

II. Developments in the advanced industrial economies

Highlights

Despite significant policy stimulus in the advanced industrial countries, output recovered only modestly in 2002 (Table II.1). Household spending remained resilient, but firms continued to scale back investment. Demand in the first quarter of 2003 was unexpectedly sluggish, although how far this was due to geopolitical uncertainties and how far it reflected more underlying forces holding back growth is difficult to gauge. The consensus view of forecasters is that there will be a modest pickup in activity later this year. The recent increase in profits, the strengthening of corporate balance sheets and continued technical progress create favourable conditions for a revival in capital spending. But the household debt burden is higher and consumption growth may slow. Domestic demand remains weak in Japan and Europe – especially in Germany.

Downward pressures on the prices of goods worldwide have prompted some commentators to express worries about the possibility of global deflation and what dangers might be attached to it.

Other important policy challenges remain. Budget deficits have widened recently and, over the longer term, ageing populations in the advanced industrial countries will put upward pressure on public spending. The design of fiscal frameworks and the medium-term need for fiscal consolidation are thus key issues. The continued widening of current account imbalances in the industrial countries since the mid-1990s has been accompanied by shifts in global saving that may have future implications.

Growth and inflation								
Average annual percentage changes								
	Real GDP				Consumer prices ¹			
	1991–2000	2001	2002	2003 ²	1991–2000	2001	2002	2003 ²
Advanced industrial countries	2.5	0.9	1.7	1.7	2.4	2.1	1.5	1.9
United States	3.2	0.3	2.4	2.3	2.8	2.8	1.6	2.4
Euro area	2.1	1.4	0.8	1.0	2.4	2.4	2.2	2.0
Japan	1.4	0.4	0.3	0.8	0.8	–0.7	–0.9	–0.6
United Kingdom	2.3	2.1	1.8	2.0	3.2	2.1	2.2	2.8
Canada	2.8	1.5	3.4	2.7	2.0	2.5	2.2	3.1
Australia	3.4	2.7	3.8	3.0	2.2	4.4	3.0	3.0
Other countries ³	2.1	1.3	1.5	1.3	2.1	2.2	1.8	2.1

¹ For the euro area, harmonised index of consumer prices; for the United Kingdom, retail price index excluding mortgage interest payments. ² Consensus forecast published in May. ³ Denmark, New Zealand, Norway, Sweden and Switzerland.

Sources: © Consensus Economics; national data. Table II.1

The global recovery in 2002

Disappointing growth despite supportive policies

Following a relatively shallow downturn in 2001, the advanced industrial countries experienced a rebound in 2002. However, the global economy rapidly lost steam and ended the year on a weak note, with output gaps widening in most regions. Most notably, the growth of final demand softened in the United States. Some other industrial countries performed better, with particularly strong final domestic demand in Australia and, to a lesser extent, in Canada. The Japanese economy grew only modestly in 2002, despite a marked upswing in exports. Output growth turned out to be much weaker than expected in the euro area and almost stalled in Germany.

Given significant policy stimulus, these developments were particularly disappointing. In the United States, policy interest rates had been cut sharply and the budget moved into a large and widening deficit (Graph II.1). Policies were less expansionary in the rest of the industrial world. The fiscal stance was broadly neutral, with automatic stabilisers allowed to work, but with discretionary measures limited by high government deficits and public debt in the euro area and even more so in Japan. The room for easing monetary policy was also constrained by inflation stickiness in the euro area and by the zero lower bound on nominal interest rates in Japan (see Chapter IV). Monetary policy was tightened in a few countries (particularly in Australia and Canada) in the face of robust demand and some inflationary pressures.

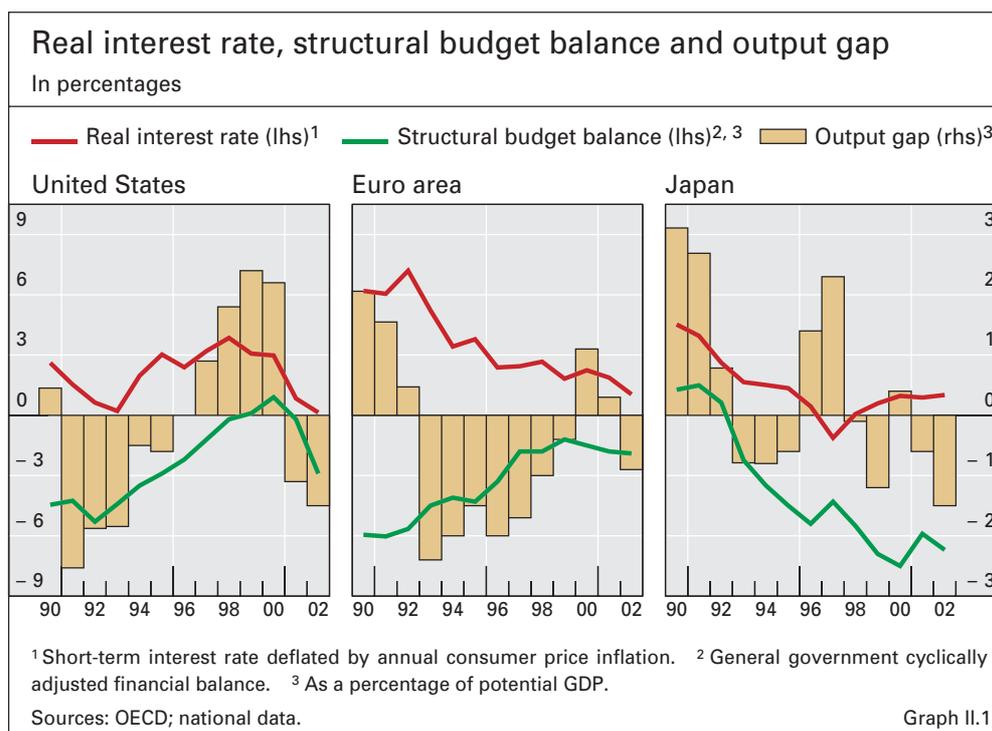
Business investment failed to recover

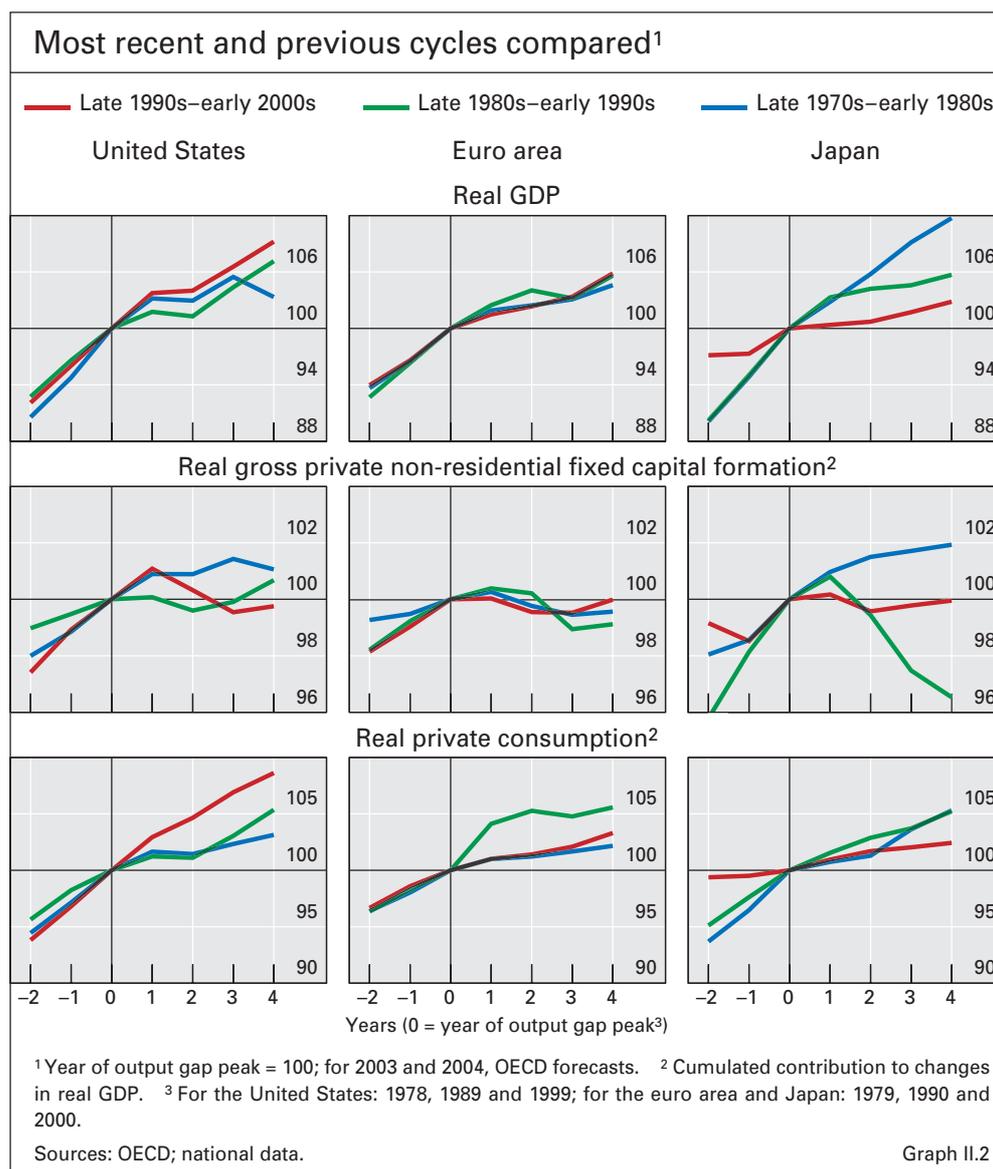
Business investment, which fell in the advanced industrial countries during 2002, has been unusually weak (Graph II.2). This was partly a reaction to the

The global economy lost steam in the course of 2002 ...

