I. GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

Overview: a slow recovery

Economic activity is hesitant…

The upturn is hesitant and drawn-out, with confidence fragile. The short-term weakness foreseen in the previous *OECD Economic Outlook* is proving to be unexpectedly protracted, against the background of sharp swings in the oil price, sizeable exchange rate shifts and continuing equity price erosion. Forward-looking indicators suggest a deferral of the area-wide upturn until later in 2003. This year, OECD GDP growth is thus likely to only marginally exceed the 1¾ per cent recorded in 2002 (Table I.1). At the same time, regional growth disparities are rising, with the output gap set to widen less markedly in the United States than in the euro area.

… but should revive later in 2003, subject to negative risks

Sluggish growth in the near term is partly related to the geopolitical uncertainties created by the Iraq crisis. The rapid resolution to the conflict, and the more settled geopolitical climate that is assumed to follow, should allow investor and consumer confidence to strengthen gradually, with positive effects on demand. The headwinds which were holding back the recovery at the time of the previous *Outlook* have abated somewhat, as interest rates have declined and the capital overhang has been reduced. Monetary policies and fiscal easing in several countries, notably the United States, continue to support demand, in a context of declining core inflation. If, as assumed, oil prices remain around $25 per barrel, OECD growth should revert to around 3 per cent – exceeding its potential rate – in 2004. There remains, however, a degree of uncertainty regarding the underlying cyclical momentum of the OECD-area economy, relating to persistent imbalances and, in some economies, insufficient structural reform. But while the risks are mainly negative they are not exclusively on the downside.

Table I.1. **Output growth**

Percentage changes in GDP

	2001	2002	2003	2004
United States	0.3	2.4	2.5	4.0
Japan	0.4	0.3	1.0	1.1
Euro area	1.5	0.9	1.0	2.4
European Union	1.6	1.0	1.2	2.4
Total OECD	0.8	1.8	1.9	3.0

Source: OECD.

Nature of the cycle and geopolitical risks

Major forces acting

The business cycle has some unusual features…

Two unusual sets of short-term influences are at play in the current conjuncture. The first relates to the nature of the cyclical downturn, which started in all the major OECD regions during 2001. The slowdown was not, as on many occasions in the past, generated by monetary tightening in response to increasing inflationary pressure and/or growing international imbalances. Rather, it was characterised by a classical over-investment cycle. Corporate balance sheet and excess capacity problems have been more severe than in earlier recessions and have taken longer to be worked off. However, because inflation pressures were generally subdued, central banks have been able to respond vigorously. The second set of influences arises from the pervasive geopolitical uncertainty deriving from the Iraq crisis, together with ongoing security risks in other regions and those related to global terrorism. Besides the effect on energy prices, this has hurt already fragile corporate and consumer confidence. Both sets of influences were combined with an unusually severe bear market in equities, following the bursting of the stock market bubble.

… which impair conjunctural visibility

Viewed in this double perspective, the strength of the upturn is determined by: *i)* how geopolitical tensions and oil prices will evolve; *ii)* responses to the policies in place; and *iii)* most importantly, the extent to which the imbalances built up during the boom have unwound and corporate sector headwinds abated.

Impact of geopolitical tensions

Oil prices have gyrated…

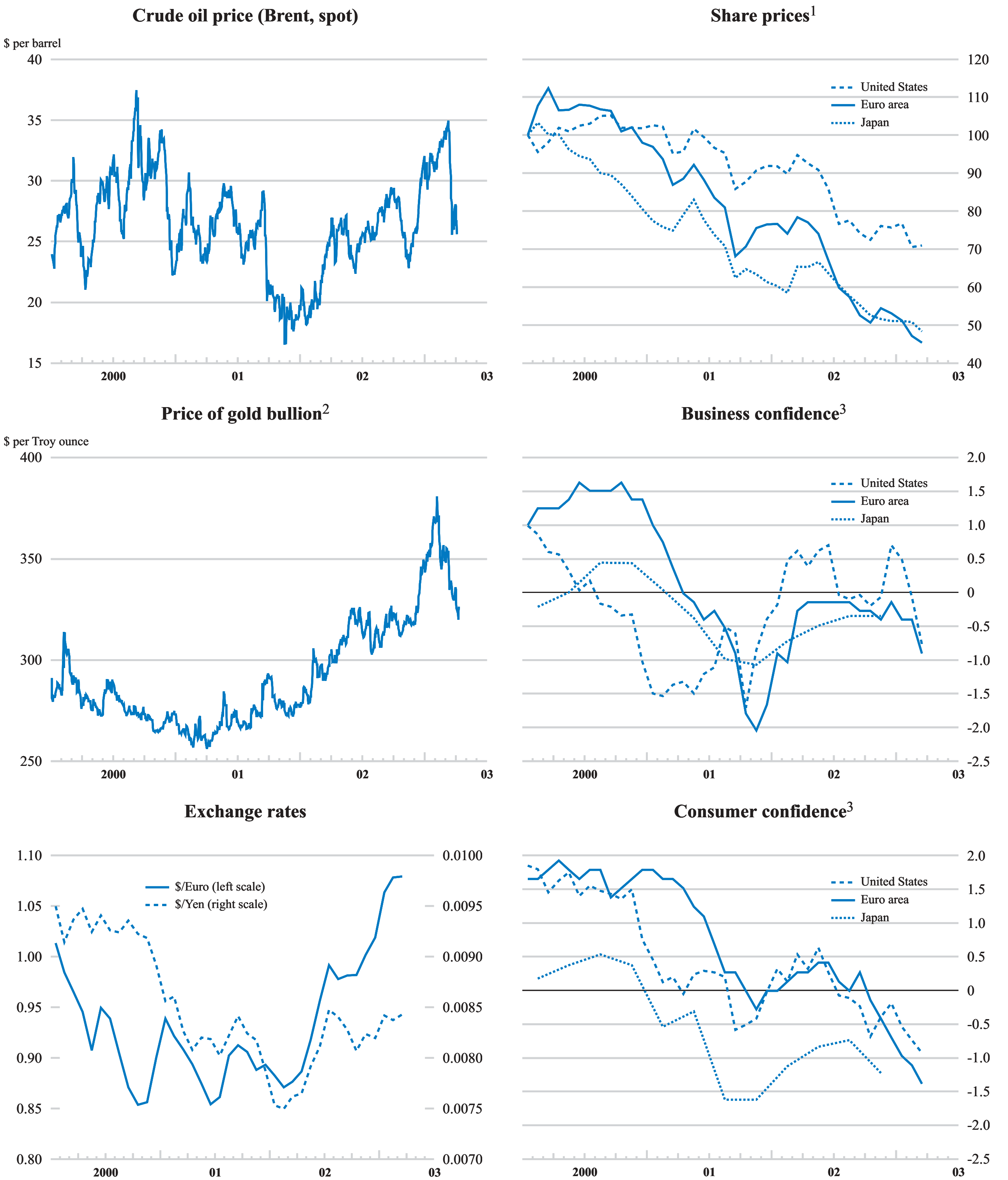
Perhaps the most direct global economic manifestation of the geopolitical tensions has been the volatility of oil prices. Higher oil prices played a key role in ending the already mature expansion in 1990-91, but came this time early in the recovery stage and whilst inflation trends were generally benign, so the parallels are limited. Over the year to mid-March, spot oil prices rose from $20 to $35 per barrel for Brent crude.[1] Apart from a substantial and rising war-premium, this increase also reflected the supply shortfalls caused by strikes in Venezuela and Nigeria, the demand boost from unusually cold weather in North America and Japan, and unusually low OECD crude oil stocks. In the early stages of the war, oil prices plummeted, and by early April 2003 they were hovering around $25 per barrel, with futures quotes showing market expectations they would stay at this level – the mid-point of the range targeted by OPEC – over the coming year.

… and geopolitical risks have weighed on consumer and business confidence

The crisis over Iraq has affected the global economy in other, more diffuse ways than fluctuations in oil prices (Figure I.1). In particular, equity markets have remained turbulent, as the pricing of risk has become very difficult. Investors have been searching for safe havens, causing shifts in relative prices between equities on the one hand and gold and government bonds on the other.[2] Household confidence has fallen to levels approaching those observed during the Gulf crisis in the early 1990s; and while business confidence has held more steady, it has more recently tended to follow suit. The link between swings in confidence (especially

1. In real terms, this increase is only half as large as the surge that followed Iraq's invasion of Kuwait in 1990.
2. For an analysis of behaviour across markets, see Leigh, A., J. Wolfers and E. Zitzewitz, "What do financial markets think of war in Iraq?", *NBER Working Papers*, No. 9587, 2003; and Rigobon, R. and B. Sack, "The effects of war risk on US financial markets", *NBER Working Papers*, No. 9609, 2003.

Figure I.1. Tensions and uncertainties in the global economy, spring 2003



1. January 2000 = 100.
2. Daily prices.
3. All series have been normalised at the average for the period for which data are available and are presented in units of standard deviation.

Source: OECD, *Main Economic Indicators*, Datastream and the US Energy Information Administration.

business sentiment) and fluctuations in activity becomes less predictable when changes in confidence are driven by political rather than economic factors, as has recently been the case. Estimates of the direct costs of war, as incorporated in the OECD projections, are spelled out in Box I.2 below.

Consumption responses to the policies in place

Consumption has held up in a number of countries…

The downturn has prompted substantial demand-supportive policy responses (described below), the most powerful effects of which can be seen in relatively strong personal consumption in a number of countries. Tax cuts and/or low interest rates have boosted household spending in the United States, the United Kingdom, Australia and Spain, partly via buoyant residential property markets (both directly in housing construction and indirectly through property-wealth effects). Interest rate effects have also been conspicuous in the US motor vehicle sector. These positive influences have been vying with the negative effect of volatile and fragile household confidence and financial wealth losses.[3] In the euro area at large – but especially reflecting developments in Germany and Italy – policy measures have not sufficed to sustain household spending growth. In Japan, consumption, though by no means strong, has been a steadying factor in aggregate demand growth.

… financed by rising household debt

These rather disparate outcomes are reflections of differences in the balance sheet behaviour of households. Household spending has been sustained, in some countries, by taking on debt, which now exceeds 100 per cent of disposable income in the United States and 120 per cent in the United Kingdom. Mortgage equity withdrawal, in particular, has played a substantial role. Debt increases have had a counterpart in rising house prices and household net wealth has been cushioned, to some extent, from equity price falls. Moreover, debt service flows have been contained by lower interest rates and households have used refinancing opportunities to pay down expensive consumer credit.[4] In continental Europe, steep equity price falls have to be seen in the context of much narrower household share ownership, while refinancing of mortgages is more difficult and property markets have been less buoyant. As a consequence, house prices and low interest rates have a smaller impact on consumption, even though housing forms a relatively large part of household wealth. In Japan, the protracted weakness in equity and property prices is cushioned, at least in a statistical sense, by rising real household wealth held as government debt, despite concerns about future pensions and taxes.

Financial headwinds and the investment cycle

Financial stress has eased

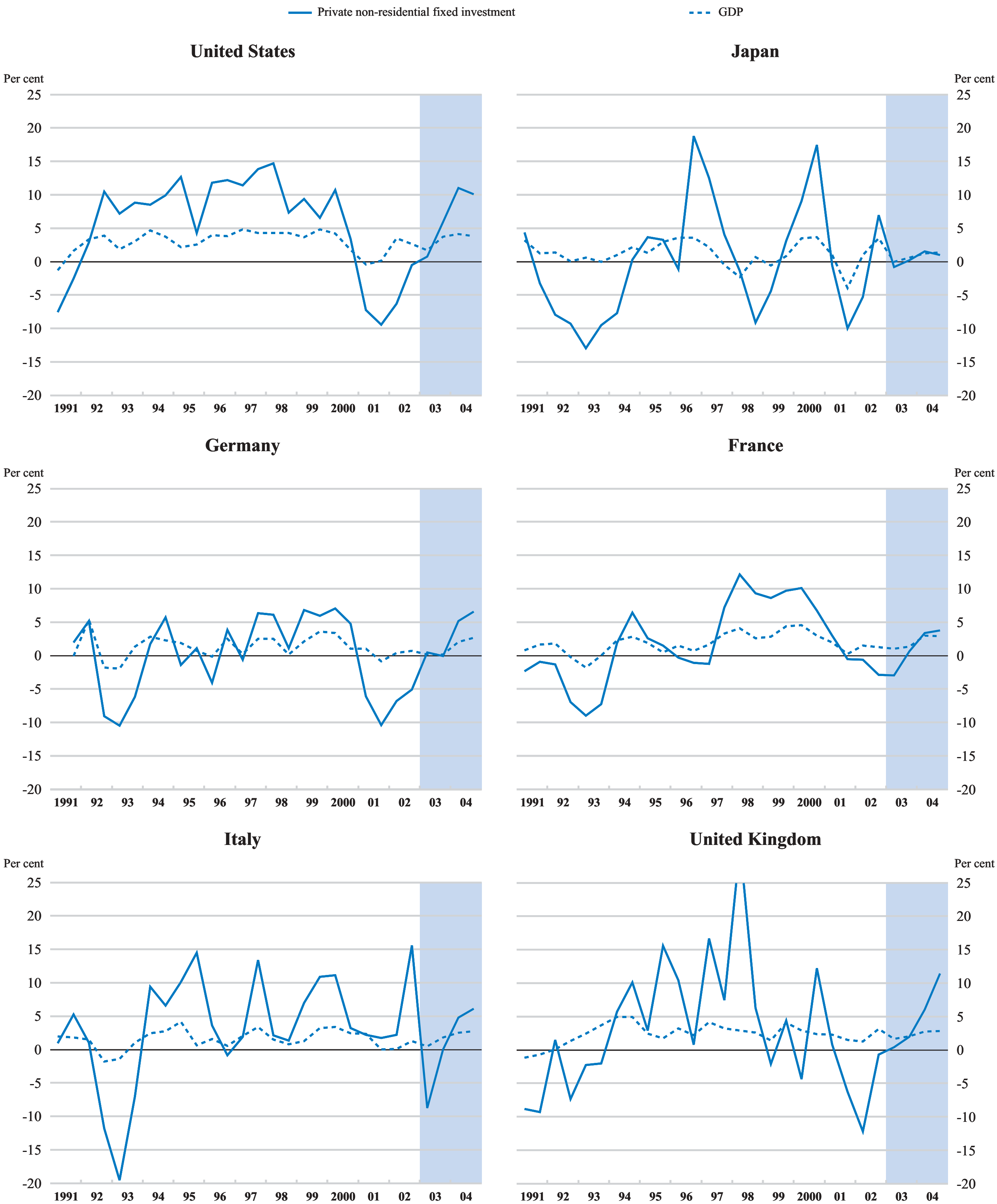
Financial headwinds have abated, though equities remain volatile

The financial headwinds noted in the previous *Outlook* have abated, albeit not completely. Long-term interest rates have remained low and spreads on corporate bonds have narrowed substantially, although this is due in part to the drying up of high-risk credit demand and/or lenders becoming more selective. The number of profit downgrades has fallen to more normal levels. Stock markets are still unsettled, however, even though price-earnings ratios have come closer to their historical

3. In the United States, the residual drag on household consumption from past equity falls was recently estimated by Federal Reserve staff to amount to 1 percentage point in 2003 and ½ percentage point in 2004, under the benign assumption that equity prices would move in line with income this year and next.
4. See Aizcorbe, A., A. Kennickell and K. Moore, "Recent changes in US family finances: evidence from the 1998 and 2001 Survey of Consumer Finances", *Federal Reserve Bulletin*, January 2003.

