EDITORIAL
LESS ROBUST THAN MEETS THE EYE?

World growth has been broadening over the past few months. Already strong in North America and most of Asia, economic momentum now looks well established in Japan, and continental Europe is progressively recovering from its latest bout of weakness. The fledgling European expansion has been facilitated by low long-term interest rates, euro depreciation and buoyant export markets, although final domestic demand is still growing below trend.

All in all, global growth has been exceptionally vigorous, fuelling large price increases in oil and commodities markets. These higher prices have acted as an impediment to recovery in those European economies which did not fully participate in the global expansion but as a moderating influence where aggregate demand was already buoyant. In a dynamic but turbulent environment, economic performance has been highly correlated with resilience. This connection was vividly illustrated in the United States, where the economy sailed through devastating hurricanes and disruptions in energy supplies.

One important and reassuring feature of the present situation is that virtually all countries have maintained price stability in the face of the oil price shock, without compromising activity. Higher oil prices have not spilled over into higher wage demands and long-term inflation expectations seem well anchored. As a result, although headline inflation has surged, contagion to non-oil prices has remained minimal.

The absence of second-round effects is epitomised by the behaviour of core inflation – excluding food and energy. In the United States, despite the recent spike in gasoline prices, core inflation has remained stable at around 2%, in a context where there is little slack left in the economy. In contrast, in the euro area core inflation has been trending down over the past four years towards fairly low levels, against the backdrop of persistent slack. As a consequence, headline inflation has only moderately overshot the ECB's long-term objective. In Japan, where the challenges are quite different, core inflation may reach into positive territory as the recovery broadens to household demand.

Looking further ahead and assuming oil prices do not shoot up again, inflationary pressures should progressively recede. Indeed, core inflation is expected to drift only modestly upward in the United States, as activity expands beyond capacity, and to remain low in the euro area, where persistent economic slack would keep bearing down on prices.

With price stability being maintained, a powerful impetus arising from the Asian and US economies and the respending of oil exporters' higher revenues, the case for a prolonged world expansion, finally extending to convalescent European economies, looks plausible. This is indeed the baseline presented in this *Economic Outlook*. But the risks surrounding such a forecast are substantial. They include a renewed surge in oil prices, ever-worsening current account imbalances and abrupt exchange rate realignments, as well as long-term interest rate back-ups and asset price reversals.

Because they involve financial variables and asset prices, which often behave erratically in the short run, the potential impact and timing of these risks is hard to pin down. As a result, they only feature in forecasting exercises in the form of risk assessments surrounding a central scenario. If they materialise, their consequences for growth and inflation may depend a lot on economies' resilience.

It is worrying in this context that current account imbalances seem set to widen substantially over the next two years, with the US external deficit exceeding 7% of GDP in 2007 while China and Japan move into extremely large surpluses. These imbalances largely reflect inadequate macroeconomic policies, notably large fiscal deficits and tax incentives biased against savings in the United States and "mercantilist" exchange rate management geared towards market-share maximisation in several emerging Asian economies. As stressed in previous *Economic Outlooks*, such a policy configuration contributes to increasing the probability of a disorderly unwinding of current account imbalances, coupled with an evaporating appetite for dollar-denominated assets.

The economic consequences of such a shift in market preferences seem clear: long-term interest rate back-up and falling asset prices, including house prices, in the United States; steep currency appreciation and strong deflationary risks in those areas outside the United States (Japan, euro area) where core inflation is already low and sometimes falling; and, finally, weakening world growth. Given the relentless drift in imbalances, adjusting policies becomes increasingly pressing. It would help ensure world growth is sustainable and does not overly rely on borrowed momentum.

The risks surrounding energy prices are less easy to gauge. On the one hand, oil prices could still be on an upward medium-term path, but on the other hand they may well have overshot in the short run. On a less speculative note, it seems likely that the full impact of higher oil prices on activity and inflation may take time to materialise. It cannot be excluded for instance that following an extended period of real income losses, wages finally accelerate. As well, the negative consequences for investment of higher and more volatile oil prices may set in only gradually.

Worsening fiscal and current account imbalances present policymakers with clear challenges. Addressing them successfully will require substantial policy adjustments.

In the United States, where aggregate demand is buoyant, there is a clear need for early fiscal retrenchment and tax reform to redress the saving/investment balance in conjunction with the current tightening of monetary policy. In Japan, mounting public spending pressures associated with ageing call for faster fiscal tightening, while monetary policy should keep a very easy stance until the output gap moves squarely into positive territory and deflation is definitively uprooted.

