

WORLD ECONOMIC PROSPECTS

The global economy has gained considerable strength since mid-2003. The recovery is led by the United States, as often in the past, but also benefits from a rebound of Japan and the United Kingdom. By contrast, output growth has been weak until now in the euro area, in particular in large countries where consumer sentiment is depressed. The *OECD Economic Outlook* projects an expansion that broadens progressively, with growth exceeding 3% this year and next. The recovery will reduce much of the OECD output gap by late 2005. Even though vulnerabilities persist, downside risks have abated and the upturn is expected to be sustained.

Recovery has considerable momentum in US

In the United States, the expansion has gathered considerable momentum. Household spending continues to be robust, thanks to the support from low interest rates, income tax rebates and rising housing wealth. Business investment is rebounding in an environment of increasing corporate earnings and easy financial conditions. Exports benefit from world trade expansion and a weaker exchange rate. Looking ahead, output should continue to grow somewhat above potential in the near future, helping to close the output gap next year.

The projected reduction in resource slack makes desirable an early withdrawal of policy stimulus. Nominal short-term interest rates have long remained at or near historical lows and a gradual move towards a more neutral monetary policy stance would be consistent with the narrowing of the output gap. As well, medium-term fiscal consolidation would be advisable. Despite the recovery, the fiscal imbalance remains very large and is not expected to improve decisively on current trends, which could contribute over time to a rise in long-term interest rates.

Genuine upturn seems to be unfolding in Japan

In Japan a genuine, if somewhat irregular, recovery seems to be in train and is projected to continue. In contrast to the past two upturns, the current expansion is unfolding without the benefit of a large fiscal stimulus. Private demand has regained strength, in particular business investment which has been boosted by higher profitability. Exports are growing at double-digit rates thanks to strong intra-Asian trade, in particular with China.

Nonetheless, several underlying fragilities remain, including weaknesses in the financial sector, and monetary policy needs to continue to focus on ending deflation. The monetary policy strategy of quantitative easing has helped in this respect and should continue until the risk of deflation has become negligible. On the fiscal side, the expected decline in the budget deficit this year and next is welcome. As well, the time seems ripe to plan a more ambitious medium-term consolidation. This would help to re-establish confidence and slow the increase in public debt.

Prospects more uneven in euro area

In contrast to other regions, activity remains weak in the euro area, particularly in Germany and Italy where growth has been anæmic. While exports benefit from strong world trade expansion, consumer sentiment remains depressed, savings rates are high and rising and private consumption is sluggish. Nonetheless, a recovery is projected to unfold in the euro area later this year and next, as the buoyant international environment continues to support exports and eventually exerts traction on domestic demand. In the course of next year, real gross domestic product (GDP) growth should have built sufficient momentum to start reducing the output gap. This outlook is consistent with further disinflation and some loosening of monetary conditions.

By contrast, with a growing number of European countries experiencing large structural public deficits, vigorous fiscal retrenchment seems necessary and should start as soon as economic activity has achieved enough momentum. There is generally neither scope nor need for fiscal stimulus.

Risks arise from persistence of large current account imbalances

Even though a sustained expansion seems likely, vulnerabilities may materialise and cloud the outlook. An issue of concern in the international economy is the very large current account imbalances prevailing in several countries, particularly in the United States, and the international effects of their possible adjustment. Contrary to past experience, the US current account deficit did not recede during the downturn and is unlikely to materially decline at the 2005 horizon. Given the magnitude of the imbalance, various scenarios may well materialise that would involve significant effects. A sharp unwinding of the current account deficit could have a negative impact on economic activity outside the United States, although such effects depend on circumstances and policies.

Risks arise from possible adverse bond market reaction

Another possible source of fragility is the unusually low levels of risk premia, especially on corporate bond and emerging debt markets. While they have played an important role in supporting the recovery, low risk premia could revert rapidly towards historical averages, implying triggering sudden bond or equity market reactions. There is also the possibility of a sharp increase in long-term interest rates, which would negatively affect borrowers, including highly-leveraged households, possibly offsetting positive housing wealth effects. This highlights the importance of starting fiscal consolidation sooner rather than later, especially where public finances display large borrowing requirements. Rising debt and deficit positions imply that embarking on a credible course of fiscal consolidation would help in bringing about a lasting and robust recovery.

Employment prospects would benefit from labour market reforms

So far, the global recovery has created fewer jobs than usual, including in the United States. Even though job creation is likely to revive over time, a variety of factors could slow the increase of employment levels and hinder the retreat of unemployment. The public debate has focused on the potential role of “offshoring” in weak employment creation, but the relocation of jobs abroad appears too modest in magnitude to be a major determinant. The risk that labour market prospects remain sluggish underscores the important role that structural policies could play to stimulate job creation. Employment prospects could benefit from various reforms adapted to circumstances, including enhanced labour market flexibility, improved incentives to participate in the labour force and increased adaptability of the workforce, as discussed in the next chapter of this brochure.