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Let me start by summarising the main messages of this Economic Outlook:

- The recovery is strong worldwide;
- But it is not yet evenly shared. It remains elusive in Continental Europe and has not yet fully benefited labour in the US;
- We expect this recovery, however, to broaden progressively to Europe and to end the so-called "jobless recovery" in the US;
- This recovery is not without risks. I'd like to single out three of them today: the risk of an excessive divergence in economic growth across the world, the risk of an abrupt rise in long-term interest rates because of exceedingly high public deficits and, more recently, resurging geopolitical risk;
- Of course, these risks could be alleviated through appropriate responses in terms of monetary, fiscal and structural policies.

**I. The recovery is strong and should remain so in 2005**

**A. It is obviously very strong currently with North America and Asia racing ahead**

In Asia, the Chinese economy has been cruising at 9% a year or more and is now close to overheating. Japan and Korea have taken advantage of the Chinese investment boom to boost their exports of capital goods.

But the recovery in Japan has gone well beyond the mechanical impact of higher exports. It has involved a strong recovery of business investment and a pick-up in consumption.

It's a bit early to tell, but Japan may well be on its way out of deflation after years of efforts to restructure its economy.

In the US, the investment slump is now history and economic activity is surging ahead. We expect growth to reach 4.5% during the first half of 2004 and approximately the same figure for the year as a whole. In these circumstances, we expect that, by the beginning of 2005, there will be no more slack in the US economy.

Altogether, we expect growth for the whole OECD to reach 3.5% in 2004 against 2.2% only in 2003. To give just another headline figure: in the OECD, in 2004, 17 countries out of 30 should be growing at rates close to or above 3% a year: 4 members in Australasia, 3 from North-America, 10 from Europe, of which 3 from the euro-zone (Ireland, Greece and Spain).

## **B. We expect this recovery to be sustained in 2005**

Growth in the OECD at large would still settle in the neighbourhood of 3.5%, despite a progressive tightening of monetary policy in English-speaking countries, as well as less expansionary fiscal policies. In the English-speaking countries again, household spending would decelerate progressively while investment would accelerate and take over the baton. What we would have then is a textbook case in economic stabilisation, with household spending playing a very effective role in supporting activity in the bad times and cooling it in the good times.

In large Continental European countries, business investment and household spending took a dive over the past few years and they should both recover in 2004 and 2005.

In our scenario, inflationary pressures would remain relatively subdued. In 2005 inflation would stabilise around 2% in the US and the UK and 1.5% in the euro zone. This outcome is based however on the assumption of oil prices stabilising at 32\$ a barrel (Brent) rather than 37\$ as of last Friday close of business.

## **II. The recovery is not yet evenly shared**

It has been elusive in Continental Europe. While Asia and North America are racing ahead, Germany and Italy are still struggling to revive their economies. In Germany, the difficulties stem from a surprisingly persistent weakness in domestic demand, while in Italy problems are situated on the export side, in a context of continuous losses in cost competitiveness.

Moving to the US, we know that until recently growth did not translate into strong job creations or accelerated wages. This "jobless and income-less" recovery has had a depressing effect on consumer confidence. It has also nurtured a lively debate about the role of job outsourcing away from the US. As in other OECD countries, these disappointing developments in labour markets have been associated with rising protectionist pressures.

What I wanted to state again this morning is that if you look at the figures, outsourcing is of smallish magnitude compared to the number of jobs that are naturally destroyed in the US economy every year. Outsourcing may be a useful scapegoat but it does not explain why job creation has been lower than expected. The most likely explanation is rather a boring and cyclical one. During the years of irrational exuberance, the US economy not only experienced over-investment but also too many hirings. And time may have been needed to work off past excesses.

## **III. At the OECD we nonetheless think that difficulties will recede in the near future**

With strong world markets, and provided the euro remains relatively stable, a progressive recovery should develop in the euro area, with growth reaching 1.5% in 2004 and 2.4% in 2005. So at the end of the day the rising tide of the world economy would lift the European boats.

Although welcome, this European recovery would still leave a lot of slack in the economy in 2005. With effective demand still 2% below production capacities for the year as a whole.