In the euro area, where underlying inflation has been steadily declining and economic slack remains entrenched, monetary tightening should wait until the recovery gathers enough momentum and becomes more resilient, which may take a few more quarters. At the same time, euro area governments should take advantage of buoyant foreign demand and accommodative monetary conditions to push ahead with economic reforms and start restructuring public finances in earnest, at a pace commensurate with the returning momentum of the recovery. Achieving fiscal consolidation, while preserving the recovery, means in particular giving priority to spending cuts over tax increases so that deficit reduction is both growth-friendly and long-lasting.

Looking to the future, enjoying strong and sustained world growth should not be taken for granted. Efforts are needed to nurture this “global public good” through a more open trading system and continued economic reforms. In this respect, a successful completion of the Doha Round and further progress in agricultural reforms would greatly contribute to making world growth more sustainable.

25 November 2005

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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
mb/d	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		

Summary of projections

	2005	2006	2007	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	Fourth quarter 2005	Fourth quarter 2006	Fourth quarter 2007
						Per cent							
Real GDP growth													
United States	3.6	3.5	3.3	3.7	3.3	3.5	3.5	3.3	3.2	3.2	3.7	3.4	3.1
Japan	2.4	2.0	2.0	1.7	1.9	2.1	1.9	2.0	2.0	2.1	3.2	2.0	2.1
Euro area	1.4	2.1	2.2	2.2	1.9	2.0	2.2	2.1	2.2	2.2	1.8	2.1	2.2
Total OECD	2.7	2.9	2.9	3.1	3.0	2.8	2.6	2.9	3.2	2.9	3.0	2.8	2.9
Inflation													
United States	2.7	2.5	2.3	2.9	2.2	2.3	2.3	2.3	2.6	2.2	2.9	2.3	2.2
Japan	-1.1	-0.1	0.6	-0.2	0.0	0.1	0.3	0.5	0.6	0.7	-1.3	0.2	0.8
Euro area	1.8	1.7	1.9	1.9	1.5	1.5	1.5	1.8	2.0	2.1	1.9	1.6	2.0
Total OECD	2.1	1.9	1.9	1.5	1.4	2.1	2.4	2.0	1.7	1.8	1.9	2.0	1.9
Unemployment rate													
United States	5.1	4.8	4.7	5.0	4.9	4.9	4.8	4.8	4.7	4.7	5.0	4.8	4.7
Japan	4.4	3.9	3.5	4.3	4.1	4.0	3.9	3.8	3.7	3.5	4.3	3.8	3.3
Euro area	8.7	8.4	8.1	8.6	8.5	8.5	8.4	8.4	8.3	8.2	8.6	8.4	8.0
Total OECD	6.5	6.3	6.0	6.4	6.3	6.3	6.2	6.2	6.1	6.1	6.4	6.2	5.9
World trade growth	7.3	9.1	9.2	9.3	8.8	8.8	8.9	9.1	9.3	9.4	8.1	8.9	9.3
Current account balance													
United States	-6.5	-6.7	-7.0										
Japan	3.4	3.9	4.7										
Euro area	-0.2	-0.2	-0.1										
Total OECD	-1.8	-2.0	-2.0										
Cyclically-adjusted fiscal balance													
United States	-3.6	-4.2	-3.9										
Japan	-6.3	-6.1	-6.4										
Euro area	-2.2	-2.1	-2.0										
Total OECD	-3.1	-3.3	-3.2										
Short-term interest rate													
United States	3.5	4.8	4.9	4.2	4.6	4.9	4.9	4.9	4.9	4.9	4.2	4.9	4.9
Japan	0.0	0.0	0.7	0.0	0.0	0.0	0.0	0.0	0.3	0.6	0.0	0.0	1.0
Euro area	2.2	2.2	2.9	2.2	2.2	2.2	2.2	2.3	2.6	2.8	2.2	2.3	3.3

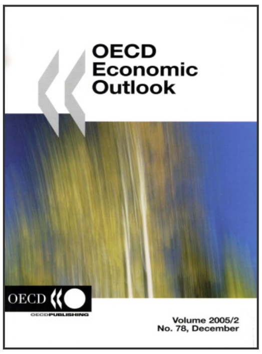
Note: Real GDP growth, inflation (measured by the increase in the GDP deflator) and world trade growth (the arithmetic average of world merchandise import and export volumes) are seasonally and working-day-adjusted annual rates. The "fourth quarter" columns are expressed in year-on-year growth rates where appropriate and in levels otherwise. The unemployment rate is in per cent of the labour force while the current account balance is in per cent of GDP. The cyclically-adjusted fiscal balance is in per cent of potential GDP. Interest rates are for the United States: 3-month eurodollar deposit; Japan: 3-month certificate of deposits; euro area: 3-month interbank rate.

Assumptions underlying the projections include:

- no change in actual and announced fiscal policies;
- unchanged exchange rates as from 11 November 2005; in particular 1$ = 118.00 yen and 0.85 euros;

The cut-off date for other information used in the compilation of the projections is 22 November 2005.

Source: OECD Economic Outlook 78 database.



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