Figure I.2. **Variability of output and investment growth**

Percentage change from previous period, annual rate



Source: OECD.

averages. Equity price declines have been particularly pronounced in Europe and Japan. In Europe, this may reflect the fact that profit margins have been squeezed by rising unit labour costs, while in Japan corporate and financial restructuring still has a long way to go. Moreover, some sectors of the financial markets (life insurers in the United Kingdom, banks in Germany) are still suffering balance sheet strains, with repercussions on their own equity market value and on share prices generally via a lower institutional demand for shares. These explanations apart, shares still look more richly valued in the United States than elsewhere.

Credit conditions remain supportive

On the positive side, banks in the major countries, outside Japan and to a lesser extent Germany, entered the recent downturn in a healthy condition, with favourable capital and liquidity positions and low risk exposures. Most of the capital losses from the investment boom of the late 1990s ended up outside the banking system, both in the United States and Europe. More recently, some signs of stress have emerged due to the increased incidence of corporate defaults. However, there is no evidence of any generalised credit squeeze in OECD economies.[5] In Germany, bank lending is contracting in real terms, but this may be partly explained by the fact that real interest rates are relatively high compared with other euro area countries.

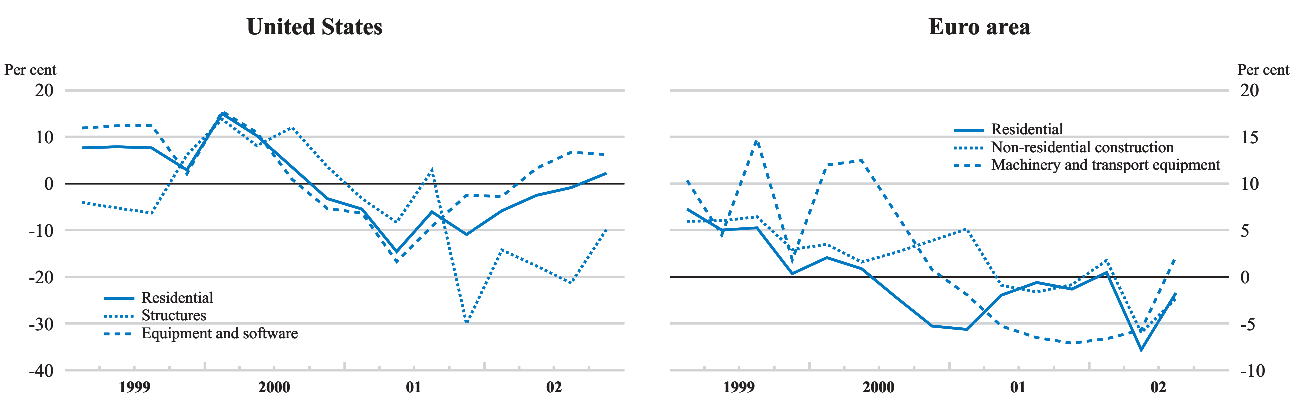
What is left of the capital overhang?

The slump in investment is deeper than in past downturns…

The economic boom of the late 1990s saw a substantial increase in business investment, mostly reflecting strong growth in machinery and equipment, notably in the information and communications technology sector (ICT). Fuelled by the stock market and the rapid decline in computer prices, investment attained unsustainable levels, in particular in the United States. The slowdown has, to a large extent, reflected a need to reduce the ensuing capital overhang. For the past two years, capital spending has fallen well short of long-term trend, especially, but by no means uniquely, in the United States, where business investment dropped sharply in 2001 and 2002. The cumulative decline for the OECD area was almost 6 per cent over these two years.

Figure I.3. **Private investment spending in the United States and the euro area**

Percentage change from previous period at annual rate



Source: OECD.

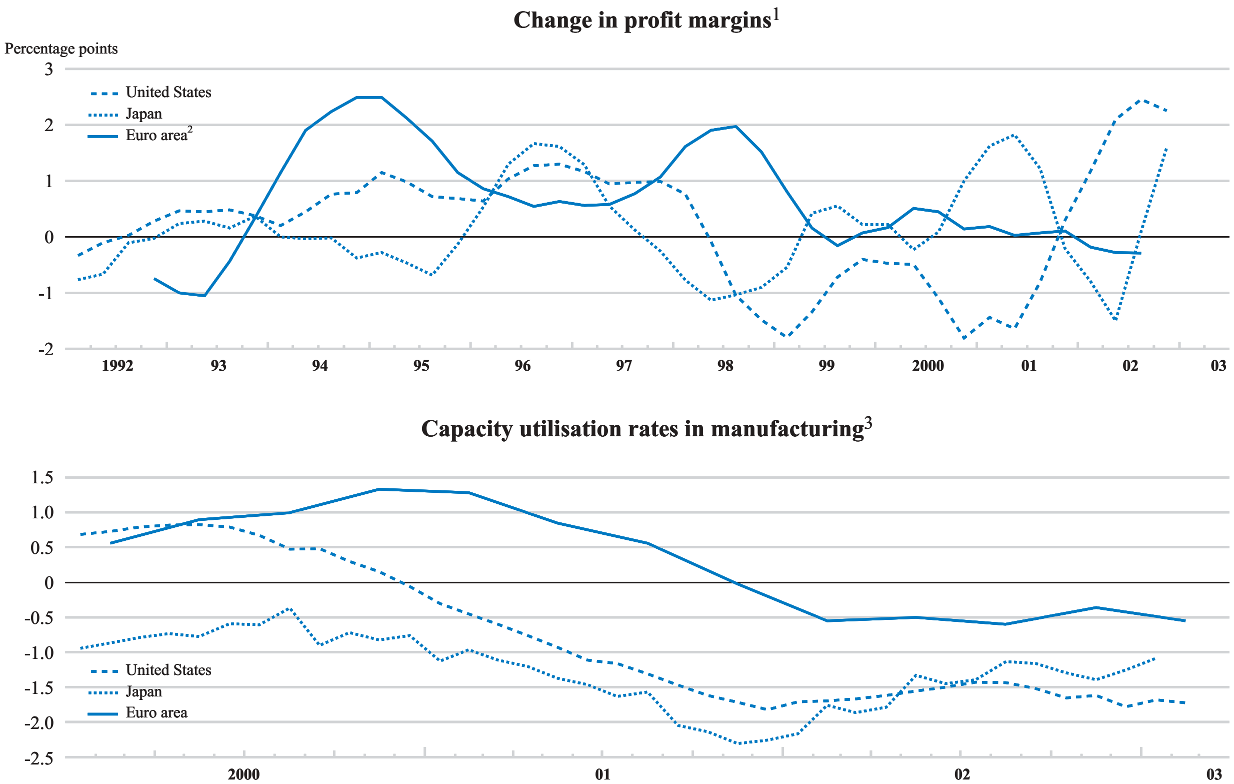
5. For supporting evidence in the US case, see Stiroh, K. and C. Metli, “Now and then: the evolution of loan quality for US banks”, Federal Reserve Bank of New York, *Current Issues in Economics and Finance*, Vol. 9, No. 4, 2003.

Business investment amounts to no more than a third of private consumption spending, but is normally the most volatile component of final demand, and has accounted for as much of recent variations in output as has household demand (Figure I.2).

… and the global capital overhang has been largely eliminated…

Following two years of retrenchment, the bulk of the excess capital stock has in all likelihood been worked off (Box I.1). Business fixed investment appears to have bottomed out in the United States, albeit with certain sectoral weaknesses (Figure I.3). Spending on high-tech investment (equipment and software) began to recover from the spring of 2002, though moderately so. However, investment in machinery and equipment continued to contract in 2002 in the euro area. In Japan, where corporate restructuring is proceeding, capital spending picked up during the second half of 2002, but this rebound is not expected to be sustained. Moreover, capacity utilisation rates in manufacturing remain below historical averages in all three major regions (though most significantly in the United States), suggesting that some excess capital still exists in sectors relying on more durable assets, such as structures (Figure I.4). Also holding back a decisive investment recovery are the relatively high levels of debt built up during the boom years, most conspicuously perhaps in the telecommunications sector.[6]

Figure I.4. **Profit margins and capacity utilisation rates**



1. Approximated by GDP deflator divided by unit labour costs in the business sector, year-on-year percentage changes, moving average on 4 quarters.
2. Whole economy.
3. All series have been normalised at the average for the period for which data are available and are presented in units of standard deviation.
Source: OECD, *Main Economic Indicators*; European Central Bank, Monthly Bulletin.

6. See Chapter IV, “After the telecommunications bubble”.

Box I.1. What is left of the capital overhang?

Non-residential fixed capital formation accelerated in the second half of the 1990s in a number of OECD countries – particularly the United States, the United Kingdom, Italy, Canada, Australia, Denmark, the Netherlands, Spain, and Sweden – durably outpacing GDP. Despite the trend decline in the relative price of investment, its share in nominal GDP also rose during that period. The subsequent global slowdown in activity saw investment spending drop sharply, especially in the United States.[1] At the same time, equity prices collapsed. This fuelled concerns that a "capital overhang" had been built up during the boom years, foreshadowing a spell of subdued investment growth long enough for the excess capital to be worked off.[2]

Several pieces of evidence seem to corroborate the view that by the turn of the millennium too much capital had been put in place too soon. A recent cross-country study based on a system of panel cointegration equations for gross business investment found that in a number of OECD countries investment rose more than could be explained by output growth, the cost of capital and financial market development.[3] Specifically, only one-third to one-half of the increase in business investment between 1995 and 1999 in the United States, the United Kingdom, Canada, Austria and Denmark could be attributed to these fundamentals. A significant portion of the increase also failed to be captured in these equations in the cases of Australia, the Netherlands and Sweden. Although Japan did not witness any investment surge during the 1990s, the study also showed over-investment in this case.[4] At a slightly more disaggregated level, unsustainably rapid investment growth in some sectors supported the notion of an overhang. Globally, this has been a widespread perception as regards ICT, in part but not solely related to the frontloading of Y2K-related outlays. In the United States, such over-accumulation has been documented, albeit on a limited scale, concerning computer and communications equipment but also trucks.[5] Further evidence of an overhang includes very low capacity utilisation rates in US manufacturing, which remain far below their levels of the early 1990s recession.[6]

However, it is unlikely that at the economy-wide level there now remains significant excess capital in North America or in Europe. Indeed, the overhang symptoms listed above are subject to some caveats. *First*, in several countries, rapid investment growth represented a catch-up following a period of investment decline or stagnation. *Second*, the cited cross-country regressions did not allow for the possibility that economies were in the process of adjusting to a regime of higher trend output growth. Nor did they take into account the likely shift to higher depreciation rates (not least in connection with the growing share in the capital stock of fast-depreciating computer, equipment and software), which *ceteris paribus* raises gross investment requirements.[7] *Third*, the overall, net US capital-output ratio (measured as the net capital stock divided by net domestic product) is not out of line with its long-run historical average.[8] *Fourth*, any such overhang as did emerge in computer and software equipment was bound to erode rapidly, given that depreciation rates are so much higher in that sector. In fact, US nominal and *a fortiori* real high tech spending started to turn around in 2002.

Some local or sectoral pockets of capital overhang may nonetheless persist, notably for some more durable types of capital. Commercial real estate vacancy rates in particular have shot up in the United States, as well as in a number of other OECD countries. This is partly related to the longer lags inherent in this type of investment project, which takes several years to be completed. In the telecommunications sector, as well, some overcapacity may remain, although it does not necessarily signal excessive past investment and probably coexists with capacity shortages, *e.g.* as regards the "last mile".[9]

1. US non-residential fixed investment declined cumulatively by close to 11 per cent in 2001-02, against a briefer and shallower contraction of barely 5 per cent in the recession of the early 1990s. Elsewhere, however, the recent drop has been smaller so far than that witnessed in the early 1990s (although it is almost as large in the United Kingdom).
2. It has also led some to describe the current cycle as an "Austrian" one. See Oppers, S., "The Austrian theory of business cycles: old lessons for modern economic policy?", *IMF Working Papers*, No. 02/2, 2002.
3. See Pelgrin, F., S. Schich and A. de Serres, "Increases in business investment rates in OECD countries in the 1990s: how much can be explained by fundamentals?", *OECD Economics Department Working Papers,* No. 327, 2002.
4. Comparing the market and the replacement value of physical assets, another recent study reaches the same conclusion. See Ando, A., D. Christelis and T. Miyagawa, "Inefficiency of corporate investment and distortion of savings behavior in Japan", *NBER Working Papers*, No. 9444, 2003.
5. See "Evaluating the evidence of a capital overhang in the US economy", in *United States: Selected Issues*, IMF Country Report, No. 02/165, 2002.
6. Again, this contrasts with developments in Europe, where capacity utilisation rates remain close to historical averages.
7. See Pelgrin *et al.*, *op. cit.*, and Tevlin, S. and K. Whelan, "Explaining the investment boom of the 1990s", *Journal of Money, Credit and Banking*, Vol. 35, No. 1. Depreciation rates may well fall back somewhat, however, in the context of a protracted slowdown.
8. This is so in nominal terms. In real terms, the net US capital-output ratio probably exceeds its long-run average.
9. For example, it is rational to install more optical fibre than can be used in the short run, since this material is long-lasting and the bulk of the investment costs stem from digging the trenches and installing the fibre.

… with improved profits in the United States, but less so elsewhere

Falling capital investment has been associated with a reassessment of future profitability in many sectors. Many corporations have seen their capital base come under pressure, and cutbacks in capital spending, tight inventory management, and labour shedding/productivity increases have become the main vehicles for improving their balance sheets. Profit margins have been helped by sustained productivity gains in the United States, but have been held back by the typically slower labour market adjustment in continental Europe and – where defined-benefit occupational pensions are the norm (United States, United Kingdom, Netherlands) – by the need to top up corporate pension funds. In this context, even in the absence of geopolitical events and uncertainty, the upturn would in all likelihood be moderate, dependent for some time on expansionary macroeconomic policies.

Strength and general dynamics of the upturn

Lower oil prices and supportive policies…

Oil prices are assumed to stay around $25 per barrel

The projections have been built on the assumptions that the acute risk attaching to the oil price has subsided, and that the more diffuse uncertainties attaching to the aftermath of the Iraq war will dissipate more gradually. The oil price is taken as averaging $25 from the second quarter of 2003 onwards (Table I.2). Hence, the projected impact of recent price spikes on output and inflation is limited. The negative effect of uncertainty on confidence would, at the same time, give way to conditions where, in particular for business investment, the option value of waiting falls rather quickly to more normal levels.

Monetary policies remain supportive…

Macroeconomic policies remain expansionary, although to differing degrees, on both sides of the Atlantic (see Box I.2). Monetary indicators suggest that the monetary policy impulse is greatest in the United States. However, policy rates across the OECD area are at or near historical lows and the OECD projections embody a further 50 basis point decline in short-term interest rates in the euro area. Money market rates are assumed to remain low for some time, before rising as the recovery

Table I.2. **Oil and non-oil commodity prices**

	2000	2001	2002	2003	2004
	Percentage changes				
OECD import oil price (cif)	62.1	-15.8	2.4	7.8	-3.8
Non-oil commodity prices[a]	3.1	-8.6	-0.3	9.5	5.1
	$ per barrel				
Memorandum item:					
OECD import oil price (cif)[b]	28.0	23.6	24.1	26.0	25.0

a) Total Hambourg commodity price index, excluding energy. OECD estimates and projections for 2003-04.
b) The historical data for the OECD crude oil import prices are average cif unit prices as calculated by the International Energy Agency; that is, they include cost, insurance and freight but exclude import duties. OECD estimates and projections for 2003-04.
Source: Hamburg Institute for Economic Research (HWWA), International Energy Agency and OECD.