... despite significant policy stimulus

Falling investment as firms rebuilt balance sheets





previous investment boom, when overly optimistic profit expectations had led to unsustainable increases in credit and asset prices. The appearance of sizeable excess capacity in several sectors – particularly in the IT industry – and poor demand prospects reduced the demand for new equipment. In addition, firms had to rebuild their balance sheets and restore profits in the wake of falling asset prices. Investor confidence was further hit by heightened concerns about corporate governance following several high-profile financial disclosure scandals and large defaults. Lower equity prices, a tightening of credit standards and widening corporate spreads also made it harder for firms to raise finance. In some major European countries and Japan, the supply of credit was somewhat constrained, especially for small and medium-sized enterprises.

Resilient household spending

Yet aggregate household spending held up relatively well on average in the advanced industrial countries in 2002, despite substantial declines in

Robust household spending ...

household financial wealth and adverse developments in the labour market. Private consumption and residential investment were quite strong in several economies – especially in the United States and the United Kingdom. The responsiveness of household demand to policy impulses in these countries was a major factor. The expansionary fiscal stance benefited households, for example through tax cuts, higher wages for public sector workers, or increased social benefits. Meanwhile, the widespread easing of policy interest rates and the decline in long-term interest rates led to a substantial fall in the cost of credit. For instance, average household borrowing rates fell by almost 1 percentage point in the course of 2002 in the United States and vehicle sales were stimulated by generous credit terms. Household spending was much less buoyant in the euro area, where saving rates rose noticeably. In Japan, consumption was relatively resilient but residential investment dropped further.

Structural changes in financial markets in many countries have increased the availability of credit and enabled households to take on more debt. Another supporting factor was real estate values, which continued to rise strongly in 2002 and even accelerated in some countries, providing a source of liquidity for households (see Table VII.2 on page 129). The upswing in property prices seems to have partly offset equity market losses, in particular in North America, the United Kingdom and some countries in continental Europe. In those countries, heightened competition and innovations in mortgage markets have given homeowners a greater opportunity to borrow against unrealised capital gains on their homes. Moreover, the transaction costs of refinancing loans have fallen, allowing borrowers to benefit more easily from lower interest rates.

... supported by rising property prices and mortgage refinancing

The global outlook

An uneven but gradual expansion

Heightened concerns about developments in the Middle East are thought to have been a crucial factor in holding back expansion in the most recent past, driving oil prices up and confidence down. Although the present situation is still clouded by geopolitical uncertainties, the consensus view is for an abatement of previous recessionary forces. The inventory correction seems to have run its course, with inventory/sales ratios at historically low levels in the United States. Several factors also suggest a turning point in fixed investment. New equipment is likely to be needed after two years of declining investment, a requirement accentuated by the rapid obsolescence of high-tech investment goods. Further support for capital spending should come from profits, which strengthened in 2002 on a national income accounts basis, and healthier corporate balance sheets. Financial conditions have also improved recently.

Recessionary forces could unwind in 2003 ...

Even so, output growth has remained weak in most regions so far in 2003, and there is little evidence that world trade has revived. Nor do current surveys suggest a widespread upturn in business confidence. But financial markets do indicate some improvement: yield curves point to a pickup in growth later in the year, bond spreads have narrowed and equity prices have recouped much of their war-related losses. In any event, markets did not

... but few signs of a sustained recovery to date

prove to be good predictors of economic developments in 2002, a year marked by rapid ebbs and flows in sentiment.

Question marks
over the consensus
view

There are several question marks over the consensus view that household spending will remain resilient and bridge the gap until investment picks up. On the one hand, a quick removal of geopolitical uncertainties could revive confidence and the willingness to spend in both the household and corporate sectors. This could lead to a stronger expansion than currently assumed. On the other hand, the impact of past policy stimulus could fade before final demand strengthens in a self-sustaining way. In particular, public spending and interest-sensitive household demand components are already at high levels, and there may be some falling-off in the near future. Indeed, a weaker phase in the consumer durable goods sector seems to have already begun in the United States. In those countries where a buoyant housing market has supported household spending, the stimulus from mortgage refinancing could diminish. The rise in house prices in some countries seems to have already peaked and long-term interest rates seem to have stopped falling.

Another downside risk is that policy impulses might actually start to reverse. On the fiscal side, deteriorating budget prospects have not only prevented the authorities from adopting further significant stimulus in many countries, but have also led to some restraint in Europe, as well as at the state and local level in the United States. On the monetary side, the scope for further stimulus has largely been exhausted in countries where both policy and government bond interest rates are now at historically low levels. Some commentators have indicated concerns about a possible upward correction in long-term rates should investors become worried about price or fiscal developments. Finally, new difficulties at the corporate level or hidden financial vulnerabilities in some countries might restrict lending for some time.

Private balance sheets

Corporate balance
sheets have
strengthened
somewhat ...

How far the need to rebuild corporate balance sheets is still holding back growth remains unclear, but there are grounds for optimism. Weak business fixed investment has allowed the corporate sector's financial balance (ie the difference between corporate saving and investment) to improve significantly in Japan, the United States and Europe. In Japan, profitable companies have continued to pay back the large debts built up in the past; over the last decade, corporate debt/value added ratios have declined by more than 30 percentage points (Graph II.3). In the United States, the corporate financial balance was almost in equilibrium in 2002 and debt has started to decline. In the euro area, corporate debt, which rose sharply in the second half of the 1990s, has recently fallen and the deficit in the financial balance has been reduced since 2000.

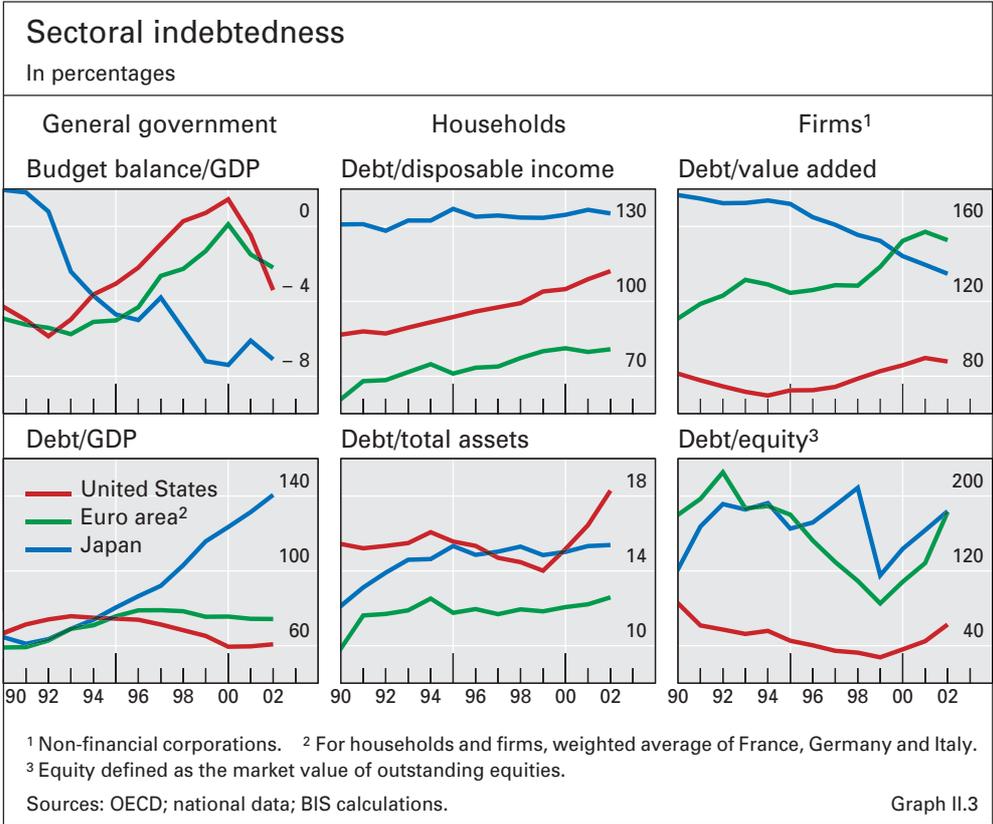
Two additional considerations are also positive. First, debt/equity ratios remain moderate, as the decline in equity prices has been partly offset by some deleveraging. Second, low interest rates have allowed firms to reduce debt servicing costs. The interest costs of US non-financial corporations, for

instance, had fallen to around 14% of their cash flow by late 2002. This was a reduction of nearly 2 percentage points since the last peak in early 2001 and was more than 5 percentage points lower than at the beginning of the 1990s. However, if interest rates start to rise, corporations may try to reduce interest costs by further postponing debt-financed investment. Moreover, repairing balance sheets is a slow process. The fact that the US corporate debt/value added ratio now stands at 88%, compared with 80% in the early 1990s, may induce further deleveraging. This risk looks even higher in Europe. Finally, hidden corporate liabilities (eg from underfunded pension schemes) may mean that the underlying picture is less healthy than is suggested by published figures.

