II. Developments in the advanced industrial economies

Highlights

Output revived in the advanced industrial countries in 2003 with the support of substantial policy stimulus in the United States and stronger demand in Japan. At the same time, growth in the euro area remained subdued. A feature of the recent expansion has been a shift from household to corporate spending. In addition, fears of deflation have eased.

The global recovery is projected to gain further strength this year, while inflation is expected to remain low (Table II.1). Nonetheless, the sustainability of the expansion is subject to a variety of risks. First, the weakening in budget positions in several countries makes it increasingly necessary to restore credible medium-term frameworks aimed at reducing fiscal deficits. Second, household debt has continued to rise, in contrast to the recent improvement in corporate balance sheets. Third, global current account imbalances have widened and how any future adjustment will proceed is unclear.

Assumptions about productivity trends play a crucial role in assessing whether these medium-term issues need be a source of serious concern. While cross-country comparisons are imprecise, the improved performance of productivity in the United States gives some grounds for optimism looking forward.

Growth and inflation

Average annual changes, in per cent

	Real GDP					Consumer prices[1]				
	1991–2000	2001	2002	2003	2004[2]	1991–2000	2001	2002	2003	2004[2]
Advanced industrial countries[3]	2.6	1.0	1.5	2.1	3.2	2.3	2.1	1.5	1.8	1.6
United States	3.3	0.5	2.2	3.1	4.6	2.8	2.8	1.6	2.3	2.2
Euro area	2.1	1.6	0.9	0.4	1.6	2.4	2.3	2.3	2.1	1.8
Japan	1.5	0.4	–0.3	2.7	3.1	0.8	–0.7	–0.9	–0.3	–0.2
United Kingdom	2.4	2.1	1.6	2.2	3.1	2.7	1.2	1.3	1.4	1.5
Canada	2.9	1.9	3.3	1.7	2.6	2.0	2.5	2.2	2.8	1.5
Australia	3.4	2.5	3.8	3.0	3.9	2.2	4.4	3.0	2.8	2.2
Other countries[3, 4]	2.1	1.5	1.5	0.7	2.4	2.1	2.2	1.8	1.7	0.9

[1] For the euro area and the United Kingdom, harmonised index. [2] Consensus forecast published in May. [3] Weighted average based on 2000 GDP and PPP exchange rates. [4] Denmark, New Zealand, Norway, Sweden and Switzerland.

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

The global recovery in 2003

Pickup in growth

The recovery gained strength

The recovery in the industrial countries that began in 2002 firmed last year, especially in the second half. This strengthening was somewhat unexpected, given the shallowness of the preceding downturn, an investment correction after the boom in the late 1990s, and high risk aversion at the beginning of 2003 in a context of geopolitical tensions and high-profile scandals concerning corporate governance.

Two pillars for global growth

The upturn spread across many of the main economies via a sharp acceleration in global trade. Unsurprisingly, a major impetus emanated from the United States, where the recovery became more secure, but global demand also benefited from a boom in emerging Asia. As analysed in Chapter III, the rapid development of this region has been a key feature of recent years and accounted for around one half of world output growth in 2003 (Table II.2).

The role of China

This rebalancing of global growth has several implications. On the one hand, faster export growth in emerging Asia has focused attention on the possibly adverse effects for the industrial countries, as it will amplify the pressure on low-skilled workers already arising from technological advances. On the other hand, domestic demand has gained significant strength in some Asian countries more recently, and it has become evident that Asia also has a growing demand for exports from the industrial countries. China has become one of the world's largest importers, and Chinese trade surpluses with the United States and the European Union have been redistributed in favour of neighbouring Asian countries, including Japan. At the global level, moreover, the increased division of labour in manufacturing and services should lead to greater efficiency and lift living standards everywhere. In particular, all