Box I.2. Policy and other assumptions underlying the central projections[1]

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, the procedure is to incorporate them if the assessment is that they will be implemented in a shape close to that announced. For the present projections the implications are as follows:

- The US projection embodies the main thrust of the Administration's tax proposals, which bring forward tax cuts that were built into the 2001 Tax Act and change the personal income tax treatment of dividends. It also incorporates the $75 billion supplemental appropriations request submitted by the President to Congress on 25 March 2003.
- The projection for Japan incorporates the supplementary budget for fiscal year (FY) 2002, passed by the Diet in early 2003, as well as the FY 2003 Budget, passed by the Diet in March 2003.
- Measures to meet budget deficit objectives under the Stability and Growth Pact are incorporated provided they are enshrined in law or about to be legislated.

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 was last lowered to 1¼ per cent in November 2002, is assumed to rise gradually from late 2003 to 3½ per cent a year later, as some withdrawal of policy stimulus becomes appropriate in order to maintain price stability. In the euro area, the main refinancing rate, lowered by ¼ percentage point in early March to 2½ per cent, is assumed to be cut by ½ percentage point over the coming months, and to start gradually moving up from around mid-2004. In Japan, short-term interest rates are assumed to remain close to zero throughout the projection period.

The projections assume unchanged exchange rates from those prevailing on 26 March 2003, at one US dollar equals ¥ 120.1 and € 0.936. For Turkey, the exchange rate is assumed to depreciate in line with projected inflation.

The baseline assumption is that, following the fairly swift resolution of the Iraq crisis, with limited collateral damage, geopolitical uncertainty more generally will dissipate, leading to a return to "normality" in the second half of this year.

Since early 2002, oil prices have responded to production cutbacks and political tensions in the Middle East, falling sharply in March 2003, and the working hypothesis is that OECD oil import prices average $25 per barrel from the second quarter of 2003 onwards.

The cut-off date for information used in the projections was 4 April 2003.

1. Details of assumptions for individual countries are provided in the corresponding country notes.

firms and it becomes necessary to adjust the stance of policy. Despite increasing budget deficits, long yields have remained low. Steeper yield curves are expected only late in the projection period.

… though financial conditions are affected by exchange rate shifts

Relative financial conditions have, however, been affected by substantial exchange rate movements (Figure I.5). The dollar has weakened notably since last autumn and even more so from its peak in early 2002. A large part of the adjustment has fallen on the euro, against which the dollar has lost almost a quarter of its value in the year to early April 2003. The dollar has also fallen by 11 per cent against the yen.[7] The British pound as well has weakened substantially since last autumn.

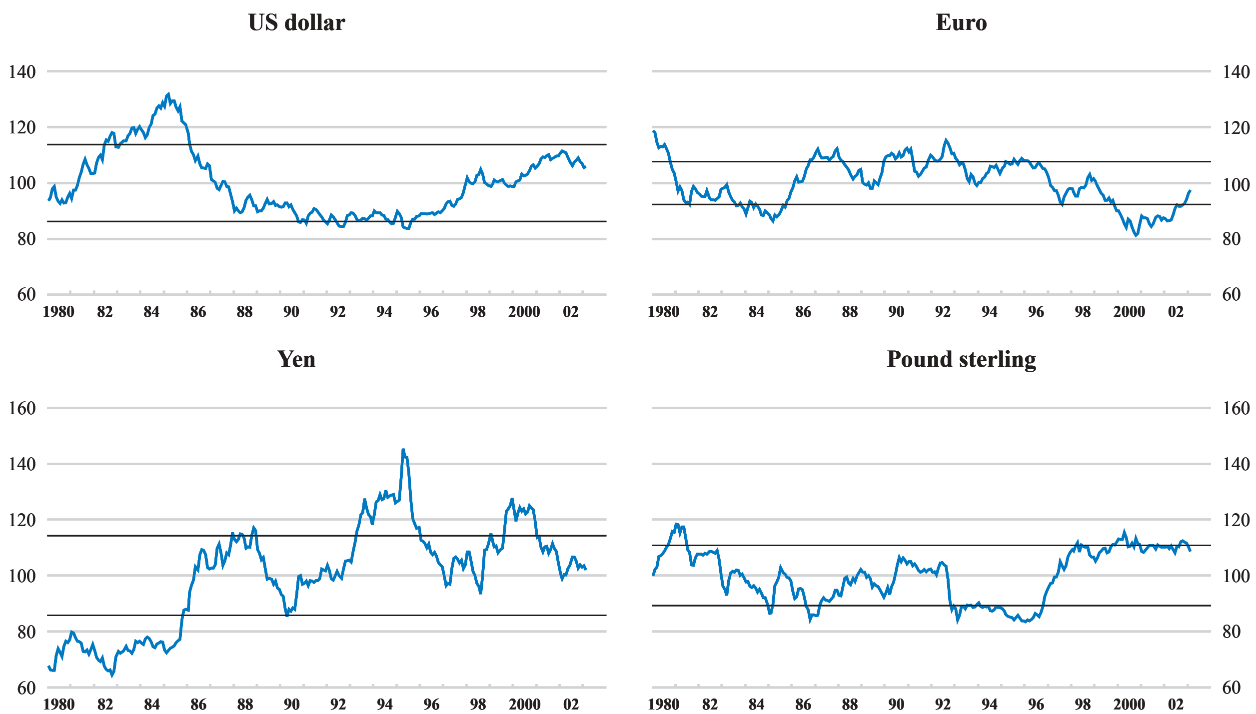
Fiscal policy is expansionary in many countries

Fiscal positions have deteriorated sharply in the course of the downturn, both for cyclical and for structural reasons, and part of the associated impulse (amounting to a swing in the cyclically-adjusted deficit of over 1½ per cent of GDP for the OECD area as a whole in the course of 2001-02) has still to come through. Looking

7. Over the same period, non-Japan Asia continued to rapidly build up foreign exchange reserves, as many countries in the region resisted currency appreciation, thereby pushing an additional burden on the euro area and Japan.

Figure I.5. **Real effective exchange rates**

Average since 1980 = 100[1]



1. Horizontal lines delineate +/- one standard deviation from the average since 1980.

Source: OECD, *Main Economic Indicators*.

forward, the OECD overall fiscal deficit is expected to widen further in 2003, partly because of built-in stabilisers. As well, an additional *ex ante* stimulus is likely to accrue from a further increase in the cyclically-adjusted deficit amounting to a little under ½ per cent of GDP. The fiscal stance is set to loosen in particular in the United States, the United Kingdom, Austria and Finland. In the euro area as a whole, the stance becomes a bit more restrictive in 2003, mainly reflecting significant tightening programmed for Germany. In Japan, the stance is expansionary this year, reflecting the increase in expenditures in the fiscal year (FY) 2002 supplementary budget and the planned tax cuts in the FY 2003 budget. Budget deficits in several OECD transition economies should shrink, while remaining uncomfortably large (5 to 6½ per cent of GDP). Australia, Canada and Korea would continue to record budget surpluses.

… should underpin stronger but uneven growth from late 2003

Growth is uneven across OECD regions in early 2003

Following a weak end-year quarter, the latest information on consumer spending, durable goods orders and purchasing manager intentions points to some modest growth pick-up in the first quarter of this year in the United States and less so in Europe. Empirical work at the OECD using high frequency data to forecast growth in the very short term points to continued modest growth in the second quarter in the euro area and possibly some slowing in the United States (Table I.3). In Japan,

Table I.3. Very short-term output growth projections

Per cent, quarter-on-quarter, seasonally-adjusted [a]

	Outcome 2002 Q4	Estimates 2003 Q1		Projections 2003 Q2	
United States	0.4	0.7	(0.2 – 1.2)	0.4	(-0.1 – 0.9)
Euro area	0.2	0.3	(0.1 – 0.5)	0.3	(0.0 – 0.6)
Germany	0.0	0.3	(-0.1 – 0.7)	0.3	(-0.3 – 0.9)
France	0.2	0.3	(0.0 – 0.6)	0.1	(-0.3 – 0.5)
Italy	0.4	0.3	(0.0 – 0.7)	0.4	(0.0 – 0.8)
United Kingdom	0.4	0.2	(-0.1– 0.5)	0.5	(0.1 – 0.9)

a) Based on available conjunctural indicators published until 1 April 2003. In parentheses is the associated ± 1 standard error range.
Source: OECD.

surveys and leading indicators suggest that following an apparent spurt in late 2002, growth may have stalled in early 2003.

Inventories may be normalising

The inventory cycle is playing a neutral – perhaps even positive – role at this stage. Inventory adjustment has come to an end in the United States, and a build-up of stocks may add to demand at least in the early part of this year. In the euro area, business surveys also point to a modest improvement: the balance of firms finding stocks excessive has diminished, although not in Germany. The stock-output ratio in Japan continued to decline throughout 2002 and is edging below its long-term trend.

Table I.4. Contributions to changes in real GDP

Per cent of GDP in previous period

	2001	2002	2003	2004
United States				
Final domestic demand	1.7	2.5	2.7	3.9
of which: Business investment	-0.8	-0.8	0.2	1.2
Stockbuilding	-1.4	0.7	0.3	0.3
Net exports	-0.2	-0.8	-0.6	-0.3
GDP	0.3	2.4	2.5	4.0
Japan				
Final domestic demand	1.0	0.1	0.4	0.3
of which: Business investment	0.2	-0.6	0.2	0.2
Stockbuilding	0.0	-0.4	0.1	0.0
Net exports	-0.7	0.7	0.6	0.8
GDP	0.4	0.3	1.0	1.1
Euro area				
Final domestic demand	1.4	0.4	1.1	2.0
of which: Business investment	0.1	-0.3	-0.1	0.5
Stockbuilding	-0.4	-0.1	0.0	0.3
Net exports	0.5	0.5	0.0	0.1
GDP	1.5	0.9	1.0	2.4
OECD				
Final domestic demand	1.3	1.6	1.9	2.8
of which: Business investment	-0.3	-0.5	0.2	0.8
Stockbuilding	-0.7	0.3	0.2	0.2
Net exports	0.3	-0.1	-0.1	0.0
GDP	0.8	1.8	1.9	3.0

Source: OECD.

The United States will lead the cyclical upturn…

Against this background, the US recovery is expected to be driven by a very gradual strengthening of business fixed investment and modest re-stocking. Household consumption growth is, meanwhile, projected to slow as the mortgage-refinancing effects abate and a weak labour market negatively affects consumer spending propensities, at least in 2003. Moreover, a significant part of the Administration's proposed tax cut is assumed to be saved. Federal government spending may rise strongly, but this may to some extent be offset by restraint at the state and local level. Despite the weaker dollar, the drag from net exports is projected to diminish only slowly, with exports being held back by less than robust growth of export markets. Overall, and in year-average terms, growth will remain relatively subdued in 2003 at around 2½ per cent, but accelerate to 4 per cent in 2004 (Table I.4).

… with the euro area trailing…

Activity in the euro area is expected to grow only modestly this year and next, while intra-regional growth trends are becoming increasingly divergent, with among the larger economies Germany and the Netherlands lagging France and Spain. In the near term, private consumption is likely to remain weak in the face of deteriorating employment prospects (Table I.5). With exports recovering only moderately (in part due to the stronger euro), significant unused capacity and pressures on profit margins, business investment may only gather momentum in 2004. As unemployment stops rising in 2004, consumption should regain some of its normal strength. All this sums up to a very gradual recovery in 2003, before growth picks up, but only to around potential rates, in 2004.

… and Japan slowing down

The Japanese economy is not expected to sustain the growth performance recorded in 2002, when it grew by 2½ per cent during the year (but by 0.3 per cent

Table I.5. **Euro area: summary of projections**

	1999 current prices		2000	2001	2002	2003	2004
	Billion euros	Per cent of GDP	Percentage changes, volume				
Private consumption	3 587 .4	57.3	2.6	1.8	0.7	1.2	2.1
Government consumption	1 247 .4	19.9	2.2	2.1	2.7	1.6	1.2
Gross fixed capital formation	1 316 .1	21.0	5.1	-0.2	-2.3	0.2	2.7
Residential	364 .4	5.8	1.3	-3.1	-1.5	0.8	1.0
Business	794 .3	12.7	7.4	0.4	-2.2	-0.6	3.8
Government	157 .4	2.5	2.7	3.2	-4.5	3.1	0.9
Final domestic demand	6 150 .8	98.2	3.1	1.4	0.4	1.1	2.0
Stockbuilding[a]	19 .1	0.3	0.0	-0.4	-0.1	0.0	0.3
Total domestic demand	6 169 .9	98.5	3.0	1.0	0.3	1.1	2.4
Net exports[a]	92 .4	1.5	0.6	0.5	0.5	0.0	0.1
GDP at constant prices			3.6	1.5	0.9	1.0	2.4
GDP at current prices	6 262 .3	100.0	5.0	3.9	3.2	3.0	4.1
Memorandum items							
Harmonised consumer price index			2.4	2.5	2.4	2.0	1.6
Private consumption deflator			2.1	2.4	2.2	1.7	1.4
Total employment			2.3	1.5	0.4	-0.1	0.7
Unemployment rate			8.4	8.0	8.2	8.8	8.7
General government financial balance[b]			0.1	-1.6	-2.3	-2.5	-2.4
Current account balance[b]			-0.4	0.2	1.1	1.4	1.4
Output gap[c]			1.1	0.3	-0.9	-1.8	-1.5

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) As a percentage of GDP.
c) As a percentage of potential GDP.
Source: OECD.

year-on-year).[8] Going forward, growth is expected to average 1 per cent in 2003-04 and to be driven largely by exports, as subdued wage growth and deteriorating employment prospects will restrain household spending. Despite some improvement in profit expectations, continuing corporate restructuring will weigh on business investment.

Labour markets are worsening and disinflation continues

The recovery has been jobless in the United States…

In the United States, aggressive labour shedding against the background of strong productivity growth (Table I.6) has allowed relatively strong *per capita* income growth to be maintained while reducing unit labour costs and partially rebuilding profits. While output has increased by 3 per cent since the onset of the recession in March 2001, employment has shrunk. Even more so than in the early 1990s, the upturn has been a "jobless" one. Nevertheless, the US labour market having entered this recession tighter than it had been in 30 years, the unemployment rate remains lower than in the aftermath of most recent recessions, at just under 6 per cent.

… and unemployment is rising in the euro area and Japan

In the euro area, unemployment remained fairly stable in the early phases of the downturn. This may be partly thanks to the ongoing impact of labour market reforms, which have been pricing low-productivity workers into jobs, as well as to the fact that the initial slowdown was milder than across the Atlantic. Comparatively stronger employment protection rules may also have delayed layoffs, despite the rising share of flexible work contracts. Unemployment has, however, started to rise more rapidly since, and now stands at 8¾ per cent of the labour force. In Japan, unemployment currently stands near a historical peak, at 5¼ per cent of the labour force, despite a falling participation rate.

Disinflation is likely to continue

Inflation is generally low or trending down in core terms, but with exceptions (Canada and some smaller euro area countries). In the United States, although inflation has tended to pick up, reflecting rising energy prices and stronger import prices resulting from a weaker dollar, it will remain moderate. As higher energy prices unwind, inflation should slow, consistent with the negative output gap prevailing over the entire projection period. In the euro area, where the output gap is widening sharply and rising oil prices were largely offset by euro appreciation, inflation is projected to decline from 2½ per cent in 2002 to 1½ per cent in 2004, as measured by the harmonised index of consumer prices. Inflation in Germany and Switzerland would approach zero. In Japan, deflation is not expected to abate, and the consumption deflator should continue to decline by about 1½ per cent per year.