Unlike corporations, households in the advanced industrial countries on average continued to borrow and spend during the recent phase of the cycle, despite a notable weakening in the euro area. As a result, household indebtedness continued to increase more rapidly than income in 2002. This trend was especially marked in those countries where lower nominal interest rates led to higher demand for housing and also induced households to refinance old mortgages. This process generated funds for increased household spending and was reinforced by substantial rises in house prices.

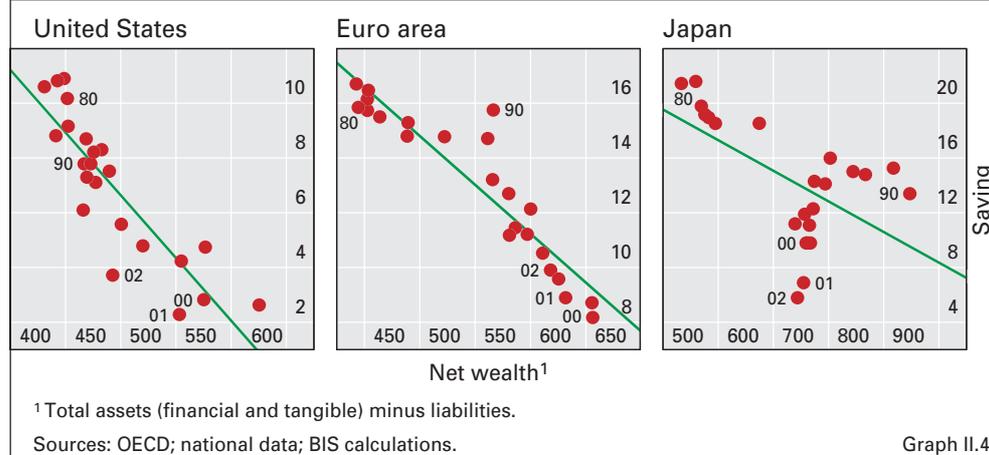
... but household debt has increased

Once allowance is made for the value of household assets, debt does not seem particularly high. With the exception of Japan, the average ratio of household liabilities to wealth in the G7 countries has remained almost stable at around 15% for many years. Nonetheless, outstanding liabilities have risen to more than 105% of household disposable income in the G7 countries,



Household saving and net wealth, 1980–2002

As a percentage of household disposable income



almost 15 percentage points higher than in the early 1990s. Debt service costs have also increased. For instance, such costs subtracted around 14% from US personal disposable income in 2002, appreciably more than a decade earlier despite substantially lower borrowing rates. Although the overall household sector is protected to a significant degree by locked-in long-term mortgage rates, it could therefore be vulnerable should interest rates rise or the labour market deteriorate. Low inflation might have led some households to underestimate the real burden of future debt repayments.

While household balance sheets do not suggest an immediate threat to spending, household saving rates could move higher. They have already risen significantly in the euro area in the past few years, and there might be more grounds for concern in Japan: sizeable wealth losses have been accumulated over the last 10 years yet the household saving rate has continued its downward path (Graph II.4). In the United States, the household saving ratio still looks low, although it had already begun to rise in 2002. Tax cuts have allowed US households to improve their saving position somewhat. However, the equilibrium level of household saving is likely to have declined over the past two decades because of rising net wealth.

Longer-term prospects

A striking feature of the recent downturn in economic growth is that it was also felt in regions – especially continental Europe and Japan – which had not experienced the preceding spending boom. The apparently high degree of synchronisation in business cycles across industrial economies reflects financial and confidence channels as well as trade flows. According to some observers, such linkages have become stronger in recent years, with the leading role of the United States becoming more marked (see the *72nd Annual Report*). First, supranational links at the corporate level have grown substantially following a surge in international mergers and acquisitions in the 1990s. Second, the widening of the US current account imbalance was accompanied by increasing capital inflows. Consequently, some foreign financial and non-

Developments in the United States remain pivotal

financial firms that had participated in the funding of the US upturn suffered heavy losses and were forced to cut costs to restore profits.

Yet the appearance of greater US influence on global growth may also reflect some specific weaknesses in other regions. Over the past 10 years, Japan has grown at an average rate of only 1% a year. This suggests that its potential growth rate may now stand well below the 4% estimated in the 1980s. Potential growth has also weakened in some major European economies, especially in Germany, which is discussed more fully below. These trends are important, and not only because of what they imply for secular developments in living standards. Low potential growth rates outside North America could complicate the process of current account adjustment needed to deal with present external imbalances. Moreover, low potential growth often reflects structural rigidities and little resilience to adverse shocks. Consider how well the United States, where potential growth remained robust, weathered the last downturn. The dynamic supply side of the US economy seemed to provide more scope for new sources of growth and a greater capacity to respond to demand stimulus.

Japan and
Europe weak ...

The first element behind long-term performance is the labour force. While still growing strongly in the United States, it has already started to decline in Japan and will soon do so in some rapidly ageing European economies. Furthermore, there have been striking differences in the functioning of the labour market. Structural unemployment has decreased steadily in the United States since the mid-1970s, but has increased in Japan. The picture is more mixed in the euro area. Structural unemployment rose to high levels until the mid-1990s but has since been reduced in some countries – with the notable exception of Germany – through successful efforts to promote employment growth. A second significant element has been the relative strength of labour productivity growth in the United States, particularly last year, when output per worker increased markedly. In the euro area and Japan, however, labour productivity growth has been weaker in recent years.

... due to lower
labour force
growth ...

The superior US performance seems to be mainly attributable to continued technological progress as measured by growth in total factor productivity (TFP), the growth in output beyond that which can be attributed to increases in labour or capital. Indeed, US TFP gains have accelerated significantly since the period of slow output growth during the 1970s, in striking contrast to developments observed in Europe and Japan. In Europe, there is some evidence that recent reforms in labour markets led to employment gains which held down measured productivity. In Japan, attention has mainly focused on the dysfunctional financial system, which is often seen as the greatest impediment to sustained growth.

... and poorer
productivity

Although the implementation of some structural reforms could lead to higher unemployment in the short run, it could also release latent demand (eg in the domestic service sector) and increase employment over time. In addition, the announcement of a reform programme could in itself improve confidence, particularly in the corporate sector. Moreover, there may be a more urgent need than usually thought to improve the way markets function. First, rigidities can remain undetected for a long time before the adverse

Need for product
and labour market
reforms

effects on supply become apparent. Second, long-term productivity gains could be threatened should heightened geopolitical risks lead to higher security and defence expenditures, which act as a hidden tax on the economy. Finally, stronger productivity gains will be required to compensate for the adverse impact of ageing on income per head in virtually all industrial countries.

Subdued longer-term growth prospects in Germany

Weak economic performance in Germany ...