Contributions to world growth

In percentage points

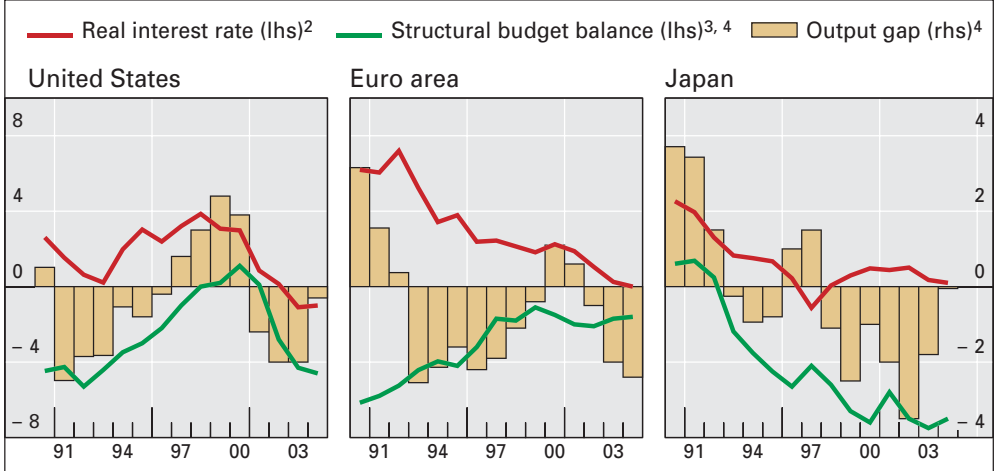
	Average 1991–2000	2001	2002	2003	2004[1]
Advanced industrial countries	1.5	0.6	0.8	1.1	1.7
Of which: Household demand[2]	*1.0*	*0.8*	*0.7*	*0.8*	*1.0*
Corporate demand[3]	*0.3*	*–0.5*	*–0.2*	*0.2*	*0.6*
Public demand[4]	*0.2*	*0.3*	*0.3*	*0.3*	*0.2*
Of which: United States	0.8	0.1	0.5	0.7	1.0
Euro area	0.4	0.3	0.1	0.1	0.3
Japan	0.1	0.0	0.0	0.2	0.2
Emerging Asia[5]	1.6	1.3	1.6	1.9	1.9
Of which: China and India	1.2	1.0	1.2	1.5	1.5
Rest of the world	0.2	0.5	0.6	0.9	1.0
World growth[6]	3.3	2.4	3.0	3.9	4.6

[1] Based on IMF and OECD forecasts. [2] Private final consumption expenditure plus private residential gross fixed capital formation. [3] Private non-residential gross capital formation. [4] Government final consumption expenditure plus government gross fixed capital formation. [5] Asia excluding Japan. [6] In per cent.

Sources: IMF, *World Economic Outlook*; OECD; national data. Table II.2

Real interest rate, structural budget balance and output gap[1]

In per cent



[1] For 2004, OECD forecasts. [2] Short-term interest rate deflated by annual consumer price inflation. [3] General government cyclically adjusted financial balance. [4] As a percentage of potential GDP.

Sources: ECB; OECD; Eurostat; national data. Graph II.1

consumers will benefit from lower prices for manufactured goods and services, as high productivity gains in Asia are passed through to export prices.

Policy played a major role in the global recovery

During 2003, demand in the advanced economies was buttressed by expansionary policies. Cyclically adjusted fiscal deficits widened as rising public expenditures and tax cuts continued to support GDP growth (Graph II.1). The main exception was the euro area: although the fiscal deficit widened in a context of weak growth, the structural deficit narrowed. Financial conditions were also favourable in an environment of continued low policy interest rates and long-term yields. Real interest rates, already near or below historical lows, declined further. Corporate spreads tightened and equity prices increased in major markets, driven by positive economic news and earnings reports, and a broad-based search for yield (see Chapters IV and VI).