World trade should regain momentum

World trade will rebound, but external imbalances worsen

World trade growth slowed late in 2002 as global economic activity lost some of its strength and world ICT markets relapsed. It is projected to pick up gradually in the course of 2003, as OECD activity firms (Table I.7). Reflecting the uneven recovery, current account imbalances are projected to increase. The US current account deficit is set to rise by ¾ per cent of GDP between 2002 and 2004, to 5½ per cent of GDP, while the Japanese and euro area surpluses would increase by 1 per cent and ¼ per cent of GDP respectively over the same period.

8. This was, however, partly due to the adoption of a new definition of the national accounts deflators that showed a stronger deflation than had previously been expected. Nominal GDP declined 1½ per cent in 2002.

Table I.6. **Productivity, unemployment, output gaps and inflation**

	2001	2002	2003	2004
	Per cent			
Labour productivity growth				
United States	0.2	3.9	2.0	2.3
Japan	0.8	1.7	1.6	1.3
Euro area	-0.1	0.5	1.3	1.8
European Union	0.3	0.7	1.5	2.0
Total OECD	0.3	2.2	1.8	2.0
Employment growth				
United States	0.0	-0.3	0.9	1.4
Japan	-0.5	-1.3	-0.6	-0.2
Euro area	1.5	0.4	-0.1	0.7
European Union	1.4	0.5	0.0	0.7
Total OECD	0.5	0.1	0.4	1.0
	Percentage of labour force			
Unemployment rate				
United States	4.8	5.8	6.0	5.8
Japan	5.0	5.4	5.7	5.7
Euro area	8.0	8.2	8.8	8.7
European Union	7.3	7.6	8.0	7.9
Total OECD	6.4	6.9	7.2	7.0
	Per cent			
Output gaps[a]				
United States	-1.1	-1.5	-2.1	-1.2
Japan	-0.6	-1.5	-1.8	-2.0
Euro area	0.3	-0.9	-1.8	-1.5
European Union	0.2	-0.9	-1.7	-1.4
Total OECD	-0.4	-1.2	-1.8	-1.4
Inflation[b]	GDP deflator			
United States	2.4	1.1	1.6	1.3
Japan	-1.6	-1.7	-2.2	-1.8
Euro area	2.4	2.4	1.9	1.7
European Union	2.4	2.5	1.9	1.8
Total OECD *less* Turkey	2.0	1.4	1.3	1.2
Total OECD	2.9	2.1	1.7	1.4
	Consumer price index			
United States	2.8	1.6	2.4	1.7
Japan	-0.7	-0.9	-0.9	-1.0
Euro area[c]	2.5	2.4	2.0	1.6

a) Per cent of potential GDP.
b) Percentage change from previous period.
c) Harmonised index of consumer prices.
Source: OECD.

Domestic demand remains relatively strong in Asia…

Beyond the near-term, the relative dynamism of the non-OECD Asian economies as a whole, and in particular China and Dynamic Asia,[9] is likely to continue to be a positive contributor to growth in global trade. Non-OECD Asia accounted for close to 45 per cent of global trade volume growth in 2002 and is projected to account for over 30 per cent this year – approximately double the share of these economies in total world trade. China's strong real GDP growth performance in 2002 has been driven

9. Dynamic Asia economies include Hong Kong, China; Chinese Taipei; Indonesia; Malaysia; the Philippines; Singapore and Thailand.

Table I.7. **World trade and current account summary**

	2001	2002	2003	2004
	Percentage changes			
Merchandise trade volume				
World trade[a]	-0.2	3.6	5.9	8.8
of which: Manufactures	-1.1	3.8	6.1	9.4
OECD exports	-0.5	2.7	4.6	7.9
OECD imports	-0.7	2.5	4.9	7.5
Non-OECD exports	-0.6	7.6	9.8	11.3
Non-OECD imports	2.8	5.2	8.3	12.6
Intra-OECD trade[b]	-1.0	1.5	3.4	6.6
OECD exports to non-OECD	2.1	5.6	9.1	12.4
OECD imports from non-OECD	-0.2	8.0	9.8	10.6
Trade prices				
OECD exports[c]	-2.6	1.1	7.8	1.3
OECD imports[c]	-3.3	0.7	8.2	1.3
OECD terms-of-trade with rest of the world[d]	2.0	0.4	-0.7	0.2
Current account balances	Per cent of GDP			
United States	-3.9	-4.8	-5.4	-5.5
Japan	2.1	2.8	3.1	3.9
Euro area	0.2	1.1	1.4	1.4
European Union	0.1	0.9	1.0	1.0
OECD	-1.0	-1.1	-1.2	-1.2
	$ billion			
United States	-393	-503	-587	-629
Japan	88	114	129	160
Euro area	15	73	105	115
European Union	10	75	98	99
OECD	-255	-289	-338	-345
Non-OECD	100	129	184	181
World	-155	-159	-154	-164

Note: Regional aggregates include intra-regional trade.
a) Growth rates of the arithmetic average of world import volumes and world export volumes.
b) Arithmetic average of the intra-OECD import and export volumes implied by the total OECD trade volumes and the estimated trade flows between the OECD and non-OECD areas based on the 1995 structure of trade values.
c) Average unit values in US$.
d) The OECD terms of trade are calculated as the ratio of OECD export to OECD import prices, excluding intra-OECD trade.
Source: OECD.

largely by domestic demand, which was boosted by exceptionally strong growth in government investment spending and by booms in real estate investment and consumer durables, all of which are likely to ease over the coming two years. As a result, growth is likely to depend increasingly on progress on structural reforms.

… and Russia…

The global slowdown has had a limited negative impact on activity in Russia, where GDP growth is expected to remain robust in 2003-04. The main contributing factors are rising investment in oil and utilities and strong private consumption. Despite high oil-driven capital inflows, inflation should continue to decline gradually, supported by the ongoing real appreciation of the rouble.

… but weak in Latin America

Import demand from Latin America will remain weak, following unexpectedly large adjustments of current account deficits in the region. In Brazil in particular, the current account deficit shrank from 4.6 per cent of GDP in 2001 to 1.8 per cent in

2002, due to depressed demand and intense import substitution. The deficit is projected to decline further this year, reflecting *inter alia* continued adherence to prudent macroeconomic policies. Argentina now displays a sizeable current account surplus and is only slowly recovering from the 2002 recession, as political uncertainties and financial blockages hinder the resumption of growth.

Risks remain mainly on the downside

Downside risks continue to dominate

Significant uncertainties attach to the strength of the cyclical recovery, independently of those created by geopolitical tensions. Possible aggravating factors include balance-sheet stress in the household sector, a failure of investment to pick up, a disorderly unwinding of international imbalances or some combination thereof. At the same time, oil prices and business and consumer confidence are subject to a wide range of possible outcomes. The majority of these risks would seem to be on the downside. Even so, activity could well stage a stronger than foreseen comeback in response to an ending of war and successful stabilisation in Iraq, and to the recent macroeconomic policy impulses that have yet to fully work their way through.

Oil price risks are no longer only on the upside

As noted, the more acute risks attaching to a surge in oil prices faded as the risk of serious damage to oil production and distribution infrastructure receded. But significant and lasting changes in oil prices – in either direction – cannot be ruled out. Simulations with the OECD's INTERLINK model suggest that a $10 increase (decrease) in the average OECD import price of oil would, if sustained for a year, lead to a ¼ per cent decline (rise) in OECD area-wide growth and ½ percentage point increase (fall) in headline inflation.[10] The actual impact of an unexpected shift in oil prices, however, would depend on the context and might differ from what past experience seems to imply, not least because inflation is now benign and well-anchored.

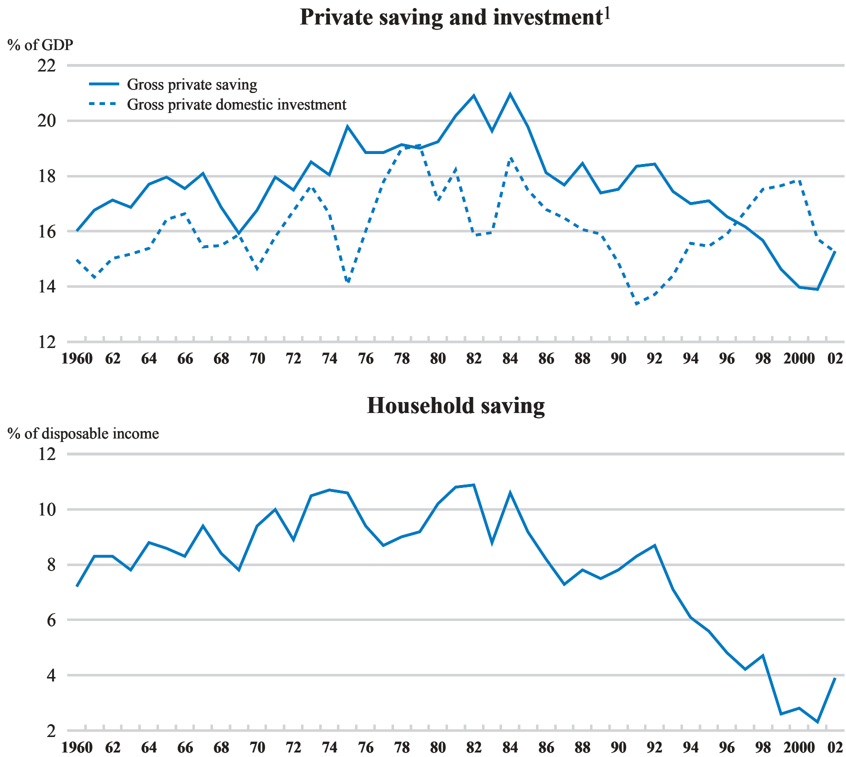
Consumption could be weaker

An underlying cyclical risk is that the consumption impulse could wane before investment recovers. This might translate into a more rapid increase in the household saving ratio towards long-run historical averages than embodied in the projection (Figure I.6). There are several dimensions to this risk:

– Housing prices could fall, either in response to an interest rate shock (possibly in connection with worsening fiscal concerns) or for other reasons, causing household balance sheet strains to emerge.[11, 12]

10. The impact on Japanese and euro area growth would be stronger than that in the United States, reflecting their respective dependence on net oil imports. The underlying assumptions are specified in Dalsgaard, T., C. André and P. Richardson, "Standard shocks in the OECD Interlink model", *OECD Economics Department Working Papers*, No. 306, 2001.
11. In this connection, it should also be noted that US housing market risk is concentrated in the portfolios of two large and modestly capitalised government-sponsored agencies, which may be a problem if it were to materialise. See Poole, W., "Housing in the economy", Speech delivered at the Office of Federal Housing Enterprise Oversight Symposium, Washington DC, 10 March 2003.
12. In the United Kingdom, debt-to-income ratios have risen most rapidly for the lowest-income mortgage-holding households, and ratios of unsecured debt to income more than doubled for the lowest-income households. These are the ones most vulnerable to shocks increasing financial stress, such as unexpected interest rate hikes or spells of unemployment. See Cox, P., J. Whitley and P. Brierley, "Financial pressures in the UK household sector: evidence from the British Household Panel Survey", *Bank of England Quarterly Bulletin*, Winter, 2002. Housing market bubble symptoms have arguably also been observed in other OECD countries, including Spain and Australia.

Figure I.6. **Saving and investment in the United States**



1. There is a statistical discrepancy in the national accounts, reflecting conflicting information from source data regarding product and income, with gross saving exceeding gross investment (by 1.1 per cent of GDP in 2002).

Source: US Bureau of Economic Analysis and OECD.

– Further equity price declines are still a source of potential instability. Price-earnings ratios remain relatively high in North America compared with long-run averages and with those in Europe,[13] while expected equity price volatility remains elevated. Even if equity prices do not drop any further, household consumption could be affected by an increase in saving as pension plan holders gradually realise the extent of the losses they effectively incurred.

– While lower interest rates have allowed corporations to consolidate their accounts by rolling over or refinancing loans, profit margins remain generally quite low and pricing power weak.[14] This implies not only a risk of further deferred investment but also of accelerated labour-market adjustment, especially in the euro area, where unit labour costs have been under pressure. The ensuing increase in uncertainty would push up precautionary saving.

13. However, following recent corporate governance scandals and the ensuing tightening of regulation (see Box I.3 in the previous *Outlook*), reported and forecast earnings may have become more conservative, implying that price-earnings ratios may look higher than they otherwise would have.
14. Even in the United States, non-financial corporate profits are still relatively low, at 7.5 per cent of GDP in 2002 (as against an average of 8.7 per cent over the last four decades).

Box I.3. Economic consequences of the spread of severe acute respiratory syndrome

An atypical form of pneumonia, called severe acute respiratory syndrome (SARS), emerged in China in late 2002. It has been spreading considerably since, leading to an emergency travel advisory issued by the World Health Organisation and to precautions being taken by healthcare professionals around the world. The early manifestations of the disease are non-specific, resembling symptoms of the common cold or influenza, making it difficult to detect in timely fashion. By mid-April 2003, over 3 200 cases had been reported in 24 countries, with 154 deaths, mostly in mainland China and in Hong Kong, but also *inter alia* in Singapore, Vietnam and Canada.[1]

The economic impact of this epidemic depends largely on how promptly and effectively the virus can be brought under control. Preventive measures have been taken in the countries most directly affected, but they have disrupted traffic and business. A cheaper method of prevention or a cure have yet to be discovered. More specifically, the SARS has pushed stock prices down and taken a toll on airlines, tourism and retailing in several non-OECD Asian countries and has affected travel to or from New Zealand and Canada. In several countries, some workplaces have temporarily closed or employees are being invited or obliged to stay at home. A number of Japanese firms are restricting travel by employees to Singapore and other Asian cities. The ultimate macroeconomic repercussions of the epidemic are difficult to ascertain at this early stage, but past experience with other disease outbreaks[2] suggests that local or sectoral impacts in the most seriously affected countries could be significant if the emergency were to worsen and persist.

1. For a clinical perspective, see "A major outbreak of severe acute respiratory syndrome in Hong Kong", *New England Journal of Medicine*, 7 April 2003, and for an up-to-date count, *www.who.int/csr/sarscountry/en/*.
2. For example the meat-related diseases in the late 1990s (Box I.4 in *OECD Economic Outlook*, No. 69, June 2001).

A new epidemiological risk has surfaced

On top of the above geopolitical and economic tensions, a new risk has recently emerged, with the spreading of an atypical form of pneumonia (Box I.3). It has caused significant disruptions in several countries, particularly China and Hong Kong. Its effect on the global outlook is as yet very uncertain. It will depend *inter alia* on how effective containment measures are, on how rapidly its propagation is understood and on whether a vaccine or cure is discovered.

External imbalances remain of concern

The external counterpart of low private and declining public saving in the United States is a large and rising current account deficit, which is set to widen to 5½ per cent of GDP by 2004, despite the recent dollar depreciation. The experience of the late 1980s suggests that the narrowing of the external gap need not be disruptive, but it may also point to the possibility of further exchange rate adjustment, not least if central banks in Asia were to significantly reduce the pace at which they build up dollar reserves.