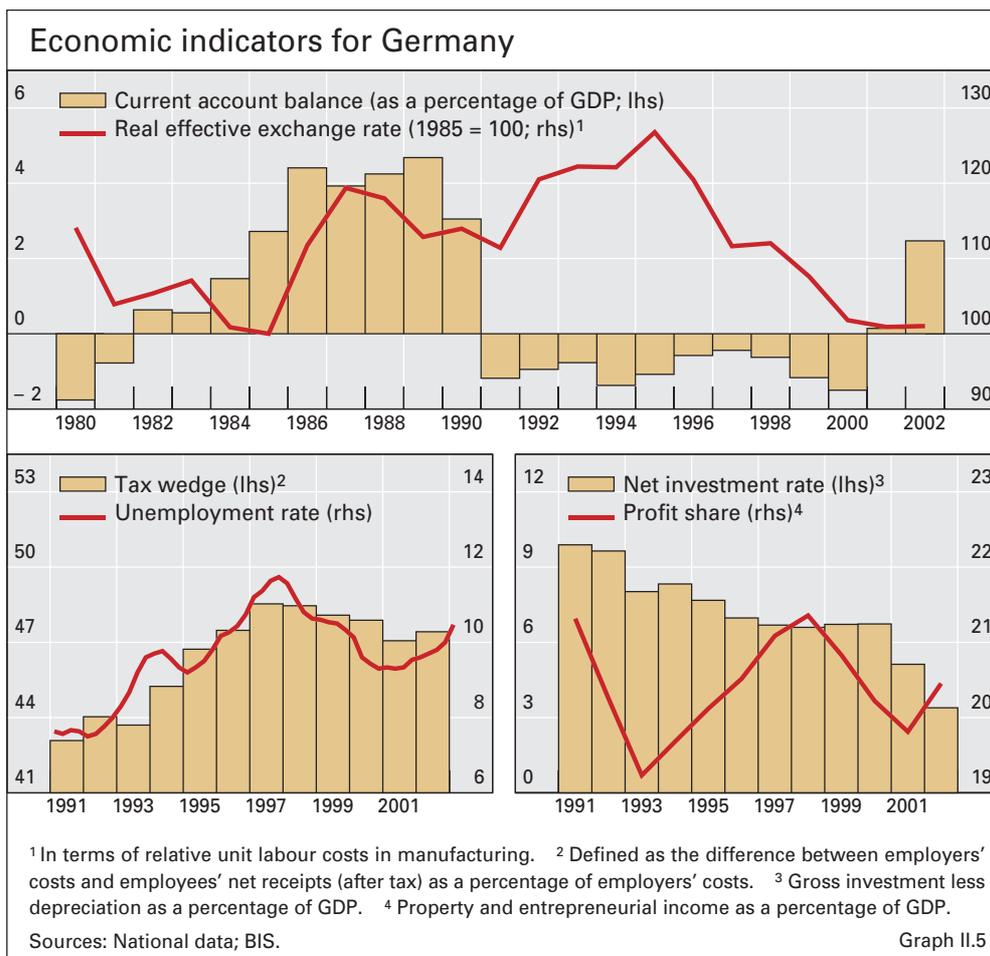
In this longer-term context of structural weaknesses hampering growth, many observers have recently focused on continental Europe. The degree and nature of the impediments to growth vary from country to country. The case of Germany – the largest economy of the area – is of particular interest: GDP growth has been unusually weak in recent years. This underperformance seems mostly attributable to sluggish domestic demand. Over the last five years, the contribution of exports to total output growth has averaged more than 2 percentage points. This is above the average for the 1980s and higher than for France and Italy. By contrast, private consumption has been weaker and investment has been a significant drag, contributing to a decline in Germany's potential rate of growth to only 1½%. This compares with estimates of nearly 2½% in the rest of the euro area.

... despite recent improvement in competitiveness

Several reasons for Germany's deteriorating growth performance have been suggested, some of which might seem less well grounded than others. Some observers have argued that Germany entered EMU with an overvalued exchange rate. It is true that Germany did lose competitiveness and international market shares during the first half of the 1990s; but the real effective exchange rate has fallen significantly since the mid-1990s (Graph II.5, upper panel). As a result, Germany has gained market share in the last few years and the exports/GDP ratio is at a record high. Similarly, it has been argued that high real interest rates have reduced investment spending and growth overall. At first glance, this claim also seems unfounded. Since 1997, the real long-term bond rate (deflated by CPI inflation) has averaged 3½%, compared with an average of 4% since the 1960s. However, since the rate of potential growth has fallen, it could be argued that the "natural" rate of interest (ie the rate that equilibrates saving and investment) has also fallen.

Costs of reunification

A much more plausible argument is that Germany is still suffering the direct and indirect costs of reunification in 1989–90. Most firms in the former German Democratic Republic collapsed, causing a lasting deterioration in the labour market. The resulting fiscal transfers (almost 4% of GDP per year over the 1990s) appear to have caused a secular worsening of the German fiscal balance, which has significantly reduced the room for policy manoeuvre. The tax increases required to finance reunification also seem to have adversely influenced labour market developments through a significant increase in the "tax wedge" (Graph II.5, bottom left-hand panel). Finally, reunification led to an unsustainable rise in construction spending. Its subsequent contraction has reduced German real GDP growth by nearly ⅓ percentage point per year since 1995. Moreover, house prices declined in the second half of the 1990s and have been almost stable over the past few years. German households



have thus been deprived of an offset to equity losses which households in most other industrial countries have enjoyed.

Perhaps the strongest sign (if not cause) of the underperformance of the German economy has been the decline in firms' ability or willingness to invest. Since the early 1990s, net investment as a proportion of GDP has fallen sharply (Graph II.5, bottom right-hand panel). Although reinvestment (ie the replacement of obsolete equipment) can also be used to introduce new growth-enhancing techniques, this decline is a matter of concern. If sustained, it would seem likely to reduce further Germany's potential growth rate.

Although the low propensity to invest is partly cyclical, more fundamental or structural factors also appear to be at work. One of these might be that firms do not expect the rate of return on new investment to cover the risks incurred, suggesting that corporate profits are too low. There are also signs that small and medium-sized companies, which have historically been the main source of job creation but mostly serve the domestic market, have fared worse than large corporations which export a sizeable share of their output. The problem may have been exacerbated in recent years by banks imposing stricter lending standards. This could have hit smaller companies particularly hard.

Product and labour market rigidities are also likely to have affected firms' propensity to invest, as well as overall growth performance. Several restrictions (eg on shop opening hours) could well have constrained the

Decline in corporate investment ...

... and difficulties for medium-sized companies

Rigidities in product as well as labour markets

service sector, affecting in particular its ability to absorb redundant workers from industry. The setting-up of new firms, with its potential for job creation, has been held back by strict regulatory requirements. Severe rigidities also remain in the labour market. In addition to the widening tax wedge referred to above, strict job protection measures could have deterred hiring. The tax structure, unemployment benefits and social security payments tend to discourage job searches, especially for those with low skills and incomes. The scope for wage settlements linked to the performance of individual firms or workers also remains very limited.

Some positive signs

While the short-term outlook for Germany does not seem very favourable at present, several positive signs should not be overlooked. The strength of exports shows that German firms are able to compete in difficult global conditions. The after-effects of reunification should dissipate over time. The required contraction of the construction sector seems well advanced and the consequences for banks and other financial institutions appear to have been contained (see Chapter VII). The government appears determined to introduce several important structural reforms. Hence, fears that Germany is facing prolonged economic weakness, similar to that in Japan, seem wide of the mark.

Inflation

Recent developments

Subdued price pressures

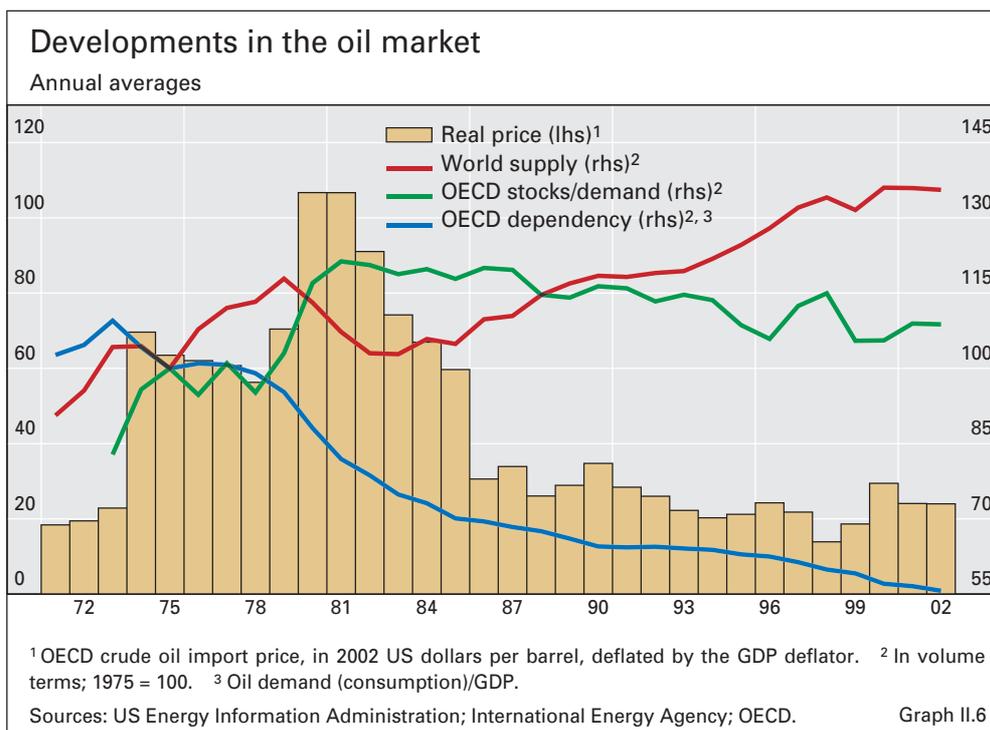
Global price pressures remained subdued in 2002. However, this overall picture obscures diverse developments across countries. Inflation increased in the fastest-growing economies, threatening inflation targets in Canada and the United Kingdom towards the beginning of 2003. Core CPI inflation rose above the 2% threshold in the euro area in 2002, while it eased substantially in the United States. Consumer prices were almost stable in Switzerland and fell in Japan for the fourth year in a row.

Notable divergences were also evident within regions, in particular in the euro area, where consumer prices increased by little more than 1% in Germany in 2002 but by nearly 5% in Ireland. Price developments also varied across the United States, with increases spanning a range from around 0% in the Cleveland area to close to 3% in the Los Angeles region. Finally, sizeable differences emerged across sectors, with rates of price increase of domestic-oriented services and manufactured goods often diverging sharply. For instance, prices for non-food commodities dropped by 2% in the United States in 2002 while those for services rose by 3%.