Divergent economic performances among major industrial countries

Despite deepening international linkages, growth was uneven. The output recovery was strong in the United States, where policies were particularly expansionary. The revival in Japan was also notable, with the rate of growth exceeding potential and the output gap narrowing rapidly. Although the current Japanese recovery has owed much to the strength of external demand, it appears to be more promising than previous rebounds in that – for the first time since the bursting of the asset price bubble in the early 1990s – domestic demand has risen without significant fiscal stimulus. The main disappointment was the euro area. Domestic demand remained weak and the contribution of net exports to GDP growth turned sharply negative. As a result, output in the euro area as a whole barely grew in 2003; in Germany and the Netherlands it actually fell. Switzerland was also in recession. Canada faced a major deterioration in real net exports as currency appreciation more than counterbalanced the effect of strong US growth. Sizeable terms-of-trade gains, however, sustained domestic demand despite large and adverse idiosyncratic shocks. Australia continued to expand briskly.

Shift in the composition of growth

Growth has begun to shift from household to corporate spending

A salient feature of the period under review was the gradual shift of demand growth from household to corporate spending. Private consumption growth, the main source of support in 2002, decelerated slightly in the United States and remained weak in the euro area. Likewise, residential investment was bolstered by favourable financing conditions but did not gain much further strength. Higher growth was mainly due to increased corporate spending, with a long-awaited rise in business investment and a continued positive contribution from stockbuilding.

Resilient consumption ...

Private consumption remained relatively resilient, even though it had been surprisingly strong during the previous downturn. Spending was supported by the persistence of only moderate inflation, while households were the main beneficiaries of stimulative fiscal policies. Positive wealth effects, following the recovery in equity markets and the continued rise in house prices, also helped. The average ratio of net wealth to household disposable income, which had declined from 1999 to 2002, rebounded in the major OECD countries in 2003 to above its 1990s average. Low borrowing rates directly fuelled demand for durables and, together with higher house prices, encouraged households to refinance existing mortgages and extract housing equity. Those who refinanced to lower their interest payments saw their spending power increase. Those who took on more mortgage debt acquired additional funds, not only for consumption, but also for paying off more expensive debt or investing in other assets. Housing equity withdrawal, defined as the difference between net mortgage borrowing and residential investment, rose to 3½% of household disposable income in the United States in 2003 and 7% in the United Kingdom.

... but no acceleration in the face of weak labour markets ...

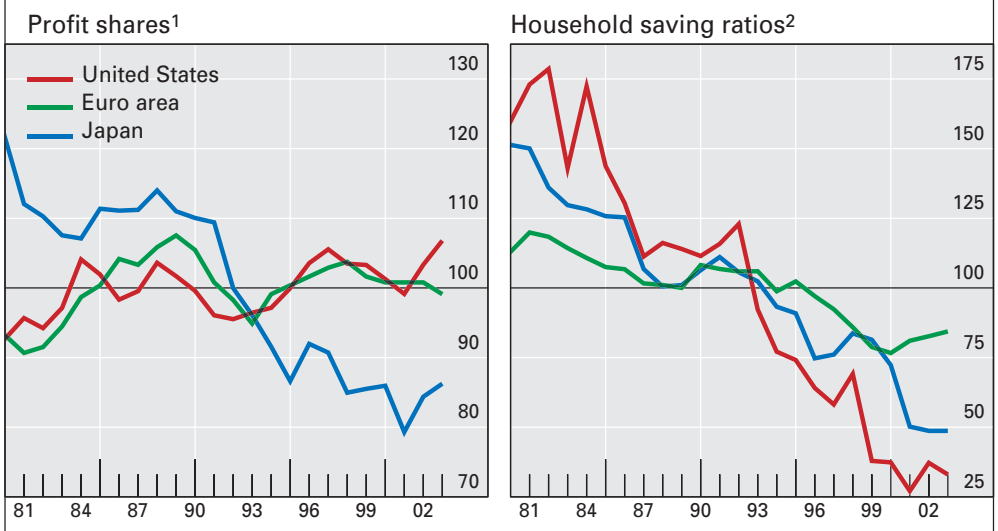
Nonetheless, private consumption was held back to some degree by the weakness of labour markets. That unemployment rose only moderately was mainly due to lower participation rates, especially in Japan and the United States. In aggregate, there was practically no net job creation in the OECD area over the past three years. Despite a strong recovery in demand, employment fell further in Japan and grew little in the United States. The Japanese performance can be attributed to continued restructuring, while the low job creation in the United States, quite unlike previous cycles, is more difficult to explain. Employment in the euro area was virtually flat and actually declined in Germany. Even so, the labour intensity of euro area GDP growth continued to increase, cushioning the job market, but also limiting measured productivity gains.