Macroeconomic policy challenges

Some rebalancing of the policy mix may be needed

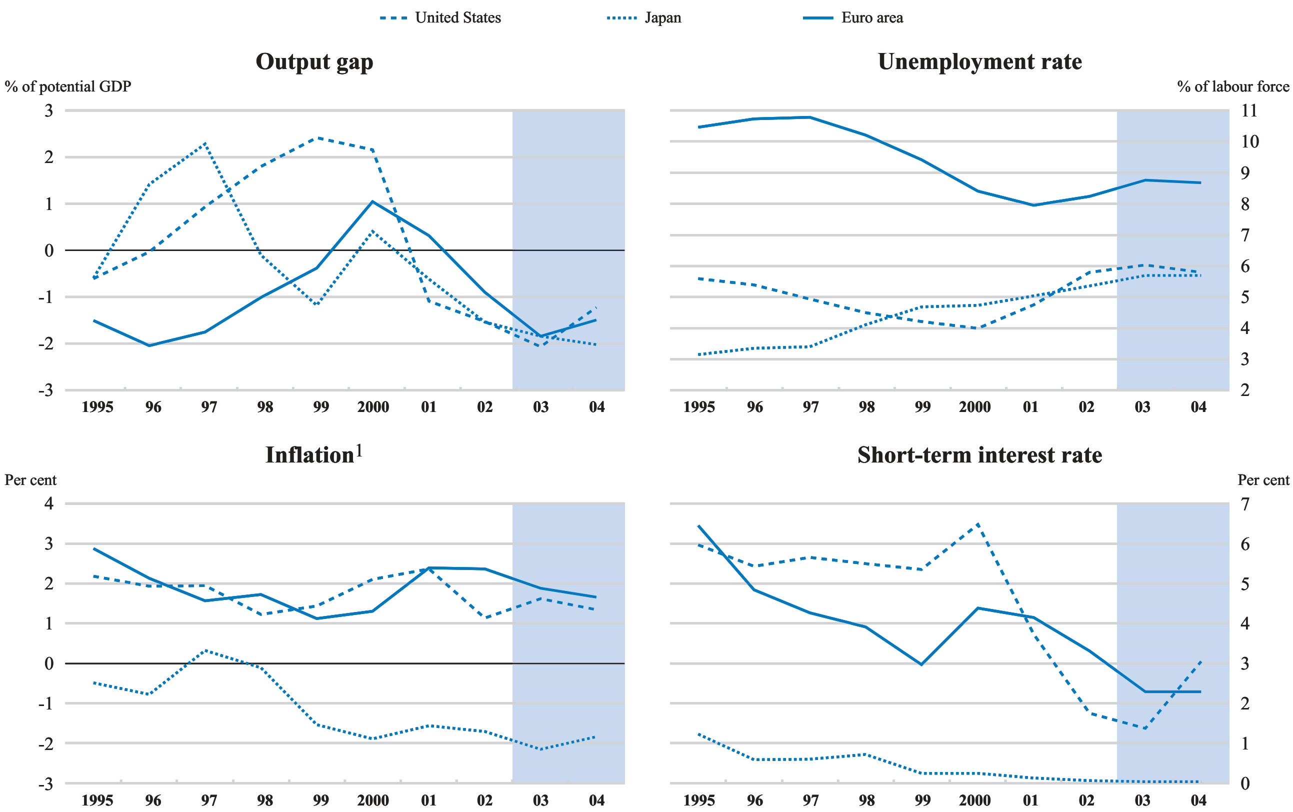
The severity of the downswing has been limited by the relaxation of macroeconomic policy, especially in the United States. Even so, persistent cyclical weaknesses and downside risks raise the issue of whether additional policy stimulus is in order. Where there remains scope for further monetary policy action, this may indeed have to be used. On the fiscal side, however, any new discretionary fiscal measures need to be set against longer-run sustainability considerations and control over spending has to improve. In some cases, consolidation ought to start even before the recovery is well established.

Monetary policy: how much more can it help?

Monetary policy has cushioned the downturn

Against the background of low inflation and widening output gaps (Figure I.7), central banks have brought down policy-controlled interest rates near or to historical lows.[15] This has helped contain the amplitude of the downturn and, given the lags associated with monetary policy, will continue to support demand in the course of 2003. At the same time, falling bond yields and buoyant house prices have, in a number of cases, limited the extent of adverse wealth effects of collapsing equity prices. Going forward, loosening monetary policy for cyclical reasons may, in some countries, aggravate domestic or external imbalances. In others, there is more clearly scope for further interest rate cuts, although monetary policy alone cannot put economies back on a balanced and sustainable growth path.

Figure I.7. **Resource utilisation, inflation and interest rates**



1. GDP deflator.
Source: OECD.

15. Australia, Canada, Korea, Mexico and New Zealand are the only exceptions among OECD countries (excluding Turkey), and even there, interest rates are low in historical perspective.

There is little room or need to cut interest rates in the United States

In the United States, nominal short-term interest rates are at their lowest levels in over four decades, following a cumulative 475 basis point cut in the Federal Reserve's target rate in the course of 2001 and an additional 50 basis point cut in November 2002. In real terms, short-term interest rates are essentially nil or negative, depending on which price index is used. This loose stance has generously supported credit and demand, notably in the consumer durables and housing sectors. The room for lowering the federal funds rate is now limited, but on current OECD projections, there is no need to cut the policy rate further. Indeed, as the recovery strengthens in 2004, it will be desirable to start moving the policy rate back towards neutrality.

There is more scope to ease interest rates in the euro area…

In Europe, with the exception of Switzerland, nominal short-term interest rates have remained well above their US counterparts. The Eurosystem cut its minimum refinance rate by 25 basis points in early March 2003, bringing the policy rate back to the level of its 1999 trough, which, however, is still 125 basis points above the corresponding US rate. Based on expected inflation, real short-term interest rates in the euro area are still, on average, close to 1 per cent. There is scope to bring the policy rate down further, given that core inflation is trending down against the background of a significant near-term widening in the output gap. Moreover, the effective exchange rate has appreciated substantially in recent months.

… but less so in the United Kingdom

In the United Kingdom, the Bank of England cut its repo rate by 25 basis points in February 2003, after a prolonged wait-and-see period, and despite the persistent vigour of house price inflation. But with growth more resilient and fiscal policy more stimulative than in the euro area, there seems to be much less of a need for further cuts.

In Japan, monetary action has not ended deflation…

In Japan, short-term interest rates have been zero almost uninterruptedly since 1999. Liquidity injections have been stepped up several times, so that banks' current account balances at the Bank of Japan have quadrupled over the last two years. The range of assets purchased by the central bank has been broadened.[16] Even so, year on year, broad money has recently been expanding at a rate of only about 2 per cent, while private bank lending has continued to contract by 2 to 3 per cent. While liquidity creation may have helped contain the acceleration of deflation,[17] it has clearly not been sufficient to pull the general price level back up. Exchange rate appreciation since early 2002 (which several bouts of effectively sterilised official intervention on the foreign exchange market failed to prevent) has also contributed to depressing the domestic price level.

… and further easing is needed, with structural reforms

Continued liquidity expansion is necessary to prevent worsening deflation, including via the purchase of foreign currency denominated assets. But as long as the monetary policy transmission mechanism is defective, "quantitative easing" in the form of liquidity injections against domestic collateral will not suffice. Bank balance sheets are saddled with very large amounts of non-performing loans (NPLs). As

16. The Bank of Japan also purchases shares held by commercial banks (and is authorised to accumulate up to ¥ 3 trillion of such shares itself), but the purpose is to reduce bank balance sheet instability rather than to boost liquidity.
17. The intensity of deflation may be understated, however, by the official consumer price index series (see Ariga, K. and K. Matsui, "Mismeasurement of the CPI", *NBER Working Papers*, No. 9436, 2003). Also, a new version of the Bank of Japan's wholesale price index, aiming at better accounting for changes in the quality of goods, shows the annual rate of deflation to be around one percentage point stronger than suggested by the old index.

described in more detail in the previous *Outlook*, new measures were introduced in late 2002 to address the NPL problem more aggressively and to work off the existing stock of bad loans. The supervisory agency has launched a second round of special inspections and there are signs that banks are indeed acting more expeditiously to recognise and work off bad loans as well as to close unprofitable branches. The expertise of foreign banks in bad loan restructuring is also starting to be called upon more. However, consistent and more far-reaching efforts are necessary to resolve this problem while implementing broad structural reform to reinvigorate credit demand.

Fiscal policy: room for manoeuvre has essentially been exhausted

Further fiscal loosening is inadvisable

In most OECD countries, the fiscal outlook (see Table I.8) is now far more sombre than in the late 1990s, owing to cyclical setbacks, higher spending and a series of deficit-financed tax cuts, but also to the often belated action to address longer-run fiscal pressures. In some cases, traditional methods of assessing the fiscal stance have failed to correct for a number of transitory factors masking underlying weaknesses, which has contributed to delaying remedial measures or prompted fiscal expansion that may be unsustainable in the long term. In particular, the tax receipts associated with the asset price booms of the late 1990s tended to be treated, implicitly,

Table I.8. **General government financial balances**

Per cent of GDP / Potential GDP

	2001	2002	2003	2004
United States				
Actual balance	-0.5	-3.4	-4.6	-4.2
Cyclically-adjusted balance	-0.2	-2.9	-4.0	-3.9
Cyclically-adjusted primary balance	2.1	-1.0	-2.1	-2.0
Japan[a]				
Actual balance	-6.1	-7.1	-7.7	-7.8
Cyclically-adjusted balance	-5.9	-6.7	-7.2	-7.2
Cyclically-adjusted primary balance	-4.6	-5.6	-5.8	-5.8
Euro area				
Actual balance	-1.6	-2.3	-2.5	-2.4
Cyclically-adjusted balance	-1.8	-1.9	-1.6	-1.6
Cyclically-adjusted primary balance	1.7	1.4	1.6	1.5
European Union				
Actual balance	-1.1	-2.0	-2.3	-2.2
Cyclically-adjusted balance	-1.2	-1.6	-1.4	-1.5
Cyclically-adjusted primary balance	2.0	1.5	1.5	1.3
OECD[b]				
Actual balance	-1.3	-2.9	-3.6	-3.5
Cyclically-adjusted balance	-1.4	-2.8	-3.2	-3.2
Cyclically-adjusted primary balance	1.1	-0.6	-1.0	-1.1

Note: Actual balances are as a per cent of nominal GDP. Cyclically-adjusted balances are as a per cent of potential GDP. The cyclically-adjusted balance excludes one-off revenues from the sale of mobile telephone licences. The primary cyclically-adjusted balance is the cyclically-adjusted balance less net debt interest payments.

a) Includes deferred tax payments on postal saving accounts amounting to 0.6 and 0.2 per cent of GDP in 2001 and 2002, respectively.

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

Source: OECD.

as a permanent improvement on the revenue side. Underlying trends have also been masked by a number of one-off operations, *e.g.* securitisation of public assets or receivables, debt swaps, privatisations and tax amnesties.[18] Identifying underlying "structural" fiscal trends is therefore difficult (Box I.4). But against the backdrop of mounting ageing-related pressures,[19] it is clear that there is, in general, little if any scope for new fiscal stimulus over and above the cushion provided by the automatic stabilisers. In some cases, consolidation cannot be delayed even if it is pro-cyclical. Rapidly rising deficits and debts would risk pushing up real long-term interest rates and crowding out private activity, as in the early 1980s and early 1990s.

Large budget deficits are likely to persist in the United States…

The turnaround in the fiscal position has been particularly marked in the United States. Adjusting for the cycle in activity (but not for any additional impact of the cycle in asset prices nor for any other special factors), the swing from 2000 to 2002 amounted to 3.8 percentage points of GDP. This constitutes the largest two-year fiscal expansion in decades and has brought longer-run fiscal sustainability concerns to the fore. The President's budget proposals for FY 2004, which are built into the OECD projection, involve significant additional loosening, both in the form of tax cuts and via higher spending, particularly on security and health care, and may add close to 1 per cent of GDP to what the deficit would otherwise have been (Figure I.8). Some of the measures, such as the acceleration of the personal income tax relief foreseen in the 2001 Economic Growth and Tax Relief Reconciliation Act, should help support household consumption later this year and next, even if part of the extra disposable income is likely to be saved. The war-related outlays should also end up boosting domestic demand. In contrast, the intensity and timing of the stimulus to be expected from some of the other proposals, notably the exclusion of dividends from individual taxable income, remains difficult to assess.[20]

… with possible adverse consequences over the longer run

The newly proposed tax cuts are seen by the US Administration as structural reform initiatives more than as attempts at fiscal fine-tuning. But coupled with some costly new spending initiatives and with the $75 billion supplemental appropriations request submitted to Congress in March 2003,[21] they imply that fiscal deficits will continue to pre-empt large amounts of national saving well beyond the point where the current cyclical slack has been absorbed. Apart from uncertainty about the eventual budgetary costs of the war in Iraq, the risk of significantly higher deficits is compounded, over the longer term, by the absence of a medium-run anchor that would tie down spending growth, as the now expired Budget Enforcement Act helped do during the 1990s. In addition, some foreseeable future tax changes, for example as regards the alternative minimum tax,[22] will also contribute to widening the fiscal gap. Based on past experience (Figure I.9), higher

18. Fiscal deficits may also be understated by "below-the-line" treatment of capital injections into state-owned enterprises where they really represent subsidies.
19. For a detailed discussion, see "Fiscal sustainability: the contribution of fiscal rules", *OECD Economic Outlook*, No. 72, December 2002.
20. Moreover, with state governments facing a severe fiscal crisis, spending cutbacks and tax increases at sub-national level are partly offsetting federal stimulus.
21. This request is built on the assumption of a rapid and decisive US military action in Iraq and does not extend beyond the end of the current fiscal year (30 September 2003). The amount approaches the total fiscal cost of the first Gulf War (which is estimated at around $80 billion at today's prices), and represents 0.7 percentage point of GDP.
22. The alternative minimum tax – originally established to ensure that high-income earners could not abuse tax shelters – is not indexed for inflation and the 2001 tax reform did not cut it alongside the ordinary income tax. If it were to remain as is, it would encroach on a rapidly rising fraction of middle-income earners.

Box I.4. **Re-assessing cyclically-adjusted balances**

Traditional methods of correcting budget deficits for the cycle in economic activity do not adjust for asset price cycles or one-off operations (tax amnesties, securitisations).[1] Regarding the former, movements in asset prices generate capital gains and losses, which impact on tax revenues with various lags. These movements are not necessarily correlated with cycles in economic activity, and can be seen as structural where the fundamentals determining asset prices (such as profit and productivity growth and risk premia) have undergone change. Where they have not, however, the cyclically-adjusted balance may give too favourable a "structural" picture by not recognising the temporary nature of tax buoyancy due to asset price fluctuations. This appears to have occurred during the recent asset price boom.

Measuring non-discretionary fluctuations in tax revenue. In several OECD countries, total government receipts as a percentage of GDP surged in the latter part of the 1990s and subsequently contracted sharply, mostly reflecting changes in household direct taxes. For example, in the United States, these grew from 10.1 per cent of GDP in 1992 to a historical peak of 13.1 per cent in 2000 but had fallen back to 10.7 per cent by 2002. In the United Kingdom, they rose from 11.8 per cent of GDP in 1993 to 13.4 per cent in 2001 and then dropped back to 12.5 per cent in 2002. Other OECD countries including Canada and Sweden have experienced similar tax revenue swings. Corporate income taxes have followed the same pattern, but to a much lesser extent.

A simple *ex post* measure of the "unexpected" deviation in the effective tax rate is what cannot be explained by cyclical variations in output and identifiable discretionary fiscal policy measures. In the United States, this difference cumulatively amounted to 3.3 per cent of GDP between 1997 and 2001 for direct household taxes. In 2002, revenues then undershot by 0.6 per cent of GDP. Thus, the sensitivity of tax revenues to GDP may differ substantially from that used to derive cyclically-adjusted revenues.

