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Summary in English

ACHIEVING FURTHER REBALANCING?

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In its *Economic Outlook* last Autumn, the OECD took the view that the US slowdown was not heralding a period of worldwide economic weakness, unlike, for instance, in 2001. Rather, a “smooth” rebalancing was to be expected, with Europe taking over the baton from the United States in driving OECD growth.

Recent developments have broadly confirmed this prognosis. Indeed, the current economic situation is in many ways better than what we have experienced in years. Against that background, we have stuck to the rebalancing scenario. Our central forecast remains indeed quite benign: a soft landing in the United States, a strong and sustained recovery in Europe, a solid trajectory in Japan and buoyant activity in China and India. In line with recent trends, sustained growth in OECD economies would be underpinned by strong job creation and falling unemployment.

Recent “hard data”, as well as consumer and business confidence, suggest that in the euro area a vibrant German-led recovery has remained on track, despite a large VAT hike at the start of this year. Interestingly, the so-far lagging Italian economy has been sharing in the upswing, notwithstanding the volatility of the quarterly accounts. All told, the recovery in Germany and Italy in 2006-07 is set to be much stronger than initially expected.

In the United States, the incoming data suggest that, following a weak first quarter, economic activity should gradually regain momentum. Sustained job and labour income growth should provide the basis for a progressive return to economic normality, while excess supply of housing is being gradually worked off.

In China, the authorities are struggling to contain business investment with a view to reining in the pace of the economic expansion, which at over 11% most recently may have exceeded the speed limit. Such buoyancy should provide solid support both for the ongoing Japanese export-led expansion and other trading partners.

The rebalancing is not without risks, however. To be sure, stronger growth in the hitherto weaker OECD economies is to be warmly commended. But going forward, several other sources of imbalance may still be standing in the way of sustained and steady growth. On the monetary front, there is a risk that, in many places, the balance between aggregate demand and supply has already started shifting towards overheating, at a time when the appetite for fiscal tightening may be waning. Looking further ahead, there is also little sign that, once adjusted for cyclical influences, current account imbalances have retreated in the United States, while they are getting even more pronounced in countries such as China and Japan, where time and again household demand seems to be lagging behind.

Imbalances may have developed in financial and housing markets too. As a general rule, spreads on risky bonds are close to historical lows and for a range of financial assets OECD analysis suggests that risk may be under-priced. Equity prices may be somewhat on the high side, for example, although current potential overvaluation in stock markets pales in comparison with the excesses that prevailed in the late 1990s. Last but not least, housing investment is at ten-year highs in many OECD countries. Assessing more precisely the extent of such remaining imbalances is of some importance to gauge the uncertainties surrounding our smooth rebalancing scenario.

In the US case, the diagnosis is tricky. On the one hand, the issue may just be one of an over-extended housing market still in need of correction. But such a sanguine assessment may need to be qualified in at least two ways. First, recent housing developments may point to the risk of a slower overall recovery. Compared to previous OECD forecasts, the housing sector has cooled somewhat more than expected, leading to a disquieting build-up in the stock of unsold housing. Second, the slowdown of the US economy could turn out to be of a broader nature. It might involve a mild form of stagflation, with weaker trend productivity and output growth than assumed heretofore translating into more overheating. Weaker prospects for long-term growth would help to explain, for instance, why inflation has been more persistent than expected and why business investment faltered recently, despite ample profits and still favourable financial market conditions.

The amount of residual economic slack is also uncertain in some of the other main OECD regions, notably in Continental Europe and the United Kingdom. This constitutes a challenge for central banks which, on both sides of the Atlantic, should probably err on the side of tightness.

In the United States, with core inflation still higher than desired and unemployment below most estimates of its sustainable level, there is a case for keeping a slightly restrictive monetary stance and not cutting policy rates in 2007. There may even be a case for additional tightening in the United Kingdom, should inflationary pressures persist, and more clearly so in the euro area, where core inflation has essentially reached the 2% mark, while activity is set to continue to expand vigorously.

In Japan, by contrast, where deflation has not yet been rooted out and economic slack may be larger than expected, policy rates would need to remain on hold for some time.

Fiscal policy has a role to play in smoothing out the current economic upswing, in improving the long-term sustainability of public finances in most OECD countries, and in providing enough scope for automatic stabilisers to act in the next downturn. Policymakers are facing treacherous waters, however. On the positive side, public deficits

have finally been shrinking, in most OECD countries, over the past two or three years. However, consolidation has been overly reliant on cyclical revenue gains rather than on lasting spending restraint. Looking forward, decisive reductions in structural deficits appear both highly desirable and rather unlikely. But, given the high stakes, there is at the very least a need to avoid, over the next few years, the unravelling of past fiscal consolidation.

In such a challenging context, policymakers need to save current tax windfalls, so that fiscal policy does not exacerbate, in the short run, the present economic upswing while preventing, in the long run, the repeat of those depressing “post-boom” budgetary crises of the past. But spending pressures will be extremely strong, given the considerable magnitude of the unforeseen capital and corporate tax receipts. Sticking to tight spending plans and waiting long enough before contemplating new tax cuts should be the “categorical imperative” for forward-looking policymakers.

Against this worrying backdrop, this *Economic Outlook* incorporates a special chapter on the political economy of fiscal consolidation, trying to infer from past experiences the policies and institutional factors that underpin successes and failures. This work yields challenging conclusions. It suggests, for instance, that successful and lasting consolidations often emerge from fiscal crisis and work better when conducted from the expenditure side. It also underlines the useful role that can be played by fiscal rules, in particular those that include a focus on expenditure control alongside budget-balance rules. Even so, there are probably no mechanical means to lock in fiscal consolidation. In the current circumstances, characterized by buoyant activity and large revenue increases, what is needed, ultimately, is political will and strong leadership.

Political will and collective wisdom will also be needed to achieve a successful conclusion of WTO negotiations. The potential costs of stalling trade integration, possibly followed by various sorts of backpedalling, could be of unforeseen magnitude. With so much emphasis in the public arena put on the drawbacks of globalisation, one may easily lose sight of the multifaceted gains arising from a more integrated world. This is indeed the central message of our second special chapter entitled “Making the most of globalisation”. It reviews, from a long-term perspective, both the potential benefits and the economic and social challenges stemming from globalisation, and highlights the importance of public policies for effectively translating the huge potential of globalisation into shared well-being.

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