Prospects

Outlook for oil prices uncertain

Inflation is expected to remain low in 2003. The spike in oil prices observed in the early part of the year, mainly attributable to the war in Iraq and output disruptions in Venezuela, has already begun to be reversed. However, prospects for oil prices remain subject to uncertainties. In the next year or so they could continue to be volatile, depending on global growth, supply from non-OPEC areas and the ability of OPEC to offset any sudden demand/supply



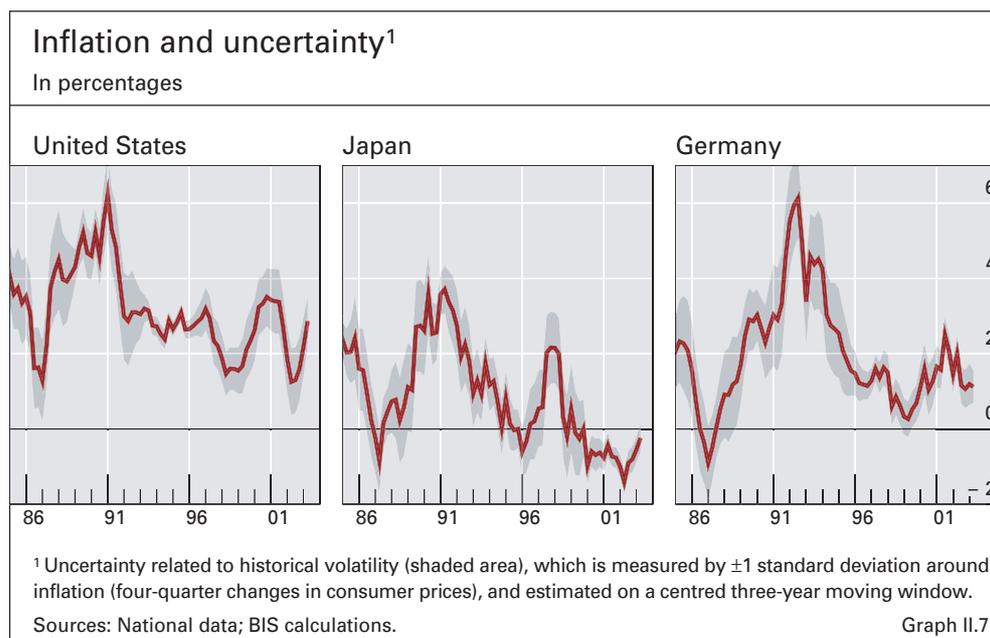
imbalances quickly. In addition, the ratio of oil inventories to demand in the industrial countries has declined since the early 1980s, so that any renewed market disruption could cause greater price fluctuations (Graph II.6). Finally, how quickly Iraqi oil returns to world markets, and on what scale, is a major issue.

There are good grounds for thinking that global inflation will remain low and stable in the near term because of subdued core price pressures. One reason is that the sensitivity of inflation to cyclical variations in output seems generally to have declined. For example, inflation has remained moderate in the United States during the past decade, despite large variations in both unemployment and capacity utilisation. In Japan, deflation has been relatively stable and rather limited in the past few years. There is also some evidence that the exchange rate pass-through has declined in countries with such a low-inflation environment. Given the lengthening record of sustained low inflation in the industrial countries, price expectations appear to be rather firmly anchored, which should help to reduce the persistence of any one-time price shocks. Increased competition, both domestic and external, might also have affected the way prices and wages are set in various markets, suggesting greater resistance to price increases.

Inflation is expected to remain low

Risks of deflation?

Given low inflation, ample spare capacity and the prospect of growth below potential in major advanced industrial countries, some commentators worry more about deflation – defined as a decline in the aggregate price level – than inflation. The fact that the GDP deflator in Japan has been falling by 1% per year since the mid-1990s, and that prices have recently been declining in a number of other Asian countries, has also attracted attention. Deflation can



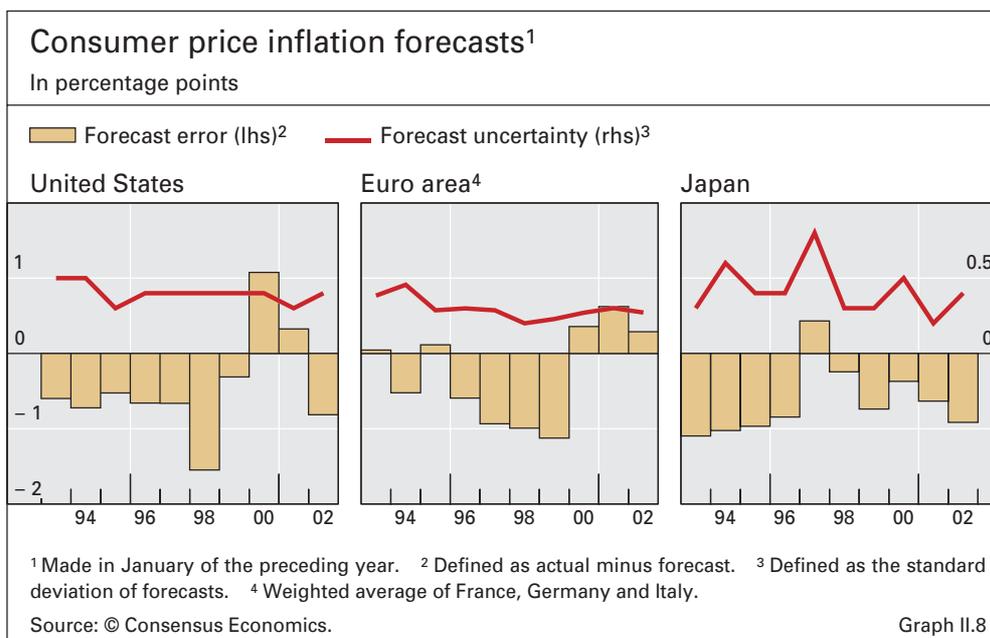
generate economic problems because most debt contracts are defined in nominal terms, nominal wages tend to be downwardly rigid and nominal interest rates cannot be negative (see Chapter IV). From this perspective, what are the risks that the global economy could fall into a deflationary environment at the present juncture?

Inflation forecasts often inaccurate

The first, obvious point is that when inflation is very low, deflation is arithmetically not far away. Moreover, the volatility of inflation remains substantial, particularly when compared to the current low level of inflation (Graph II.7), and has even increased in relative terms in some countries. The uncertainty in anticipating price developments – as measured by the standard deviation of forecasts – still represents nearly one third of a percentage point of inflation, depending on the country (Graph II.8). For long periods in the 1990s, actual inflation came in well below consensus forecasts.

Many inflation measures biased upwards

Another key issue is that measured rates of inflation typically overstate the true rates of price increase, depending on the indices and the statistical methodologies used. For instance, taking account of shifts in spending in response to changes in relative prices would have reduced CPI inflation (using fixed weights) by almost half a percentage point in the United States in 2002. Similarly, Japanese deflation would appear more severe if measured by the private consumption deflator rather than the CPI. There is also evidence that measured inflation has been overstated due to difficulties in correcting for quality improvements, difficulties that can be reinforced by the launch of innovative products as well as by the emergence of new distribution channels. Given the current low level of inflation and the uncertainty of forecasts, the possibility of episodes of declining prices (as seen in Germany in the mid-1980s) cannot be ruled out. Taking into account the measurement bias (“effective deflation”; see Table IV.1 on page 70) raises this possibility further, although measured inflation has already been lowered substantially in some countries over the past few years as a result of significant changes in its



calculation – particularly the increasing use of hedonic price indices. Since the Japanese experience clearly shows that deflation can become entrenched, despite very loose macroeconomic policies, an assessment of possible deflationary forces currently affecting other countries needs to be undertaken.

The dramatic bursting of the 1990s IT bubble created a perception of excess capacity more generally. This could in principle exert a significant deflationary force in the global economy – especially if falling prices were to interact with high levels of nominal debt. Indeed, anecdotal evidence of excess investment in developing Asia as well as very low capacity utilisation in many sectors, following the recent downturn, support such a view. Yet the evidence of generalised excess capacity in the global economy is limited. The capital/GDP ratio in the US business sector in volume terms actually declined during the 1990s, primarily due to accelerating equipment depreciation. As noted earlier, Japanese firms have tended to use profits to reduce debt rather than increase investment.