... and wage moderation

The adverse impact of soft employment on household incomes was compounded by subdued wage developments. Despite stronger aggregate productivity gains in recent years, real compensation per employee in the OECD area rose only moderately, implying that wage shares declined in the business sector. This was evident last year in the United States, where higher non-wage benefits appear to have been partly offset by lower earnings growth. Earnings barely grew in Japan in 2003, but at least they stopped falling. The main exception to the general trend was the euro area, where real compensation per employee accelerated in the business sector despite weak cyclical developments and low productivity growth.

Profit shares and saving ratios

1980–2003 = 100



[1] Property and entrepreneurial income/GDP (whole economy). [2] Saving/disposable income.

Sources: OECD; Eurostat; national data. Graph II.2

Business spending started to pick up

Business investment gradually recovered during the second half of 2003 in a context of better demand prospects, favourable financing conditions and rising aggregate profit shares in the industrial countries (Graph II.2). Temporary tax cuts might also have triggered some front-loading of investment plans in the United States. An additional factor supporting corporate spending has been the growing importance of IT equipment, which has led to a marked acceleration in the rate of obsolescence of the capital stock. In the United States, for instance, the gross investment required just to maintain the existing business capital/GDP ratio has almost doubled since the late 1980s. Investment rose particularly sharply in Japan and Australia and progressively strengthened in the euro area in the course of the year.

The near-term outlook

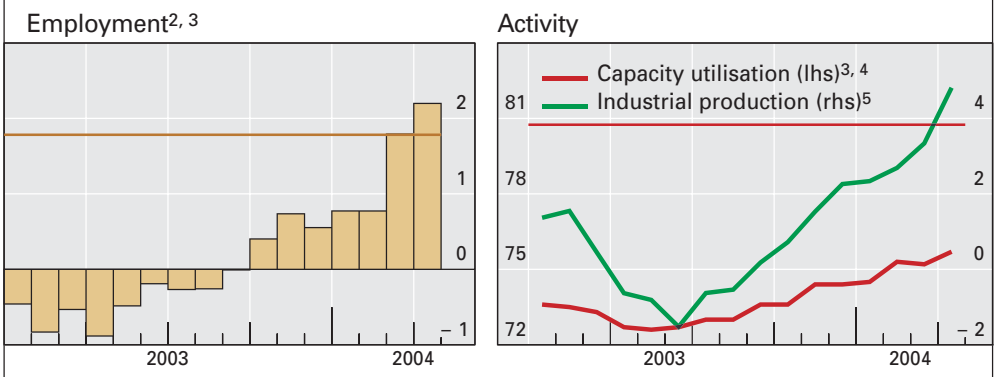
The consensus view is for the recovery to gain further strength in the near term, with global growth expected to reach 4½% this year. The latest US data on industrial production and capacity utilisation suggest that, while a significant amount of slack has already been absorbed, the current capital stock still provides room for a non-inflationary expansion (Graph II.3). Japan also entered 2004 with strong momentum, and output growth seems likely to exceed most estimates of potential growth this year. But the conditions for a significant recovery in domestic demand are not yet in place in the euro area, which is forecast to continue lagging the global upturn.

The consensus view is for further expansion ...

... but uncertainties remain regarding external developments ...