Asset price cycles and tax revenues. Direct taxes do not vary linearly with GDP. Factors altering the receipts-to-GDP ratio include the progressivity of the household income tax, the volatility of corporate profits, the non-symmetrical tax treatment of profits and losses, deferred taxation and the fact that taxable income does not include all components of GDP. Another factor leading to variations in the receipts-to-GDP ratio is the rise and fall of asset prices. As equity prices rise, capital gains accrue. When they are realised, gains show up as taxable income for households and/or corporations depending on national legislation. In the United States, taxes on households capital gains grew from $27 billion in FY 1992 to $120 billion in FY 2000 (close to 12 per cent of total direct taxes paid by households) before dropping to an estimated $55 billion in FY 2002. Similarly, in Finland taxes on capital gains paid by households (accruals basis) rose from € 0.5 billion in 1998 to € 1.2 billion in 2000 (6 per cent of total direct taxes paid by households) before collapsing to € 0.4 billion in 2002. It is capital gains realisations that are taxed rather than capital gains accruals, and they tend to lag movements in asset prices. Indeed, after a bull market such as that of the 1990s, a sizeable amount of accrued gains remains to be realised, and equity sales in a falling market can still result in taxable gains, albeit reduced.

Financial market swings may also affect tax receipts through their effect on stock options. Estimates for the United States show that income from stock options rose from negligible amounts in the early 1990s to about $50 billion in 1997, and to over $100 billion in 2000 (*i.e.* about 2 per cent of wages and salaries). This may have yielded individual income tax receipts of around $40 billion in 2000, with most of that income probably concentrated among the highest earnings taxpayers and thus taxed at the highest rates. Preliminary data suggest that income from stock options may have halved in 2001 and fallen even further in 2002. Similarly, in Finland direct taxes on stock options have risen from € 0.1 billion in 1998, to € 0.6 billion in 2000 (also representing about 2 per cent of total wages and salaries) before falling to € 0.3 billion in 2002. However, as income earned is reported as part of wage and salary income when the options are exercised, it is at the same time deductible from the corporate income tax. Given these offsetting effects on corporate profits, changes in equity prices and income tend to generate much smaller changes in total taxable income and total tax receipts.

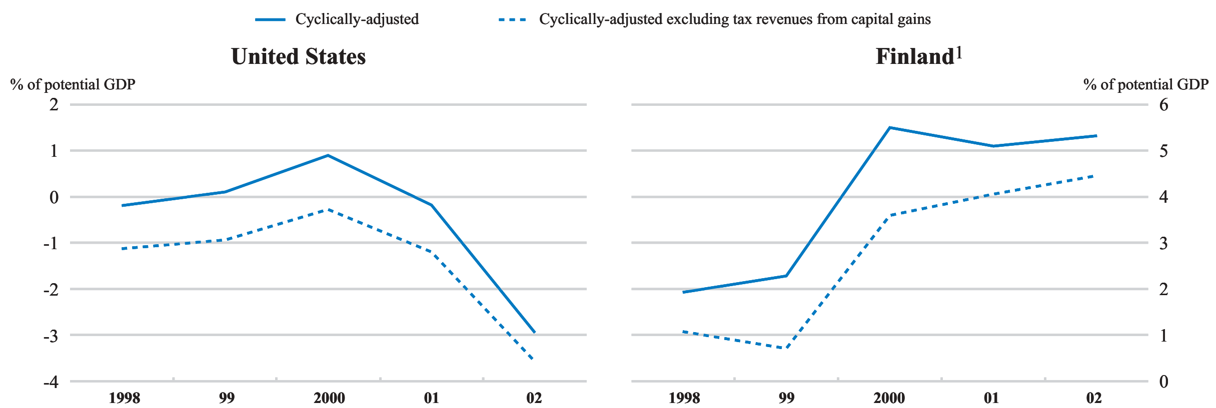
Rising asset values may also affect receipts through other routes:

- In the United Kingdom, receipts from the stamp duty – a tax on land and property transactions and on equity transfers – increased from 0.3 per cent of GDP in 1996 to 0.8 per cent in 2000, owing to buoyant property and equity markets and, to a lesser extent, to past increases in tax rates. Receipts have flattened since, reflecting the offsetting impact of house and equity price changes.
- In Denmark, the return on pension funds' investments is taxable. The fall in equity prices and the recent change in tax rates resulted in a significant drop in revenue, which fell from a peak of 1.2 per cent of GDP in 1999 to virtually zero in 2001 and 2002.
- In Greece, financial and capital transactions taxes have more than doubled between 1995 and 2000, reaching 1.6 per cent of GDP in 2000.

Accounting for asset price changes. The figure below shows the effect of excluding direct tax revenues that are particularly sensitive to asset prices on cyclically-adjusted balances in two countries (but it does not attempt to incorporate a "normal" element of such revenues in the adjusted balance). In the United States, direct taxes from capital gains realised by households rose from an average of 0.5 per cent of GDP in the first half of the 1990s to 1.1 per cent between 1998 and 2000, before falling abruptly in 2002. In Finland, the massive swing in equity prices in 2001 and 2002 caused a loss of revenue equivalent to nearly 1 per cent of GDP, accounting for a significant part of the "discretionary" easing in the fiscal stance since 2000.

Box I.4. Re-assessing cyclically-adjusted balances *(cont.)*

Adjusted fiscal balances



1. Excludes also tax revenues from stock options.
Source: OECD.

Other non-structural changes. One-off budgetary operations further complicate the interpretation of cyclically-adjusted balances. The OECD has consistently deducted the budgetary proceeds from the sales of UMTS licences. However, other possible budgetary operations should be taken into account as well:

– In some EU countries (Austria, Finland, Greece, Ireland and Italy), governments have securitised financial or non-financial assets and revenue flows.[2] The impact of these operations on the general government fiscal balance and debt depends on how the special purpose vehicle's payment to the general government is recorded. To secure consistency across EU countries, Eurostat released guidelines in 2002 on the recording in national accounts of securitisation operations. The implementation of the new guidelines has been reflected in an upward adjustment of the deficit for Italy by about ¾ per cent of GDP in 2001 and of the debt position for Austria and Greece (by about 3½ per cent of GDP in 2000-01 for Greece).

– In a number of countries, government asset sales have, at times, contributed to the improvement in cyclically-adjusted balances, amounting to ¼ per cent of GDP in 2001-02 in Belgium and to ¼ per cent of GDP in FY 2000-01 in Australia.

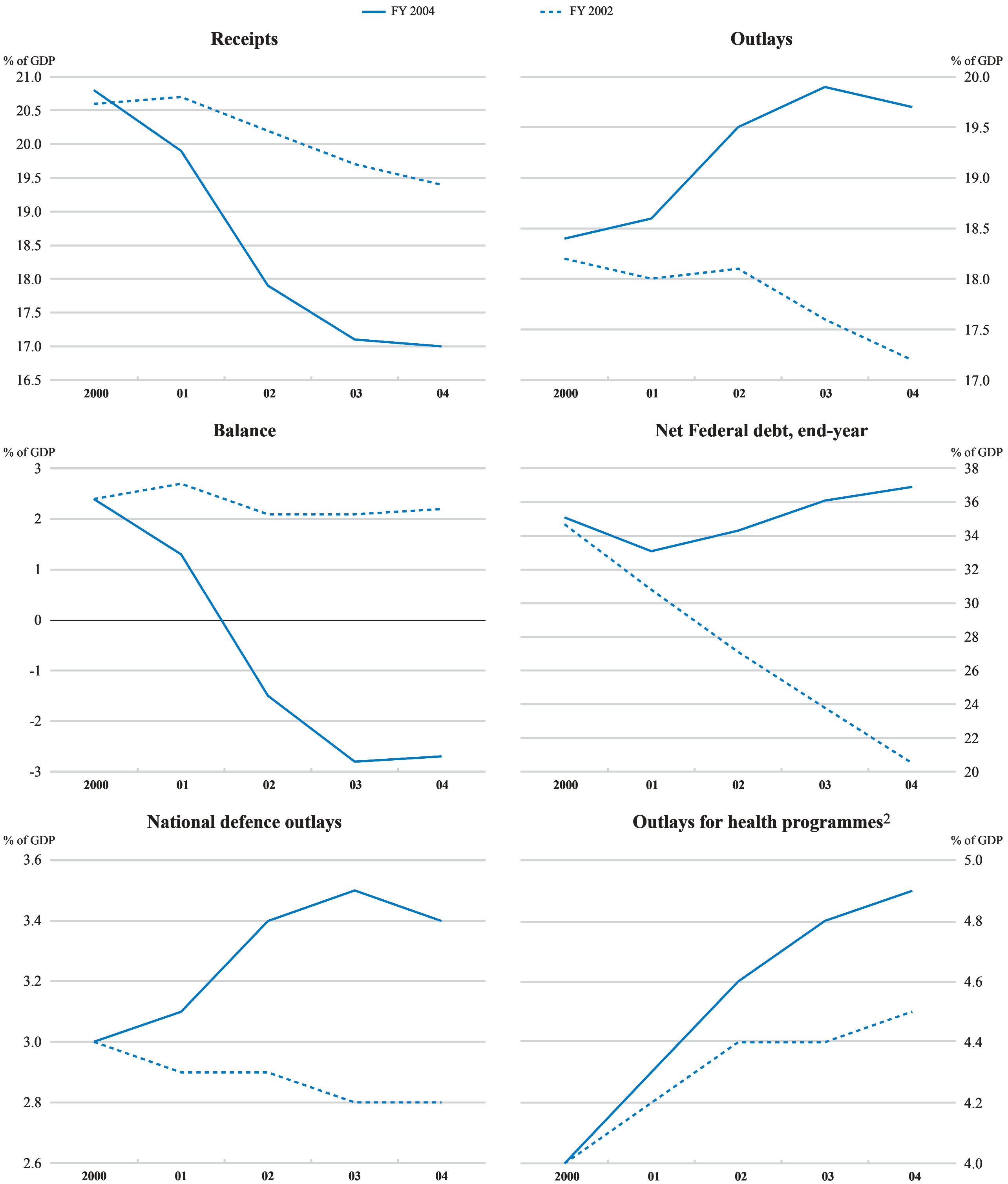
– Tax amnesties have been used in many countries. In Italy, for example, a partial tax amnesty providing temporary incentives for the repatriation of financial assets illegally held abroad was passed in 2001. The legalisation of such assets was made conditional on the payment of a penalty of 2.5 per cent of the value of the assets declared. This measure could generate revenues of 0.1 per cent of GDP in 2002.

Policy implications. In sum, careful calculation and interpretation of "structural" budget balances is warranted in light of the large non-cyclical, but temporary, shifts in government revenues observed recently in OECD countries. Overstating structural budget positions can lead governments to raise spending or reduce taxes to an extent which compromises future budget management during subsequent downturns.

1. The OECD, the IMF and the European Commission use a broadly similar approach to compute cyclically-adjusted balances. See OECD, *Sources and methods of the OECD Economic Outlook*; Hagemann, R., "The structural budget balance: the IMF's methodology", *IMF Working Papers*, No. 99/95, 1999; and European Commission, *Public Finances in EMU 2002*, Brussels, 2002.
2. Securitisation is defined here as an arrangement where the owner of an asset (or sometimes revenue flows not attached to an asset) transfers the ownership to another unit, often called a special purpose vehicle, which borrows to pay the seller, generally in the form of securities issued on its own account.

Figure I.8. **US Federal budget prospects two years apart**

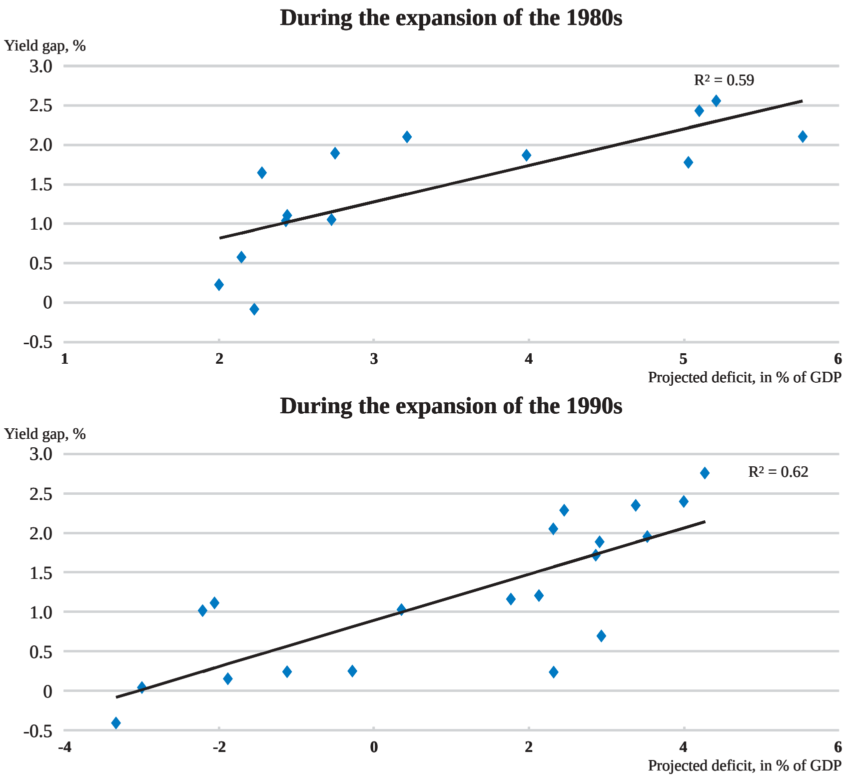
Fiscal years[1]



1. Outlays exclude the costs of a military conflict with Iraq and its aftermath.
2. Mainly Medicare and Medicaid.
Source: Office of Management and Budget, FY 2002 and FY 2004 budgets.

Figure I.9. **Projected US deficit and yield gap**

Semi-annual observations[1]



1. Expansion periods are those defined by the NBER Business Cycle Dating Committee. Observations dates correspond to the winter and summer CBO reports on the fiscal outlook. The yield gap is defined as the 5-year government bond minus the 3-month T-bill rate. The projected deficit is the CBO projection of the cumulative deficit over the next five fiscal years, in per cent of GDP.

Source: Congressional Budget Office, Federal Reserve.

deficits may translate into higher real long-term interest rates once the recovery gathers steam.[23]

In several EU countries, sizeable deficits have re-emerged…

The stability and convergence programmes presented by European Union (EU) member states on the eve of the 2001 downturn foresaw that for the euro area as a whole, the general government deficit would have fallen to 0.3 per cent of GDP by 2002 and would have disappeared altogether by 2003. The outcome was, instead, a deficit of 2.3 per cent of GDP in 2002, mostly reflecting much weaker-than-projected growth but also, in some cases, tax cuts and persistent overruns on health spending (notably in France and Germany). The deterioration in the fiscal balance was of a similar magnitude in the United Kingdom, although there a discretionary acceleration in spending accounts for a larger portion of the shift.[24] In

23. A picture similar to Figure I.9 would be obtained with real long-term interest rates instead of the difference between long and short rates, and with a ten-year rather than a five-year horizon (but the number of observations would be smaller, as the Congressional Budget Office did not project ten years ahead during the 1980s). Even so, such correlations have only a suggestive value, as interest rates are influenced by other factors, including the business cycle.
24. In 2003, budgetary outlays related to the war in Iraq may amount to 0.3 per cent of GDP.

general, the automatic stabilisers have functioned unimpeded in euro area countries and, having a larger impact than across the Atlantic, they played a more important role in cushioning the downturn.