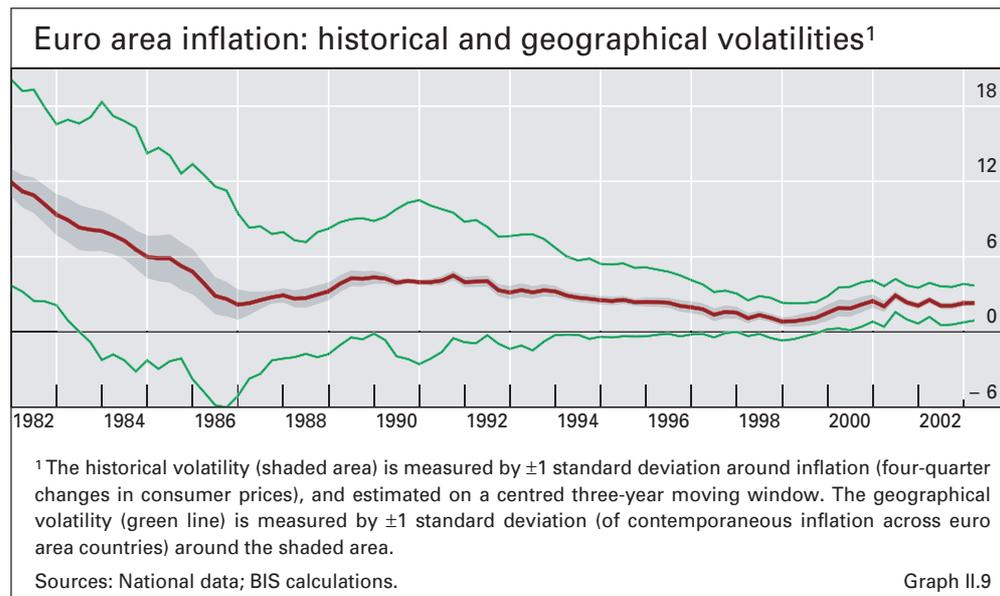
Potential deflationary forces include excess capacity ...

Many have also pointed to relative price changes as a source of deflation, suggesting that in a low-inflation environment such developments are more likely to lead to actual declines in nominal prices in the sectors benefiting from technical progress, for instance IT products. This could increase the possibility of negative changes in the overall price level given the stickiness of prices in other sectors. Such supply shocks, however, must in general be viewed as positive, since they essentially reflect strong productivity gains that are passed on as real income gains to consumers. Even if their effect is to push measured price indices into negative territory, they do not threaten profits and growth in the manner of a more generalised deflation.

... relative price changes ...

Relative price changes associated with international trade have also been raised as a possible source of deflation. Globalisation has allowed emerging market countries with lower unit labour costs to push down prices and thus “export deflation”. Prices for manufactured goods in international markets

... globalisation ...



have indeed fallen significantly since the mid-1990s in SDR terms. Attention has focused on China (see Chapter III), given that its share of world trade has more than doubled in the past decade. However, China still accounts for only around 5% of world trade. Moreover, in a world of low inflation, declining prices for tradable goods should not necessarily be interpreted as a source of worrisome deflation. In fact, it is the most desirable way in which the benefits of divergent productivity developments can be transmitted over time between international trading partners as well as across sectors within individual countries. This is not to deny that the sectors affected might have great difficulty in coping with a sudden need for adjustment.

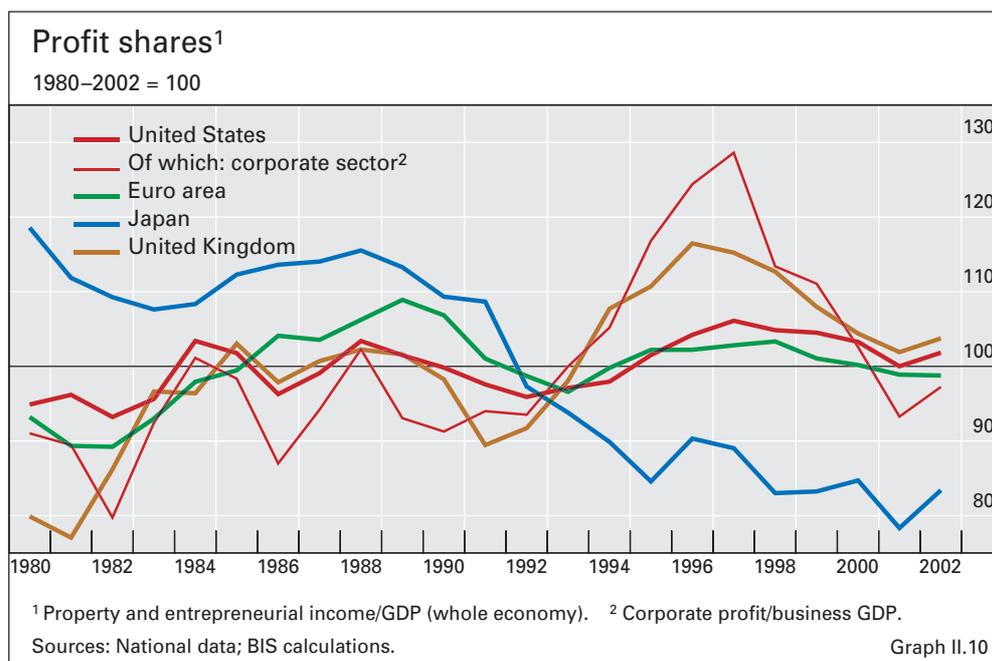
... and, in the euro area, inflation differentials

A final source of relative price changes with potential deflationary implications concerns the euro area. While inflation differentials across member countries are much lower than in past decades, they remain significant in relative terms (Graph II.9). It is thus alleged that a low inflation target for the euro area as a whole could force countries with low growth into recession and possibly deflation. This would then feed back on their real interest rates if nominal rates are fixed for the area as a whole. While these risks have to be carefully weighed in view of low labour mobility inside the euro area, they should not be overstated. As noted above, divergences in both the level and change of prices are relatively common within countries because prices are slow to adjust. In addition, countries with lower costs than their neighbours see an improvement in their competitiveness.

Profit margins and firms' pricing power

Corporate profits improved in 2002 ...

Profits have followed strikingly different patterns across major industrial countries in recent years. In Japan, despite a sharp deceleration in unit labour costs, the profit share – defined as the ratio of property and entrepreneurial income to GDP – experienced a steady decline in the 1990s and recovered only modestly in 2002 (Graph II.10). This ratio held up better in the euro area in the past decade but has deteriorated somewhat recently. Cyclical



developments weighed on productivity, and European wages were relatively sticky. Developments have been more volatile in the US corporate sector, whose share of national income improved dramatically in the early 1990s, peaking at a relatively high level in 1997. It rapidly decreased thereafter, disappointing prevailing market expectations. Intense cost cutting led to some improvement in 2002 and the US corporate profit share now stands only slightly below its average for the past two decades. Within this aggregate, profit shares in services and retail trades have been relatively stable in recent years. In contrast, corporate profit shares in manufacturing industries have generally fallen markedly, under the influence of international competition.

Unit labour costs, productivity and profits							
Average annual changes ¹							
	Labour compensation ²	Labour productivity ²	Unit labour costs	Profit margin ³	Labour share ⁴	Real labour compensation ^{2, 5}	
United States	1981–1990	5.4	1.3	4.0	0.2	-0.1	0.9
	1991–2000	3.7	1.5	2.2	-0.1	0.1	1.4
	2001–2003	3.0	1.7	1.3	0.4	-0.2	1.2
Euro area	1981–1990	7.3	1.7	5.5	0.7	-0.4	1.1
	1991–2000	3.7	1.4	2.3	0.3	-0.2	0.8
	2001–2003	3.1	0.7	2.4	-0.2	0.2	1.0
Japan	1981–1990	4.4	2.8	1.5	0.4	-0.2	2.3
	1991–2000	1.6	1.1	0.5	-0.4	0.2	1.2
	2001–2003	-1.1	0.8	-1.8	0.0	-0.3	0.5

¹ In percentages; for labour share, in percentage points; for 2003, forecasts. ² Per employed person. ³ Defined as the ratio of the GDP deflator to unit labour costs. ⁴ Defined as the ratio of compensation of employees to GDP. ⁵ Deflated by the private consumption deflator.

Source: OECD.

Table II.2

... despite lack of pricing power in manufacturing

These developments also suggest that firms worldwide have seen their pricing power constrained. This has been particularly evident in Japan, where companies have reduced nominal wages but have had to cut prices even more since the early 1990s (Table II.2). In the United States, high productivity gains helped to limit increases in unit labour costs in the 1990s, but the overall effect on profits was muted. Price adjustments have been constrained by increasingly competitive product markets, especially in newly deregulated sectors such as telecoms, and until recently by the strength of the dollar. Profit margins have nonetheless held up better in the past few years, as US unit labour costs have decelerated sharply and even decreased in 2002.

The fiscal debate

Deteriorating fiscal positions partly reflect discretionary fiscal policy

Budget deficits have widened in recent years. This followed a decade of fiscal consolidation in all major countries but Japan. The average government deficit was 3% of GDP in 2002 across OECD countries, compared to a balanced budget in 2000. The gross public debt/GDP ratio reached 75% in 2002, up from about 60% 15 years earlier. This recent deterioration has in part reflected slow global growth and the impact of declining financial asset prices. Another important factor has been discretionary measures, especially tax cuts in the United States and some European countries. Geopolitical developments have also increased expenditure on military equipment and on security, partly reversing the “peace dividend” of the 1990s. More fundamentally perhaps, the use of the fiscal tool has been seen as a quick and predictable way of countering the economic slowdown.

