policy interest rates limit the Euro-system's ability to buffer the shock, and the output loss is larger than in the United States, with a gap worsening by 1½ percentage points in the second year. Inflation declines in the face of the output gap and of an unemployment rate rising by ½ percentage point. Japan is more exposed to the US economy and with policy rates stuck at zero, short-term real interest rates rise markedly whilst growth slows substantially, the exit from deflation being further delayed.

In the case of contagion, activity in the euro area suffers an even larger hit, with the output gap widening by up to 2 percentage points, accompanied by a ¾ percentage point increase in the unemployment rate. Developments in the United States and Japan are essentially the same as in the first scenario, given that feedback effects from the euro area and the rest of the world associated with contagion are of second-order magnitude.

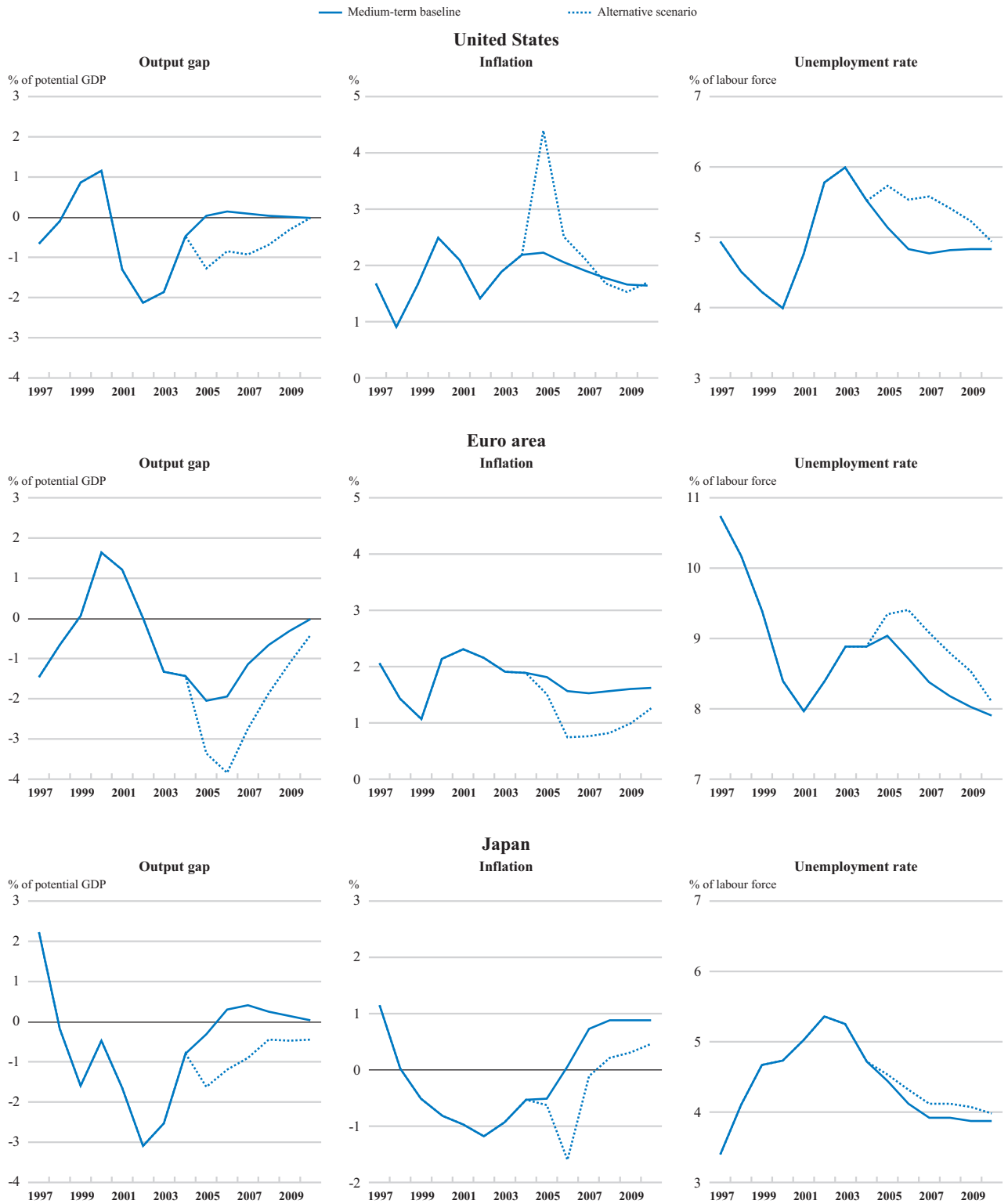
36. See Brook, A.-M., F. Sédillot and P. Ollivaud, "Channels for narrowing the US current account deficit and implications for other economies", *OECD Economics Department Working Papers*, No. 390, 2004.

Figure I.15. **Output, inflation and unemployment effects**
Scenario without contagion



Source: OECD calculations.

Figure I.15. **Output, inflation and unemployment effects (cont.)**
Scenario with contagion



Source: OECD calculations.

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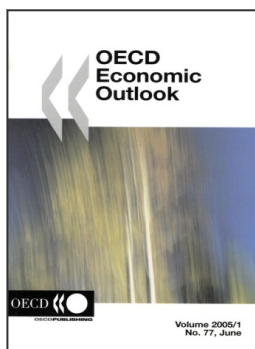
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Conventional signs

\$	US dollar	.	Decimal point
¥	Japanese yen	I, II	Calendar half-years
£	Pound sterling	Q1, Q4	Calendar quarters
€	Euro	Billion	Thousand million
mbd	Million barrels per day	Trillion	Thousand billion
..	Data not available	s.a.a.r.	Seasonally adjusted at annual rates
0	Nil or negligible	n.s.a.	Not seasonally adjusted
–	Irrelevant		



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