Despite the generally positive outlook, some uncertainties remain. Currency appreciation since 2002 has hurt prospects for net exports in the euro area and, more recently, also in Japan. Higher commodity prices, especially for oil, could also depress real incomes in the industrial countries, although

Indicators of slack in the US economy[1]



[1] Seasonally adjusted data. [2] Non-agricultural sector; three-month moving average of monthly changes at annual rate, in per cent. [3] The horizontal line represents the 1991–2001 average. [4] Manufacturing; in per cent. [5] Industry excluding construction; changes over 12 months, in per cent.

Source: National data. Graph II.3

the adverse terms-of-trade effects have been partly mitigated in countries whose currencies have appreciated against the US dollar.

... policy support ...

The current policy support is also expected to fade over time, as budgetary plans point to some stabilisation of the structural budget deficit at the OECD level. In addition, long-term interest rates have risen significantly since March 2004, and financial markets' expectations of higher policy rates in the United States have firmed.

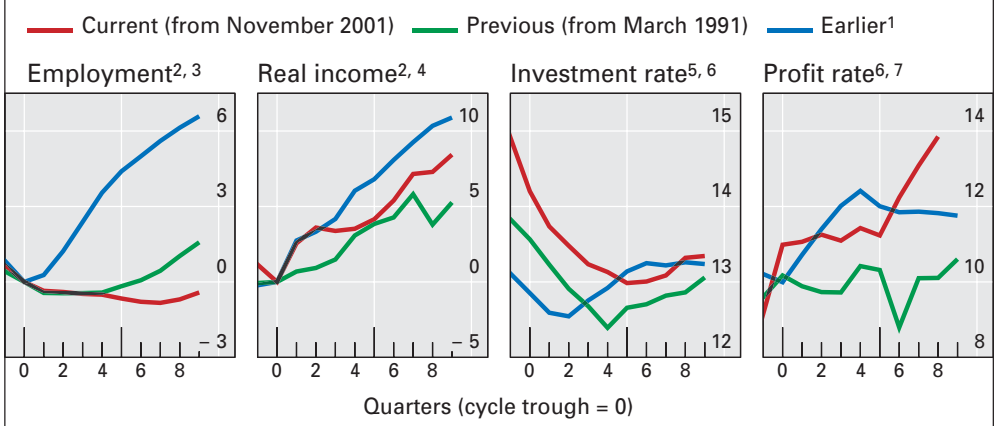
... investment decisions ...

In the United States, business spending is expected to recover further. However, the link between profits and investment has been loose in recent years and the current degree of slack is difficult to measure precisely. In Japan, prospects might be less favourable. The investment/GDP ratio is still high compared with other countries and the capital stock has continued to increase steadily. The outlook is mixed in the euro area: current investment ratios look moderate, but capital productivity and profits have been weak.

... and job prospects

With only limited signs that labour markets are reviving, could high rates of productivity growth be a cause for concern? Attention has focused on the "jobless recovery" in the United States, where employment has started to rise only very recently (Graph II.4). On the one hand, confidence might be hurt by the seemingly poor prospects for future wage income and firms might retain profits to reduce their debt. On the other hand, the productivity-led recovery in output has been reflected in higher real incomes, which should progressively boost spending, regardless of how such income increases are initially distributed. For example, the recent weakness in wage earners' nominal incomes could eventually lead to lower consumer prices and greater purchasing power. Alternatively, lower wage growth could be offset to some extent by higher dividends, since households are the ultimate owners of firms. Non-wage household income in the United States has indeed grown significantly in the recent past, in particular proprietors' and personal dividend income. Finally, higher profits should support equity price rises that could trigger positive wealth effects on spending.

Current and previous recoveries in the United States



[1] Average of eight recoveries identified by the National Bureau of Economic Research between 1949 and 1990. [2] Change from trough level, in per cent. [3] Non-agricultural sector. [4] Real personal disposable income. [5] Gross private domestic non-residential fixed investment. [6] As a percentage of business GDP. [7] Corporate profit.

