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POLICY SETTING IN THE CURRENT ECONOMIC SITUATION:
MAIN ISSUES FOR DISCUSSION
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Policy Setting in the Current Economic Situation:
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Growth has been weak…

Economic activity in the OECD area has continued to be buffeted by a number of adverse forces. Geopolitical events and uncertainties have weighed on activity through increasing the volatility of oil prices and undermining confidence. More importantly, the recovery has been held back by the slow working through of underlying economic weaknesses. These include an overhang of capital investment, negative wealth effects, fragilities of certain financial institutions and corporate governance problems.

…and very different across countries

Reflecting these adverse influences, a delayed and only modest recovery is projected. Growth rates are set to differ across countries - being higher in the United States throughout the period 2002-4 than in the euro area and Japan. The growth pattern has important policy implications. First, trend growth rates differ because of differences in underlying productivity and labour force growth. Second, abstracting from these trends, the cyclical slowdown in the euro area is not much smaller than that of the United States. This is striking given that a number of the negative shocks affecting OECD countries over the past couple of years have had their epicentre in the United States. At the same time, most other OECD countries outside of continental Europe have experienced very little slowdown and, even within Europe, the picture across countries differs. This points to differences in resilience to adverse economic shocks. Such differences are not well understood but are likely to reflect structural policy settings.

Policy efforts are needed to relaunch growth

Structural reform seen as part of a well-designed programme may not only strengthen long-term growth but could also increase resilience and might possibly also have positive confidence effects in the short term. But macro-policies obviously play an important role in relaunching activity in a sustainable fashion.

Low inflation means monetary policy can support activity

The projected modest recovery implies a correspondingly subdued inflation outlook. Only in a few countries does inflation limit the scope for monetary policy stimulus. Indeed, central banks have taken advantage of this situation to ease policy - strongly in the United States, less so in the euro area. In Japan, policy controlled interest rates are at zero and deflation persists. The United States still has room for manoeuvre to respond to an adverse shock but has come closer to the situation where the zero nominal interest floor could become binding. In the euro area, there is both scope and need for further easing.
The working of automatic fiscal stabilisers during the slowdown has led to a substantial deterioration in budget balances. Furthermore, the United States - but to a smaller extent also some other countries - have taken strong discretionary measures to ease fiscal policy. As a result, OECD-wide budgets have deteriorated from a situation of balance in 2000 to a projected deficit of about 3½ per cent of GDP in the current year. The turnaround in the medium-term budget outlook has been striking. In the context of impending population ageing, this development is a cause for serious concern. Furthermore, the persistent budget deficits are likely to be reflected in significantly higher bond yields or sharp rises in private saving. Given the adverse effects on activity in either case, it is of paramount importance to put budgets on a credible path towards consolidation.

There are a number of risks to the outlook, most of them pointing to weaker outcomes. The unwinding of balance-sheet problems in corporate, household and financial sectors could exert more downward pressure on activity than projected. Further problems with corporate governance or further strains on financial institutions (e.g. banks, insurance companies or pension funds) could generate additional shocks in the financial system. Even after the conclusive end to war in Iraq, geopolitical uncertainties may linger and retard growth. And with the United States emerging faster from the cyclical slowdown than other main OECD regions, the US external deficit would reach some 5 per cent of GDP by 2004 - a level which may prove to be unsustainable and lead to possibly disruptive adjustment.

Questions

- What are the main factors explaining sluggish growth in the OECD area and its variation across countries? What are the respective roles of (1) geopolitical events and tensions, (2) the working-off of problems such as over-investment, negative wealth effects and corporate governance failures and (3) lack of resilience caused by structural weaknesses in some countries?

- What are the main risks in the current situation and how should policy respond if they materialised?

- How threatening are increased budget deficits in the OECD area? Can remedial action be postponed any longer?

- What are the problem areas where structural reforms are most needed to stimulate sustainable output, increase cyclical resilience and help boost confidence?