Automatic stabilisers should be allowed to work

Views about the effectiveness of fiscal policy for countercyclical purposes differ widely. Most observers agree that government budgets have a natural tendency to smooth cyclical developments and that so-called “automatic stabilisers” should be allowed to work, particularly in countries without excessive government debt. Greater than average government borrowing during recessions would be offset by reduced borrowing or even debt repayments during periods of more rapid growth. Public spending seems indeed to have moved countercyclically in the main OECD countries (Table II.3). On the revenue side, however, the impact of automatic stabilisers has been less obvious: for instance, tax receipts have often shown a procyclical bias, such as a tendency in Europe to decrease rather than increase during economic upturns because of the adoption of tax cuts.

Discretionary fiscal policy has certain limitations ...

The use of discretionary fiscal stimulus measures remains more controversial. Such measures could put upward pressure on long-term rates and so weaken private investment, especially if they are not accompanied by a credible medium-term framework. A second obstacle to the effectiveness of discretionary fiscal policy has to do with the existence of various lags: the time taken to assess current developments, to decide on policy actions, to implement the measures agreed, and then for the policies to work. Hence, measures originally aimed at stabilising a swing in output could well have their full effect only after the economy had already begun to move in the opposite direction. The broad historical record in OECD countries

Fiscal indicators and the cycle ¹				
	Public spending	Public revenue	Budget balance	Fiscal stance ²
United States	-0.31**	0.12**	0.46**	0.26**
Japan	-0.06	0.11*	0.16*	0.06
Germany	-0.13	-0.01	0.14	-0.18**
France	-0.17	-0.11	0.17	-0.05
United Kingdom	-0.41**	-0.13*	0.20*	-0.09
Italy	-0.35*	-0.08	0.11	-0.08

Note: The table shows the elasticity (β_2) estimated by the equation $X = \alpha + \beta_1 X_{-1} + \beta_2 GAP$, where X is defined as public spending, public revenue, budget balance or fiscal stance, all expressed as a percentage of GDP, and GAP is the output gap, as a percentage of potential GDP; * and ** indicate significance levels of 90% and 99% respectively. Public spending moves countercyclically when the elasticity is negative (but positive for the other three indicators).

¹ 1972–2002. ² Defined as cyclically adjusted general government primary balance.

Sources: OECD; BIS calculations. Table II.3

is that, on average, discretionary changes in the fiscal stance – as measured by the structural primary budget balance – do not seem to have moved countercyclically over the last few decades. This could underscore the rather poor inherent capacity of active fiscal policy to smooth output developments. Alternatively, it could be the case that fiscal measures were rarely undertaken for countercyclical purposes.

Despite these important limitations, there might nonetheless be some scope for budgetary actions in specific circumstances. First, the impact of temporary fiscal expansion on interest rates should be relatively small, as long as such measures are expected to be reversed when conditions warrant. In this case, concerns about future inflationary pressures and government borrowing needs would remain limited. Second, fiscal policy might be useful in addressing marked balance sheet problems in the private sector. Government recapitalisation of weak banking systems is one example. A less extreme case is the tax cuts enacted by the present US administration that helped households to increase their saving rate in 2002. Tax cuts for business also helped the US corporate sector to reduce its large financing gap (ie the difference between capital spending and cash flow). Third, extreme circumstances could call for policy responses that would not be advisable in normal times. The use of fiscal policy could well prove helpful in restoring confidence after abnormal disruptions (eg acts of terrorism, geopolitical risk, etc), or in managing expectations to avoid worst case scenarios. From this perspective, some observers have argued that the recent swing towards larger deficits has helped avoid a slump in demand that would otherwise have been triggered by a correction of the imbalances built up during the expansion of the late 1990s. On this view, any overly rapid reversal of fiscal stimulus would also delay a recovery in investment.

Yet maintaining confidence in the longer-term sustainability of fiscal positions remains key. The quality of expenditure is important in this regard. Budget deficits that reflect high levels of investment in infrastructure or human capital often leave countries better prepared for tomorrow than deficits that encourage consumption. Tax cuts that reduce distortions also

... but could be useful under special circumstances

Confidence in fiscal sustainability ...

raise the rate of potential growth. In assessing the present stance of policy it should also be remembered that budget projections have often shown a tendency towards “official optimism”; initial fiscal positions could well be less healthy than currently estimated. Moreover, past government commitments, as well as the impact of an ageing population, represent sizeable future liabilities that may be even higher than current measures of public debt in some countries.

... requires a medium-term framework

For all these reasons, fiscal policy requires a credible medium-term framework. During the 1990s a number of countries introduced rules designed to enhance fiscal discipline. Many countries adopted ceilings for public expenditure, budget balances or debt. In the United States, nominal caps were imposed on discretionary public spending. The adoption of clear fiscal criteria in the Maastricht Treaty reinforced the reduction of public deficits throughout the European Union. In Japan, where no formally binding rules were adopted, the definition of medium-term guidelines may have been helpful in containing long-term interest rates at very low levels despite sharply increasing public debt.

Fiscal rules have been relaxed ...

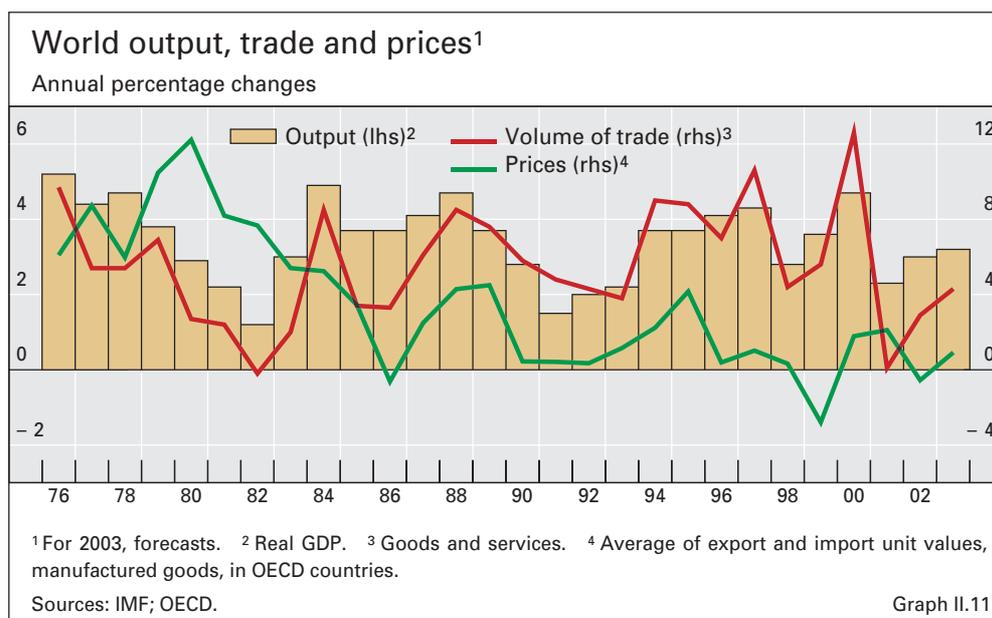
Many of these rules incorporated short-term rather than medium-term commitments. Moreover, the rules were often specified in absolute terms, irrespective of the business cycle or the possibility of exogenous shocks. These deficiencies made it tempting to relax the rules in adverse circumstances, or even to abandon them altogether. Such tendencies have been particularly evident in Japan recently, and in the United States, where constraints on spending have been eased in the last few years. In the euro area, the framework of the Stability and Growth Pact is more medium-term oriented. However, by focusing on current fiscal deficits, which were improving during good times, several countries failed to take the even tougher measures required to improve their underlying debt position. Efforts at fiscal consolidation in some countries were often paid for by cuts in investment rather than lower subsidies.

... but remain desirable

Rules that bind fiscal policy by a credible medium-term guideline would provide several advantages. First, the tendency for interest rates to rise will be reduced if it is clear that any short-term fiscal measure will subsequently be reversed. Second, guidelines can also counter pressure on governments to “give away” budget surpluses during periods of strong growth. Third, a medium-term framework helps to build room for manoeuvre – an issue of particular interest in currency areas in the face of asymmetric shocks. Finally, rules improve transparency and reduce uncertainty. This can foster better coordination amongst policymakers as well as within private markets.

Trade and current account developments

Over the last three years, movements in world trade appear to have been dominated by changes in high-tech investment and inventories, both of which are highly trade intensive. The end of destocking in the United States early last year increased trade. However, the revival proved short-lived, as firms were reluctant to expand inventories and continued to reduce



investment. The slow global recovery was also reflected in the prices of internationally traded manufactured goods, which were basically flat last year (Graph II.11).

Current account imbalances in the industrial countries widened significantly in 2002. The US deficit increased to almost 5% of GDP while Europe and, even more so, Japan recorded significant surpluses, partly reflecting their disappointing growth performance. For the United States, a larger trade deficit was the main factor but, for the first time since World War I, the net annual investment income account also showed a deficit.