In the US now, the return to strong job creation over the recent months is signalling, in our opinion, the end of the jobless recovery.

**IV. What are the main risks associated with this Economic Outlook?** I mentioned them already:

- Excessive divergence in economic growth across the world economy;
- An abrupt rise in long-term interest rates because of exceedingly high public deficits;
- Resurging geopolitical risks.
- **Excessive divergence in economic growth**

This risk would stem from macroeconomic policies remaining expansionary for too long and pushing growth too far, both in the US and in the UK.

In Continental Europe to the contrary, the risk is one of being caught in a “low confidence/low activity” trap;

This growth divergence would be associated with ever-widening current account imbalances, which could in turn trigger exchange rate instability and mounting protectionist pressures.

**Excessive public deficits would compete for funding with private investment.** This would send interest rates up and crowd out private investment. It would be bad for long-term growth.

- **Resurging geopolitical risks.**

In a way, this Economic Outlook has been badly timed for our tranquillity. When we went to press, oil prices were rising, seemingly for a variety of reasons:

- Worries about the security of oil fields and oil transportation;
- Worries about adverse tactics from OPEC, such as an ill-timed tightening of supply;
- Worries about excess demand from overheating and energy-intensive economies such as China.

Should oil prices move up very strongly, it would have negative consequences for both inflation and growth. But one should avoid over-reacting. We have seen in the past comparable and short-lived oil price spikes.

So where do we stand? As I said, prices went up recently to 37\$. This is 5\$ above our 32\$ oil price assumption. According to our simulations, it would reduce GDP by 0.2 points for the OECD as a whole and increase inflation by 0.2% for one year. These are adverse consequences but of modest magnitude.

It does not mean of course that there are no tensions in oil markets and that we should not remain vigilant. But, as of now, the shock seems manageable. We also need to remember that at 32\$ the barrel, the Brent was not particularly expensive. Expressed in dollar terms, it was of course 28% above the trough it reached in the aftermath of the Iraq war. But expressed in a larger basket of currencies, such as SDRs, it had not increased at all since the end of the Iraq war.

#### **IV. Policy implications of this Outlook**

##### **1. Monetary policy should be flexible**

- It should tighten sooner than later in many English-speaking countries where activity is very strong;

- It should remain very accommodating in Japan as long as deflation is not uprooted;
- It should remain accommodating too in Continental Europe, given that the large European economies are still sluggish and inflationary pressures should remain relatively subdued in the future.

There may even be a case for a further cut in short-run interest rates, unless the recent rise in oil prices degenerates into a fully-fledged oil shock.

## **2. On the fiscal side, there is a need for retrenchment worldwide:**

- In Europe and Japan, it should proceed at a progressive pace, but without discontinuity. In the US, it should intervene soon and decisively.

## **3. Structural policies and reforms**

There is a need in Continental Europe to take stock of the rather disappointing past performance, both in terms of potential growth and short-run resilience. A need to take stock and to draw policy lessons for the future.

We think that some policy changes may be useful:

- Fiscal policy should be run very differently;
- Reforms should be pursued on labour markets, most notably to reduce their degree of dualism and make them less fragile;
- More thought should be given to improving the flexibility of mortgage and housing markets. In those countries where mortgage markets are well developed, housing markets have played a substantial role in ensuring economies remain resilient to shocks. Conversely, it seems that most of the resilient countries have benefited from flexible mortgage markets.

We already knew that well-functioning mortgage markets are good for long-term economic welfare. They may be good for short-run resilience too. We have appended a special chapter to the Economic Outlook on this issue.

We have also produced three other special chapters: on the economic consequences of an unwinding of present current account imbalances; on how best to measure cyclically adjusted public deficits; and EU enlargement. I can come back to these later in the discussion.

So, to conclude this presentation, the global recovery seems now well engaged but it will take better structural and macroeconomic policies for it to truly extend worldwide and for a solid confidence climate to be re-established. It is especially important for instance to make further progress on the Doha Round and to better prepare for demographic ageing. Actually these two issues are at the core of our next Ministerial meeting taking place this week.