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REGAINING MOMENTUM DESPITE OIL TURBULENCE

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Since the 2001 slowdown, the world economy has moved in fits and starts and economists as well as the general public are now longing for a smooth and sustained recovery, undisturbed by chronic geopolitical risks or abrupt gyrations in oil prices and financial markets.

Although economic fortunes have been contrasting over the past few quarters, with the United States forging ahead, East Asia slowing but from a rapid pace, and Continental Europe plodding along, households seem to have been lacking confidence OECD-wide. This pervasive sense of uncertainty has proved somewhat contagious since after a year of record growth in world trade, business confidence has fallen back to just above the historical average in the United States and Europe, dashing hopes that GDP would keep growing above trend over the next few months.

Compared to cautiously upbeat assessments that could be made even two months ago, this turnaround has been a source of disappointment. It has been prompted in large part by a surge in oil prices that has depressed real incomes as well as confidence in the OECD countries. There are nonetheless good reasons to believe that despite recent oil price turbulence, the world economy will regain momentum in a not-too-distant future. Supported by strong balance sheets and high profits, the recovery of business investment should continue in North America and start in earnest in Europe, while consumer spending will benefit from the recent retreat of oil prices to less onerous levels, in a context where job creation is progressively strengthening and monetary conditions remain very accommodative. All in all, there are still some good grounds to expect OECD economies to grow again above trend in the course of 2005 and 2006.

From a geographical perspective, the momentum of this recovery will benefit from continued Asian dynamism, in China, where activity accelerated in the third quarter, following a desirable slowdown during the first half of the year, and Japan, which has staged a spectacular comeback based on a renewed export drive, broadening into a recovery of investment, employment and finally consumption, before marking a pause over the past few months. The strength of this recovery will also be enhanced by positive developments in North America. But it remains to be seen whether Continental Europe will play a strong supportive role through a marked upswing of final domestic demand.

On the latter issue, this *Outlook* takes a reasoned but positive bet on Europe. It tables a significant pick-up of final domestic demand in the euro area in 2005-06, while world trade and OECD output would not accelerate over the period. Continental Europe, and more specifically, Germany, would thus have to find enough of an autonomous momentum to achieve a higher relative growth path. For this scenario to materialise, a modicum of stability in oil prices and exchange rates is required, which would allow a traditionally weakly resilient euro area to start catching up with the fast growing economies of the OECD.

A strong appreciation of the euro, in a context of worsening external imbalances, or further rises in oil prices, may thus bear disproportionately on Continental Europe, where growth is still over-reliant on exports and high oil prices do not find their counterpart in high output growth and energy demand.

However, Europe might not be at such a disadvantage, compared with the rest of the OECD, in coping with higher oil prices. Should an additional oil shock hit, the OECD countries, including euro area members, would be less vulnerable than in the past. First, dependence on oil, expressed as a share of GDP, has been halved since the 1970s, leading to a much lower income burden than in the past for households and businesses alike. Also, and more importantly, inflation expectations are now low and well anchored, so that rising oil prices have only impacted so far on headline inflation while nominal wages and core inflation barely budged. It would thus be very surprising if OECD countries were to suffer again, as they did in the 1970s, from a nightmarish situation where wages and prices are spiralling out of control and central banks are forced to switch into severe “tightening mode”.

Nonetheless, when it comes to the impact of oil price shifts, economic agents’ perceptions and economists’ received wisdom do not seem to coincide. While estimates derived from econometric models signal a rather modest impact on output and inflation, oil price fluctuations take centre stage in the public debate and strongly influence economic confidence.

In this context, it was natural to devote a special chapter of this *Outlook* to the economics of oil. To better understand why oil matters, it is necessary to go beyond the short run. In a world where people are more “forward-looking”, uncertainty about future oil prospects may have more of an impact on the current economic situation than, say, month-to-month changes in market prices.

Here OECD expertise suggests that recent oil prices were certainly well above long-term equilibrium levels, even allowing for strong market power on the part of the OPEC cartel. There are still important resources available on the supply side, especially among

OPEC producers to match increasing demand for oil, and the efficiency of existing facilities could be significantly improved. Furthermore, alternative sources of energy may already become profitable at current prices.

This does not mean, however, that oil prices will quickly fall back to the low levels which prevailed three or four years ago. First, the fall may not be rapid in a context where strong geopolitical uncertainty and high price volatility inhibit investment in new oil facilities. Second, looking past the current situation, oil prices will retreat somewhat but are likely to remain higher than during the 1990s.

In this world of durably more expensive oil, demand emanating from dynamic emerging economies will play a strong role in shaping future prices. The importance of emerging economies stems not only from their increasing contribution to world growth but also and more importantly from the fact that for a given increase in activity their demand for oil is far larger than the OECD average. Indeed, future oil prices will crucially depend on further progress in energy conservation in emerging economies as well as the United States.

Prudent management of non-renewable natural resources is not the only issue that matters for the long-run sustainability of OECD societies. Putting public finances in order is also of vital importance for the well-being of future generations. In line with previous editorials, it bears repeating that, given existing budgetary plans, most of the largest OECD countries will see no substantial progress in bringing down structural deficits. This is regrettable in a context where pension and health care reforms are generating painful debate, and thus progressing with difficulty.

It might be hoped, of course, that prudent private agents would react to public profligacy by stepping up their own saving efforts and there certainly is evidence pointing in this direction. This is indeed the message delivered by the special chapter devoted in this *Economic Outlook* to the long-term impact of fiscal policies. But, as a general rule, private saving does not fully offset public dissaving and this precautionary reaction may be contingent on national and historical circumstances. It is, for instance, hardly discernible in the case of the United States.

At the end of the day, the role of fiscal policy is not to add to the financial pressures arising from ageing populations. It is rather to relieve them, and thus take advantage of the ongoing recovery to finally implement gradual but far-reaching retrenchment.

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