… triggering policy reactions…

With deficits exceeding or approaching the 3 per cent of GDP threshold embodied in the Stability and Growth Pact, the excessive deficit procedure has been activated for Germany, Portugal, and, more recently, France. The European Commission has also expressed concern regarding underlying fiscal weakness in Italy, temporarily masked by several one-off operations. While France and Italy have not announced any permanent fiscal adjustment measures since, the German and Portuguese governments have introduced tax hikes and spending cuts to bring their deficits down. However, in both cases, as in a number of other countries, the official national growth assumptions underpinning the budget projections seem to err on the optimistic side, implying that deficits are set to remain above or near the 3 per cent of GDP mark longer than programmed. This is all the more likely where programmes lack specific adjustment measures beyond 2003. In fact, on current policies, the deficit is projected to distinctly exceed 3 per cent of GDP in France and Germany in each of the three years to 2004.[25]

… but further measures are called for

Even over the medium run, when the near-term cyclical slack is absorbed, deficits in the three largest euro area countries would not decline much, if at all, unless significant new measures are taken (see Appendix). This would clearly breach the commitment to bring fiscal positions into balance or surplus and put upward pressure on long-term real interest rates. While an overly rapid fiscal correction could prove counter-productive against the backdrop of widening output gaps, sticking to a gradual medium-term adjustment path for structural balances of at least ½ percentage point of GDP *per annum* is necessary, not simply to preserve the credibility of the policy framework, but because of the age-related spending pressures that are about to intensify over the next few years. In the short run, fiscal consolidation should facilitate an accommodative monetary stance and be facilitated by it. Over the longer run, the best way to cope with fiscal pressures, however, is to push ahead where needed with labour market, pension and health care reform.

Japan's fiscal imbalances remain most worrying

Japan remains a fiscal outlier among OECD countries, with a deficit again exceeding 7 per cent of GDP in 2002 and a rapidly rising gross public debt ratio, which exceeded 140 per cent of GDP at the end of 2002. With yields on long-term government bonds below one per cent, their price can barely rise any further, and holders of public debt – notably the banks – are exposed to a major downside risk. In 2003, the deficit is to widen a bit further, reflecting the spending increases enshrined in the FY 2002 supplementary budget (for public works and unemployment benefits) as well as the tax cuts built into the FY 2003 budget, which are only partly offset by consolidation measures on the spending side. As a result, the stance of fiscal policy is loosening slightly in 2003.[26] The stimulative impact of the new tax cuts is open to doubt insofar as tax credits to spur business investment may be ineffective in a context where many firms face over-capacity. Tax reform is indeed needed in Japan but

25. Fiscal deficits are much larger in many EU accession countries, notably in the Czech Republic, Hungary, Poland and the Slovak Republic. See for example Coricelli, F. and V. Ercolani, "Cyclical and structural deficits on the road to accession: fiscal rules for an enlarged European Union", *CEPR Discussion Papers*, No. 3672, 2002.
26. Estimates of the output gap are particularly fragile in the case of Japan, so that cyclical adjustment can only be done on an indicative basis. It should also be noted that owing to low tax elasticities, a large output gap does not translate into that big a cyclical deficit in Japan.

should rather involve streamlining tax relief and allowances so as to broaden the tax base, while improving the incentive structure of the tax system.[27] On the spending side, introducing more formal rules capping outlays could make it easier to bring about the needed degree of fiscal discipline.

Stepping up structural reform to boost growth and resilience to shocks

Structural policies influence current macroeconomic performance

Macroeconomic performance obviously depends not just on the quality of the monetary and fiscal policy mix, but also on the timing, nature and intensity of exogenous shocks and on the resilience of growth to them. This resilience is influenced by institutions and structural policies, since sound structural fundamentals allow adverse shocks to be overcome at a lower cost. Indeed, the disparities in economic performance during the current cycle are partly related to differences in the flexibility of response to shocks among OECD economies.

The momentum and resilience of growth varies…

Among the larger OECD economies,[28] the resilience during the recent slowdown has to some extent mirrored growth performance since the mid-1990s, which has varied considerably (Table I.9). At one end of the spectrum, Canada, Australia, France and Spain stand out with a relatively limited deceleration in activity. At the other end, the output gap is widening very considerably in Japan and Germany. Despite massive macroeconomic policy stimulus, the US output gap opens up more than in the euro area.[29] To some extent, these divergent fortunes reflect differences in shocks: Germany for example is still digesting the massive unification shock, while Australia's specialisation meant that it was less exposed to the ICT boom-and-bust.

… as does vulnerability to shocks

However, the impact of any given shock depends on an economy's institutional features, as shaped over time by structural policy. For example, where the labour market institutions are such that unemployment spells tend to be protracted, adverse shocks are more likely to lead to the marginalisation of the longer-term unemployed. Thus downward pressure on wages is weaker and hence the return to lower unemployment takes longer.[30] Not coincidentally, Canada, Australia and Spain are among the OECD countries where structural reforms have made significant progress during the 1990s, while Germany and Japan are among those where they have made least headway.[31] In the case of Germany, structural bottlenecks undermine domestic flexibility: when long-lasting shocks hit, calling for labour reallocation from the tradeables to the non-tradeables sector, very strict employment protection legislation, wage rigidities and other regulations hinder

27. See the *OECD Economic Survey of Japan*, Paris, 2002.
28. The sample includes the 12 largest OECD economies based on nominal GDP at market exchange rates.
29. As noted above, while discretionary fiscal policy and monetary loosening were less aggressive in the euro area, the automatic stabilisers are about twice as powerful there, thus helping more effectively to contain the amplitude of the slowdown. In addition, compared with pre-1999 shocks, some euro area countries at least have been partly shielded by membership in a common currency area, which *inter alia* served to limit interest rate tensions.
30. See Blanchard, O. and J. Wolfers, "The role of shocks and institutions in the rise of European unemployment: the aggregate evidence", *Economic Journal*, Vol. 110, Issue 462, 2000.
31. See the corresponding recent *OECD Economic Surveys*.

Table I.9. **Growth momentum and resilience in the larger OECD countries**

Fastest growing 1995-2002				Output gap			
Real GDP		Labour productivity		2002		Cumulative 2001-2004	
Per cent				*Per cent of potential GDP*			
Korea	5.3	Korea	4.4	Canada	0.2	Canada	0.2
Australia	3.8	United States	2.0	France	-0.2	France	-1.3
Canada	3.4	Australia	1.9	Australia	-0.3	Australia	-2.9
Spain	3.3	**Total OECD**	1.7	Spain	-0.8	Spain	-3.5
United States	3.2	Canada	1.5	*Euro area*	-0.9	United Kingdom	-3.8
Netherlands	2.9	Japan	1.4	Netherlands	-1.0	*Euro area*	-3.9
Total OECD	2.7	United Kingdom	1.4	United Kingdom	-1.0	Netherlands	-4.6
United Kingdom	2.7	France	1.0	**Total OECD**	-1.2	**Total OECD**	-4.8
Mexico	2.6	Italy	1.0	Germany	-1.3	Italy	-5.4
France	2.3	*Euro area*	1.0	United States	-1.5	Germany	-5.6
Euro area	2.2	Germany	1.0	Japan	-1.5	United States	-5.9
Italy	1.8	Spain	0.8	Italy	-1.6	Japan	-6.0
Germany	1.4	Netherlands	0.8				
Japan	1.2	Mexico	0.5				

Note: Comparable output gap estimates are not available for Korea and Mexico.
Source: OECD.

adjustment, aggravating the deterioration of the labour market and the depth of the slowdown. Given Germany's relative size, its lack of resilience has significant spillover effects to neighbouring EU countries, dragging down the performance of the euro area at large. In contrast, Korea sailed through the recent downturn at impressive speed, in large part thanks to the drastic structural reforms undertaken in the wake of the 1997 crisis.

To raise or uphold trend growth, structural reform is needed…

Thus, structural reform is important to improve resilience to shocks. It is also needed to bolster or maintain potential growth.[32] On current policies, growth can be expected to slow significantly over time in a number of OECD countries (see Appendix). This will exacerbate the fiscal pressures associated with ageing populations.[33] Stepping up structural reform, especially in the euro area and in Japan, will unlock latent potential, raise living standards and facilitate the absorption of these pressures.

… in labour markets…

Labour market reform progressed during the 1990s. However, unemployment rates continue to differ considerably across OECD countries, and employment rates vary even more, especially for older age groups, signaling that human resources are not fully used.[34] In the case of Japan, a recent study estimates that removing the impediments restricting labour mobility between firms and discouraging female labour force participation could push up total labour supply by 13 to 18 per cent and thereby raise annual GDP growth by nearly 1 percentage point for a decade.[35] In the

32. See Chapter V, "Structural policies and growth".
33. See Dang, T.T., P. Antolin and H. Oxley, "Fiscal implications of ageing: projections of age-related spending", *OECD Economics Department Working Papers,* No. 305, 2001.
34. See "Increasing employment: the role of later retirement", *OECD Economic Outlook,* No. 72, December 2002.
35. See Hiroshi, O. and M. Rebick, "Constraints on the level and efficient use of labor in Japan", in M. Blomström, J. Corbett, F. Hayashi and A. Kashyap (eds), *Structural Impediments to Growth in Japan*, University of Chicago Press, forthcoming. This would, however, imply a participation rate of 83 to 86 per cent, higher even than those currently observed in Nordic European countries.

case of Germany, a government-sponsored commission put forward a set of reform proposals focused on active labour market measures, which it is hoped could halve the unemployment rate within three years.[36] This may be an overstatement of their impact, given the limited scope of the proposals, but the government has since stated its intention to introduce more fundamental and wide-ranging reforms.

… product markets…

There is also ample scope in most OECD countries for product market improvements conducive to faster growth and higher standards of living. Recent OECD work shows how lowering entry barriers and improving the regulatory framework can enhance competition and raise multi-factor productivity (MFP). In the larger euro area countries and in Greece, where heavy regulation has widened the technology gap *vis-à-vis* best practice abroad, the removal of trade and administrative barriers might increase MFP growth in manufacturing by 0.1 to 0.2 percentage point over a considerable period. In addition, progressively bringing down barriers to entry in service sectors to the OECD-wide average could add 0.1 to 0.2 percentage point to overall business sector MFP growth in Greece, Italy or Portugal.[37] Recognising these potential gains, the European Commission is preparing a new action plan to speed up the completion of the single market for services. Tangible progress in the context of the Doha Round of trade liberalisation would work in the same direction.

… and capital markets

Addressing capital market shortcomings is also necessary to boost economy-wide growth and employment. In the United States, the focus has lately been on corporate governance reform and financial market regulations.[38] In Europe, the emphasis is on the implementation of the EU financial services and risk capital action plans, which are somewhat behind schedule. The benefits to be expected from further EU integration are significant: estimates of the macroeconomic impact of the associated reduction in the cost of equity, bond and bank finance point to a permanent EU-wide gain on the order of one percentage point for GDP and ½ percentage point for employment.[39] In Japan, financial system rehabilitation and reform is of course an indispensable element of a broader set of measures needed for the economy to pull out of stagnation and deflation, as stressed in many earlier editions of the *Outlook*.

36. See Hartz Kommission, *Moderne Dienstleistungen am Arbeitsmarkt*, Berlin, 16 August 2002, which is analysed further in the *OECD Economic Survey of Germany*, Paris, 2003.
37. The estimates quoted here come from Nicoletti, G. and S. Scarpetta, "Regulation, productivity and growth: OECD evidence", *OECD Economics Department Working Papers*, No. 347, 2003 and are subject to the usual caveats associated with econometric analyses.
38. See Box I.3 in *OECD Economic Outlook*, No. 72, December 2002.
39. See London Economics, *Quantification of the Macro-Economic Impact of Integration of EU Financial Markets*, Final report to the European Commission, November 2002. Another study finding substantial gains is Giannetti, M., L. Guiso, T. Jappelli, M. Padula and M. Pagano, "Financial market integration, corporate financing and economic growth", *European Economy*, Economic Papers, No. 179, 2002. For more details and references, see the *OECD Economic Survey of the Euro Area*, Paris, 2002.

Appendix: The medium-term reference scenario

The medium-term reference scenario shows area-wide growth of around 3 per cent

The medium-term reference scenario extends the current short-term projections to the end of 2008 (see Tables I.10 to I.12).[40] It is essentially driven by the supply side of economies. Growth in output for any country beyond 2004 is assumed to be a combination of growth in potential output and a contribution from the closing of the output

Table I.10. Medium-term reference scenario summary

Per cent

	Real GDP growth	Inflation rate[a]		Unemployment rate[b]		Current balance[c]		Long-term interest rate	
	2005-2008	2004	2008	2004	2008	2004	2008	2004	2008
Australia	3.8	2.6	2.3	5.8	5.5	-3.7	-3.1	6.3	6.5
Austria	2.6	1.1	1.0	5.9	4.7	0.3	0.4	4.4	5.7
Belgium	2.7	1.2	1.1	7.7	6.9	5.3	5.1	4.4	5.7
Canada	3.1	2.1	2.1	7.0	7.1	2.2	2.2	5.7	6.0
Czech Republic	2.8	2.3	2.0	7.2	6.8	-5.1	-4.5	2.8[d]	6.0[d]
Denmark	2.2	2.3	2.0	4.4	4.7	3.6	3.6	4.5	5.6
Finland	2.3	1.5	1.4	9.0	8.0	7.2	5.3	4.5	5.7
France	2.1	1.4	1.3	9.2	8.8	2.2	2.3	4.4	5.6
Germany	2.0	0.4	0.8	8.3	7.0	3.2	3.4	4.3	5.5
Greece	3.1	3.4	2.8	9.1	9.0	-5.8	-5.7	4.4	5.7
Hungary	4.3	4.5	3.0	6.4	6.1	-3.8	-4.0	7.3[d]	7.5[d]
Iceland	2.8	2.6	2.5	3.0	3.0	-0.9	-0.9	8.0	6.0
Ireland	4.0	3.2	2.8	5.2	5.1	0.8	0.8	5.3	5.5
Italy	2.3	1.9	1.5	8.9	8.6	0.0	0.0	4.5	5.7
Japan	1.7	-1.6	-1.6	5.7	3.9	3.9	4.1	1.1	1.7
Korea	5.2	3.3	3.1	3.0	3.0	0.2	0.3	6.7	6.7
Mexico	4.3	3.5	3.0	2.4	2.3	-2.8	-3.0	8.8	8.6
Netherlands	2.4	1.3	1.2	5.0	3.5	2.5	2.1	4.4	5.6
New Zealand	3.0	2.0	2.0	5.3	5.4	-4.6	-4.3	6.2	6.5
Norway	1.6	1.6	2.0	4.6	3.6	13.2	12.0	5.7	7.0
Poland	4.1	2.3	2.2	19.9	16.5	-4.5	-4.3	6.0[d]	6.0[d]
Portugal	2.9	2.2	2.0	6.3	3.8	-5.5	-4.6	4.5	5.7
Slovak Republic	4.2	6.1	5.1	16.8	14.8	-6.1	-5.8	7.7	6.5
Spain	3.1	2.4	1.9	11.7	9.4	-3.2	-3.3	4.2	5.5
Sweden	2.3	1.7	2.0	4.3	4.5	4.4	4.4	4.8	5.5
Switzerland	1.5	0.3	0.4	3.4	1.8	12.2	11.8	2.4	3.1
Turkey	4.7	17.1	10.9	10.6	9.5	-2.6	-2.0	19.0	14.4
United Kingdom	2.6	1.0	2.0	5.2	5.1	-2.0	-1.9	5.1	5.5
United States	3.5	1.2	1.0	5.8	5.0	-5.5	-5.6	5.0	5.8
Euro area	2.4	1.4	1.3	8.7	7.6	1.4	1.4	4.4	5.6
European Union	2.4	1.4	1.4	7.9	7.1	0.9	0.9	4.5	5.6
Total of above OECD countries	2.9	1.1[e]	1.0[e]	7.0	6.0	-1.2	-1.3	4.4[e]	5.2[e]

Note: For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*
a) Percentage change from the previous period in the private consumption deflator.
b) Per cent of labour force.
c) Per cent of nominal GDP.
d) Short-term interest rate.
e) Excluding Turkey.
Source: OECD.