Widening current account imbalances

More than half of the *external* counterparts to the US current account deterioration in 2002 were found in emerging Asia and Latin America. Emerging Asia increased its share of global trade as well as its current account surplus. In Latin America, the lower deficit was mainly the result of import compression (see Chapter III). In addition, there were significant changes in the size and composition of capital flows between the three major economic areas. As the investment boom faded, equity prices declined

Sharp decline in FDI flows to the United States

Balance of payments in the three major economic areas									
In billions of US dollars									
	United States			Euro area			Japan		
	2000	2001	2002	2000	2001	2002	2000	2001	2002
Current account	-410	-393	-503	-70	-17	60	119	89	112
Net long-term capital	422	335	285	-113	-22	53	-35	-73	-142
Direct investment	129	3	-93	-5	-92	-43	-23	-32	-23
Equities	90	15	35	-228	110	46	-21	28	-54
Bonds	203	317	343	120	-40	50	9	-69	-65
Basic balance ¹	12	-58	-218	-183	-39	113	84	16	-30

¹ Current account plus net long-term capital.
Sources: ECB; national data.

Table II.4

and US firms reduced their financing gap, contributing to a sharp fall in direct investment flows to the United States (Table II.4). This impact was compounded in dollar terms by the depreciation of the US currency. Moreover, larger bond inflows increasingly reflected purchases of US Treasury and government agency paper rather than corporate securities. Last year also saw the euro area emerge as a net recipient of capital flows, as net FDI outflows declined and an earlier net outflow of bonds was reversed (see Chapter V).

Recent trends in global saving

Major shifts in the suppliers and users of saving

Since the mid-1990s major shifts in the position of countries or regions as suppliers or users of saving have accounted for the continued widening of current account imbalances (Table II.5). The proportion of global saving needed to finance the US external imbalance has more than tripled since 1997. In contrast, emerging market economies have become net suppliers of saving, with the change in emerging Asia being particularly impressive: following the 1997–98 crisis, the current account balance strengthened by more than 5% of GDP within just two years. Together with Europe, the Asian region (including Japan) covered two thirds of the US financing gap in 2002. However, because of the global current account discrepancy, not all sources of global saving can be accounted for. The discrepancy had almost disappeared by 1997 but it has since moved back towards the level of almost 1/2% of world GDP recorded 10 years ago.

Significant decline in the global saving ratio ...

Several factors have been at work in shaping changes in the supply and use of saving and the related dynamics of current account imbalances. Saving ratios have tended to fall in recent years, partly due to the general slowdown since 2000.

... with an especially sharp fall in Japan ...

The most dramatic changes can be observed in Japan. Over the last 10 years, Japan's national saving rate has fallen by more than 7 percentage points to 26½%, representing a major factor behind the reduction in the global saving ratio. Moreover, since Japan's saving propensity has remained above the world average, the shift in the distribution of global income away from Japan has reduced the global saving ratio further. As a major aspect of this trend, developments in the United States have had a negative impact on the

Current account balances, saving and GDP									
In percentages									
	Current account balance ^{1, 2}			Saving ^{1, 3}			GDP ⁴		
	1992	1997	2002	1992	1997	2002	1992	1997	2002
United States	-0.8	-1.5	-4.8	16.5	18.4	13.8	26.5	28.2	32.5
Euro area	-1.2	1.6	1.1	20.5	21.9	21.2	26.5	22.1	20.7
Japan	2.9	2.2	2.8	33.7	30.8	26.5	15.9	14.6	12.4

¹ As a percentage of national or regional GDP. ² For the euro area, sum of individual countries. ³ Defined here as the sum of investment and current account balance. ⁴ National or regional GDP in US dollar terms as a percentage of world GDP.

Sources: IMF, *World Economic Outlook*; national data. Table II.5

global saving ratio. A lower US propensity to save (particularly over the last two years) has coincided with a shift in the distribution of income in advanced industrial countries in favour of the United States. While developments in Europe have been more or less neutral, the shift in the distribution of world GDP in favour of high-saving emerging Asian countries has partly offset the impacts from Japan and the United States. Latin America has seen relatively small changes and remains a low-saving region.

As a result of the developments discussed above, the United States has increased its reliance on global saving in the past decade. Emerging Asia has increasingly become an exporter of capital and now contributes more to global saving than Japan.

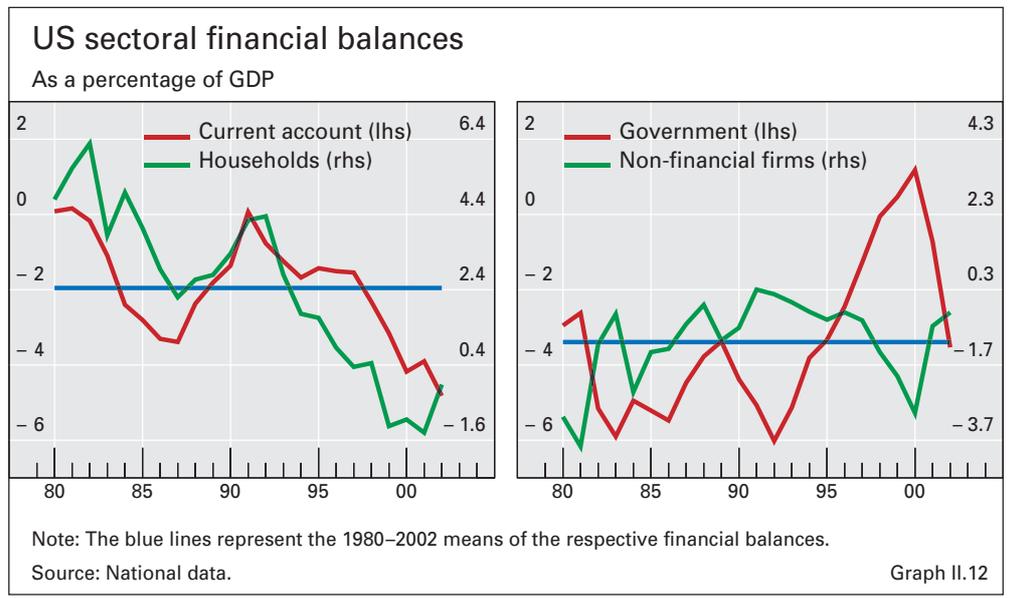
... but a rising contribution from emerging Asia

Near-term prospects

On the assumption that the United States will continue to grow faster than other industrial countries in the near future, most forecasters now predict a further widening of the US current account deficit and a concomitant rise in net foreign debt. This raises the question of sustainability as well as of the external adjustments and exchange rate movements which could take place in consequence (see Chapter V). Such developments would by definition be accompanied by changes in domestic counterparts to the current account deficit.

The widening US current account deficit since the mid-1990s ...

As mentioned earlier, both households and non-financial firms in the United States have managed to improve their financial balances during the last two years. In contrast, the government budget balance has worsened significantly so that the fiscal deficit accounted for nearly three quarters of the external deficit last year. Indeed, recalling developments during some years in the 1980s, when fiscal and external deficits increased in parallel, some observers have expressed concerns about an emerging “twin deficit” problem for the United States. The implication would be that a reduction in the external deficit requires an improvement in the fiscal balance.



... has, in particular, reflected declining household saving

Developments in the household saving rate are also crucial as they affect both the current account and the government balance. This was evident during the second half of the 1980s: a significant increase in household saving led to a narrowing of the current account deficit in the United States, while the structural government deficit remained broadly unchanged at relatively high levels. The impression that household saving (or consumption) has been an important factor behind developments in the current account in the United States is even stronger for the 1990s (Graph II.12). Between 1991 and 2000, the financial balance of the US household sector worsened by nearly 5 percentage points of GDP. In response, the current account balance went from a small surplus to a deficit of 4% of GDP while the fiscal balance shifted from a large deficit (-5%) to a small surplus (1%). Since then, the household financial balance has improved somewhat but remains significantly below its long-run average, while the current account deficit has increased further.

Lower fiscal deficits would be helpful in reducing the current account imbalance – but a markedly smaller US fiscal deficit seems unlikely in the context of recent and proposed tax cuts and increased government expenditure on both defence and domestic security. In addition, the financial deficits of non-financial firms are not far from their averages for the last 20 years. Prima facie, this would seem to limit the possibilities for a major adjustment from this source. In any event, much lower business investment as a key to current account adjustment would seem counterproductive in terms of future growth prospects. This analysis implies that, over the longer run, a sustainable reduction in the US current account deficit may need to be associated with a higher household saving rate.

In the past five years, growing US current account deficits have been almost “matched” by the rise in the global current account discrepancy and the accumulation of current account surpluses in emerging market economies, especially in Asia. By contrast, current account positions in Japan and the euro area have not changed significantly over the last five years. The external position of the euro area has remained almost in balance, although recording a somewhat higher current account surplus in 2002 as net private sector saving more than offset increased dissaving by the public sector. In Japan, the current account surplus – appreciably larger than in the euro area – has also been rather stable since the mid-1990s. This stability has reflected a combination of significant adjustment in the corporate sector, in particular reduced investment, counterbalanced by a substantial decline in the household saving rate. The government deficit also widened considerably in the course of the 1990s but has essentially stabilised at very high levels in the past few years.

Stable current account positions in the euro area and Japan