Source: National data. Graph II.4

Issues for the sustainability of the recovery

Several issues arise regarding the sustainability of the current recovery beyond the near term. One is whether expansionary fiscal and monetary policies could, at some point, lead to inflationary pressures. Another issue is whether balance sheets are sufficiently healthy to underpin spending, given the already high debt levels of both private and public agents. A third is whether the current situation of large external imbalances is sustainable. A crucial factor pertinent to the assessment of each of these issues is the pace of productivity growth that industrial countries can expect to achieve in the longer run.

Productivity prospects

Productivity levels

Productivity is a key issue

It is hard to overstate the macroeconomic significance of trends in labour productivity, ie the amount of output produced per unit of labour. It plays a major role in determining a country's living standards and, as it influences earnings expectations and thus share prices, is also of great importance for financial markets. For policymakers, estimates of productivity growth and thus potential output are a key element in ascertaining the extent of inflationary pressures, with implications for interest rates, as well as in judging the stance of fiscal policy and the sustainability of budget positions. At the global level, different productivity growth rates across countries condition relative economic performance, though other structural factors such as the dynamism of the labour force are also important. In turn, the implications of different productivity growth rates for relative expected returns are a powerful driver of international capital flows. And the degree to which higher productivity levels or gains in some countries can be replicated in others influences global growth prospects.

Productivity levels[1]

United States = 100

	GDP per capita		Labour productivity			
			per person employed		per hour worked	
	1995	2003	1995	2003	1995	2003
Euro area	69	70	86	84	90	88
Of which: Germany	74	71	82	79	92	90
France	72	75	95	96	101	106
Italy	72	71	95	87	98	88
Spain	54	63	80	80	74	72
Ireland	62	87	88	99	81	97
Japan	81	74	78	74	70	67
United Kingdom	69	79	74	81	72	77
Canada	80	87	91	92	87	84
Sweden	73	75	80	80	84	84

[1] Whole economy; calculations made using purchasing power standards (PPS).

Source: Eurostat. Table II.3

High productivity levels in the United States

The first thing to note is the large differences in GDP per capita (PPS-adjusted; Table II.3). The United States tops the league, with a lead of around 30% over other main industrial economies. Compared to this measure, the euro area is better placed in terms of output per worker, the main reason being that employment rates are lower, reflecting social choices (eg early retirement) but also higher structural unemployment. When output is measured per hour worked, the euro area disadvantage narrows to around 10% relative to the United States, as euro area employees spend less time working. In other words, the euro area lags the United States in output per capita partly because its citizens are slightly less productive, but chiefly because of structural rigidities and more leisure. The relative position of Japan is still less favourable in terms of labour productivity.

Productivity growth

US performance has recently improved in relative terms

For most of the postwar period, Europe and Japan steadily raised their productivity levels towards the US level. By the early 1990s, however, this convergence seemed to have halted, and subsequently might even have reversed. These differences have been particularly evident since the latest downturn, with US productivity rising markedly in 2002 and 2003.

Traditionally, productivity gains have displayed significant cyclical movement

Is this apparent reversal of trends genuine, or does it just reflect cyclical differences and/or measurement error? Because of the lags with which labour adjusts to changes in output, labour productivity moves procyclically. For instance, firms that have hoarded labour during a recession can raise output without much increase in measured employment once demand picks up: productivity growth therefore surges in the upswing phase. Empirical evidence suggests that the cycle does have a positive impact on productivity in almost all industrial countries. Since the United States has experienced the fastest growth in output in the recent period, this may

have raised the "cyclical component" of US productivity gains relative to other countries.

Comparisons of productivity changes as well as levels are imprecise ...