40. Assumptions underlying the medium-term reference scenario are outlined in Box I.5.

Table I.11. **Fiscal trends in the medium-term reference scenario**

As a percentage of nominal GDP

	Financial balances[a]		Net financial liabilities[b]		Gross financial liabilities[c]		Gross public debt (Maastricht definition)[d]	
	2004	2008	2004	2008	2004	2008	2004	2008
Australia	0.5	0.1	4	2	20	18	..	..
Austria	-1.1	-0.4	49	44	66	61	66	61
Belgium	0.2	0.8	90	74	99	83	99	83
Canada	1.0	1.0	34	24	75	65	..	..
Czech Republic	-6.2	-4.5	..	..	..	..	..	..
Denmark	1.9	2.2	2	-6	48	39	42	34
Finland	2.9	2.6	-47	-49	45	42	40	38
France	-3.3	-3.3	44	50	71	75	64	67
Germany	-3.3	-2.7	52	58	67	72	65	71
Greece	-0.7	-1.0	..	..	99	88	99	88
Hungary	-5.0	-3.3	..	..	..	..	..	..
Iceland	0.1	0.6	23	19	43	39	..	..
Ireland	-1.2	-1.0	..	..	31	29	31	28
Italy	-2.8	-2.8	94	90	118	115	105	103
Japan	-7.8	-7.6	89	119	164	194	..	..
Korea	3.9	3.7	-39	-42	19	29	..	..
Netherlands	-2.0	-0.3	42	39	53	50	53	50
New Zealand	0.5	0.9	17	11	38	39	..	..
Norway	10.7	9.6	-100	-122	20	22	..	..
Poland	-5.9	-3.8	..	..	..	..	..	..
Portugal	-2.7	-1.1	..	..	59	54	59	54
Slovak Republic	-5.1	-3.5	..	..	..	..	..	..
Spain	-0.2	0.3	36	28	63	55	52	47
Sweden	1.2	1.2	-6	-9	58	55	52	49
United Kingdom	-2.2	-1.6	30	32	52	54	41	45
United States	-4.2	-2.4	49	51	66	68	..	..
Euro area	-2.4	-1.9	56	56	76	76	70	70
European Union	-2.2	-1.8	50	50	73	72	66	67
Total of above OECD countries	-3.5	-2.6	51	56	81	86		

Note : For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

a) General government fiscal surplus (+) or deficit (-) as a percentage of GDP.

b) 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.

c) 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.

d) Debt ratios are based on debt figures for 2002, 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.

gap. Growth in potential for the OECD as a whole is expected to slow to below 2½ per cent *per annum* over the period, falling more substantially for some countries in the later years. This slowing reflects the combined effects of a decrease in trend growth of the labour force, partly offset by small increases in trend labour productivity growth.

Unemployment falls, inflation remains low, but fiscal deficits persist

Since most OECD economies are forecast to be operating well below output potential in 2004, the closing of output gaps implies that growth in subsequent years exceeds estimated potential. OECD-wide real GDP is projected to expand at close to 3 per cent *per annum* over the period. The area-wide rate of unemployment drops to

Table I.12. Growth in potential GDP 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[a]					
								Potential labour force participation rate		*Working age population*		*Structural unemployment*[b]	
	2004	1996-2004	2005-2008	1996-2004	2005-2008	1996-2004	2005-2008	1996-2004	2005-2008	1996-2004	2005-2008	1996-2004	2005-2008
Australia	-1.4	3.8	3.5	2.0	2.4	1.7	1.1	0.1	0.0	1.4	1.0	0.2	0.0
Austria	-2.5	2.3	2.0	1.9	1.9	0.4	0.1	0.1	0.1	0.3	-0.1	0.0	0.1
Belgium	-2.4	2.1	2.1	1.2	1.5	0.9	0.5	0.5	0.2	0.2	0.3	0.2	0.0
Canada	0.2	3.3	3.2	1.6	2.0	1.7	1.2	0.3	0.1	1.2	1.0	0.2	0.0
Denmark	-0.3	2.3	2.1	2.0	2.0	0.3	0.1	-0.1	0.0	0.2	0.1	0.2	0.0
Finland	-0.4	2.8	2.2	2.1	1.9	0.6	0.3	0.1	0.0	0.3	0.2	0.3	0.1
France	-0.8	2.2	1.9	1.3	1.5	0.8	0.4	0.3	0.0	0.3	0.4	0.2	0.1
Germany	-2.0	1.5	1.5	1.2	1.3	0.2	0.2	0.4	0.3	-0.1	-0.2	-0.1	0.1
Greece	1.1	3.1	3.4	2.5	3.0	0.6	0.4	0.5	0.2	0.2	0.0	0.0	0.1
Iceland	0.7	2.9	3.1	1.6	2.0	1.2	1.0	0.0	0.0	1.3	0.9	-0.1	0.1
Ireland	2.1	7.1	4.5	3.6	3.1	3.3	1.3	0.7	0.2	1.8	0.9	0.8	0.1
Italy	-1.5	1.8	1.9	1.3	1.5	0.4	0.4	0.4	0.5	-0.1	-0.1	0.2	0.1
Japan	-2.0	1.3	1.1	1.2	1.2	0.1	-0.1	0.4	0.3	-0.2	-0.4	-0.1	0.0
Netherlands	-2.4	2.8	1.8	1.2	1.1	1.5	0.6	0.8	0.2	0.4	0.4	0.3	0.0
New Zealand	0.3	3.1	3.1	1.4	1.9	1.6	1.2	0.2	0.1	1.2	1.0	0.2	0.0
Norway	-0.3	2.6	2.0	1.7	1.5	0.9	0.5	0.1	0.0	0.6	0.5	0.2	0.0
Spain	-1.2	2.9	2.7	1.0	1.1	1.8	1.7	1.0	1.0	0.6	0.3	0.3	0.4
Sweden	0.0	2.3	2.3	2.1	1.8	0.3	0.4	-0.3	-0.1	0.5	0.6	0.1	0.0
Switzerland	-1.4	1.3	1.2	0.7	0.8	0.6	0.3	0.0	0.0	0.5	0.3	0.1	0.0
United Kingdom	-1.2	2.5	2.3	1.9	2.0	0.6	0.4	0.1	0.1	0.4	0.3	0.2	0.0
United States	-1.2	3.3	3.1	1.9	2.1	1.4	1.0	0.0	-0.1	1.3	1.0	0.0	0.0
Euro area	-1.5	2.1	2.0	1.3	1.4	0.7	0.5	0.4	0.3	0.2	0.1	0.1	0.1
Total OECD	-1.3	2.5	2.4	1.6	1.8	0.9	0.6	0.2	0.1	0.7	0.4	0.1	0.0

a) Percentage point contributions to potential employment growth.
b) 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.
Source: OECD.

around 6 per cent, while inflation remains broadly unchanged at 2004 levels. Despite fairly robust recovery, fiscal balances remain in significant deficit for the area as a whole. This reflects continuing large deficits for the major European economies and Japan, partially offset by gradual improvement for the United States.

Growth is robust in the United States beyond 2004…

Potential output for the United States is projected to grow at a little over 3 per cent over the medium term, with increasing growth in labour productivity being offset by declining growth in the working-age population and the labour force. With output below potential for much of the period, inflation continues at a low rate. The fiscal balance remains in substantial deficit, albeit improving over the period, reflecting both the cyclical improvement and the expiry of temporary tax breaks on business investment in late 2004. Overall, the deficit falls to around 2½ per cent of GDP by 2008.

Box I.5. Assumptions underlying the medium-term reference scenario

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

- Gaps between actual and potential output are eliminated by 2008 in all OECD countries.
- Unemployment returns to its structural rate (the NAIRU) in all OECD countries by 2008.[1]
- Commodity prices and most exchange rates remain broadly unchanged in real terms.
- Monetary policies are directed at keeping inflation low, or bringing it down 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),[2] or to follow medium-term programmes where these are well-defined parts of the institutional framework for fiscal policy.

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 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* 68, December 2000.
2. This implicitly assumes that the authorities take measures to offset underlying changes in primary structural balances.

… but more modest in Europe, where fiscal deficits persist

Within the euro area, potential output growth, averaging 2 per cent *per annum* beyond 2004, is much lower 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 2004 is similar to what is observed in the United States with a negative output gap of 1½ per cent of GDP. Overall, there is a significant contribution from the closure of the gap, leading to GDP growth of around 2½ per cent *per annum* over the period. Unemployment falls by almost one percentage point to around 7½ per cent, but inflation remains subdued. Despite the recovery, the fiscal deficit for the euro area as a whole remains at almost 2 per cent of GDP in 2008. The general government deficit is, at present policy settings, projected to remain slightly above 3 per cent of GDP for France, with rising public debt interest payments broadly offsetting the cyclical contribution from the closing of the gap.[41] Significant deficits also persist in Germany and Italy and, to a lesser extent, Greece and Ireland. With the exception of the United Kingdom, which also remains in significant deficit, the fiscal positions of other European Union member countries move steadily towards balance or remain in significant surplus.

In Japan, growth remains weak and the fiscal position unsustainable

Potential output growth in Japan is projected to slow, given declines in the working-age population and relatively slow growth in the capital stock and trend labour productivity. To close the output gap from 2004 levels, GDP growth accelerates to above 1½ per cent *per annum* and the unemployment rate falls by almost 2 percentage points to around 4 per cent. Deflation nonetheless persists over the period and interest rates remain low.[42] As a result, the public debt interest burden remains proportionally much lower than in other countries experiencing high levels

41. See Box I.5 and the main text for specific details of the underlying fiscal assumptions.
42. Assessing the relationship between the output gap and inflation is particularly difficult in the current Japanese deflationary environment. The judgement taken over the medium-term horizon is that the change in the output gap also has some effect on inflation, *i.e.* that the higher growth required to close the output gap balances the deflationary pressures arising from the output gap itself.

of public debt. Nonetheless, with continuing large structural fiscal deficits of up to 8 per cent of GDP, in part reflecting the ongoing fiscal costs associated with population ageing, public debt continues to accumulate at an unsustainable rate.

World trade grows robustly but current account imbalances persist

Given fairly robust GDP growth in the OECD area, growth in world trade, at around 8 per cent per annum, remains at around the historical average of the 1990s.[43] For the area as a whole, the current account balance remains in small deficit over the medium term although, in the absence of major changes in potential growth rates or trade openness and at broadly unchanged real exchange rates, there is little overall adjustment in the current external imbalances between regions. For the euro area, the current account remains in surplus at around 1½ per cent of GDP; the US deficit stabilises at around 5½ per cent of GDP, with an increasing outflow of investment income as net foreign debt continues to accumulate, while Japan remains in a position of large surplus, at around 4 per cent of GDP.

43. In part, this reflects robust underlying growth for China and the dynamic Asian economies.

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Conventional signs

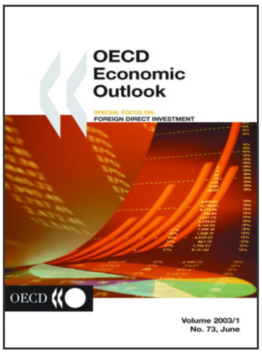
$	US dollar	.	Decimal point
¥	Japanese yen	I, II	Calendar half-years
£	Pound sterling	Q1, Q4	Calendar quarters
€	Euro	Billion	Thousand million
mbd	Million barrels per day	Trillion	Thousand billion
. .	Data not available	s.a.a.r.	Seasonally adjusted at annual rates
0	Nil or negligible	n.s.a.	Not seasonally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

Summary of projections[a]

	2002	2003	2004	2002 I	2002 II	2003 I	2003 II	2004 I	2004 II
				Percentage changes from previous period					
Real GDP									
United States	2.4	2.5	4.0	3.5	2.7	1.7	3.8	4.1	3.8
Japan	0.3	1.0	1.1	1.0	3.5	0.0	0.6	1.2	1.4
Euro area	0.9	1.0	2.4	1.1	1.1	0.9	1.4	2.6	2.9
European Union	1.0	1.2	2.4	1.2	1.4	1.0	1.5	2.6	2.8
Total OECD	1.8	1.9	3.0	2.5	2.4	1.4	2.4	3.2	3.2
Real total domestic demand									
United States	3.0	2.8	4.0	4.2	3.3	2.1	3.8	4.2	3.8
Japan	-0.3	0.5	0.4	-0.4	3.2	-0.6	-0.2	0.5	0.7
Euro area	0.3	1.1	2.4	0.4	1.0	1.0	1.5	2.6	2.9
European Union	0.7	1.3	2.5	0.7	1.5	1.1	1.6	2.8	3.0
Total OECD	1.9	2.0	2.9	2.4	2.8	1.4	2.4	3.1	3.1
				Per cent					
Inflation[b]									
United States	1.1	1.6	1.3	0.9	1.3	2.0	1.2	1.5	1.3
Japan	-1.7	-2.2	-1.8	-1.7	-2.6	-2.1	-1.8	-1.8	-1.8
Euro area	2.4	1.9	1.7	2.5	2.1	1.9	1.8	1.6	1.6
European Union	2.5	1.9	1.8	2.8	2.1	1.9	1.9	1.8	1.8
OECD *less* Turkey	1.4	1.3	1.2	1.5	1.2	1.5	1.2	1.2	1.2
Total OECD	2.1	1.7	1.4	2.0	1.7	1.9	1.5	1.4	1.3
				Per cent of labour force					
Unemployment									
United States	5.8	6.0	5.8	5.7	5.8	6.0	6.1	5.9	5.7
Japan	5.4	5.7	5.7	5.3	5.4	5.6	5.8	5.7	5.7
Euro area	8.2	8.8	8.7	8.1	8.3	8.7	8.8	8.8	8.6
European Union	7.6	8.0	7.9	7.5	7.7	8.0	8.1	8.0	7.9
Total OECD	6.9	7.2	7.0	6.8	7.0	7.1	7.2	7.1	6.9
				Per cent of GDP					
Current account balance									
United States	-4.8	-5.4	-5.5	-4.6	-5.0	-5.4	-5.4	-5.5	-5.5
Japan	2.8	3.1	3.9	3.0	2.6	2.9	3.4	3.8	4.1
Euro area	1.1	1.4	1.4	0.9	1.3	1.3	1.4	1.4	1.4
European Union	0.9	1.0	1.0	0.7	1.0	1.0	1.0	1.0	0.9
Total OECD	-1.1	-1.2	-1.2	-1.0	-1.1	-1.2	-1.1	-1.1	-1.1
				Per cent					
Short-term interest rate[c]									
United States	1.8	1.4	3.0	1.9	1.6	1.3	1.4	2.6	3.5
Japan	0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Euro area	3.3	2.3	2.3	3.4	3.3	2.5	2.1	2.1	2.5
				Percentage changes from previous period					
World trade[d]	3.6	5.9	8.8	5.9	7.9	4.1	7.5	9.3	9.4

Note: Apart from unemployment rates and interest rates, half-yearly data are seasonally adjusted, annual rates.
a) Assumptions underlying the projections include:
- no change in actual and announced fiscal policies;
- unchanged exchange rates as from 26 March 2003; in particular 1$ = 120.10 yen and 0.936 euros;
- the cut-off date for other information used in the compilation of the projections is 4 April 2003

b) GDP deflator.
c) United States: 3-month eurodollars; Japan: 3-month CDs; euro area: 3-month interbank rates. See box on policy and other assumptions underlying the projections.
d) Growth rate of the arithmetic average of world merchandise import and export volumes.
Source: OECD.



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