As for measurement error, most international comparisons have focused on productivity changes because measurements of productivity levels are notoriously imprecise. However, even productivity changes are not free of measurement problems. Different methods of calculating value added in some sectors can influence their weight in GDP and thus their contribution to output growth. The fact that retail and wholesale trade, where value added might be harder to measure, has been a major contributor to the rise in US productivity growth in recent years is one example of this. In addition, the measurement of output growth appears to vary significantly across countries. One widely noted problem in this regard is the use of hedonic price indices, which allow better account to be taken of quality improvements, especially, but not only, in IT products. Another issue is the measurement of spending on software. These expenditures have been treated as investment (thus positively contributing to GDP growth, in contrast to intermediate consumption expenditures) to a much larger extent in the United States than in the other main industrial countries. A third measurement issue is the use of chained rather than fixed indices for deflating nominal growth rates. Several calculations suggest that measured GDP growth in Europe would be higher, perhaps by almost half a percentage point annually, if statistical methods were more similar to those used in the United States. Finally, a good deal of uncertainty also surrounds the measurement of employment growth, with some estimates showing that this could influence calculations of labour productivity gains by up to another half a percentage point annually in some countries.

... while changes in productivity gains should be more comparable

If statistical measurements are time consistent, the most severe distortions present in the estimation of growth in both output and labour tend to disappear. This means that measures of changes in the rates of productivity growth should be more comparable. Even so, discrepancies may widen over time, although their contribution to changes in measured differentials in annual productivity growth rates among the main industrial countries seems to have been less than half a percentage point over the past few decades.

Business sector productivity measures

Trend labour productivity gains in the business sector have diverged across OECD countries

Restricting comparisons to the business sector avoids the special difficulties involved in measuring output in the public sector. On this basis, a general long-term trend in the industrial world has been that labour productivity gains have on average declined since the 1960s. This slowdown has been shared by most countries, though in very different ways (Table II.4). Some economies have experienced a steady slowing of trend labour productivity gains (eg Belgium and Spain); in others (eg Germany, Italy and Japan), the decline has been more uneven – productivity accelerated in the 1980s, but only temporarily. In a third group of countries (Canada, France and the Nordic countries), trend gains in output per hour dropped sharply after the 1960s but began to increase again in more recent years. A unique case is the United States, where output per hour worked has accelerated and now appears to be growing at the same pace as before the 1970s.

These divergent developments might reflect different patterns in capital accumulation ("capital deepening") as well as varying rates of technological progress (measured by the growth rate of total factor productivity – TFP). Leaving aside cyclical influences, trend gains in TFP differ considerably. A first group of countries (Canada, France, Sweden and the United States) has shown a clear improvement. The increase has been notable in the United States, where TFP accelerated in the 1980s and again in the 1990s and is now estimated to be growing by 2% per year (Graph II.5). A second group includes many countries of the euro area, Japan and the United Kingdom, which have experienced a marked decline in trend TFP. In fact, TFP appears to be flat or even decreasing in Japan and Italy, as output growth is mainly attributable to higher inputs of labour and capital deepening.

Technological progress and capital accumulation patterns differ

To sum up, the level of US labour productivity is the highest among the major industrial countries and has been rising the fastest in the recent past. Rather than just reflecting stronger capital accumulation, this performance has been associated with a higher rate of technological progress that was maintained during the latest recession. More importantly, perhaps, the US performance has improved in relative terms, as TFP growth has accelerated in the United States but decelerated in most other economies.

The US performance stands out

Productivity gains[1]

	Labour productivity				Total factor productivity			
	Previous trend		Current trend		Previous trend		Current trend	
	Start year	Average	Start year	Average	Start year	Average	Start year	Average
United States	1974	1.2	1998	2.8	1983	1.0	1998	2.1
Euro area[2]	1979	2.6	1996	1.5	1988	1.4	1994	0.7
Germany	1989	3.5	1995	1.6	1988	2.4	1994	1.0
France	1993	1.7	2001	2.8	1992	0.4	1998	1.2
Italy	1991	2.8	1997	0.8	1990	0.9	1997	–0.2
Spain	1986	2.0	1996	0.7	1982	2.2	1988	0.2
Netherlands	1983	3.6	1993	1.5	1993	1.2	2000	0.4
Belgium	1976	4.0	1982	2.1	1976	1.8	1982	0.9
Finland	1989	4.4	1995	3.0	1993	3.7	2001	1.8
Ireland	1978	3.5	1988	4.8	1995	5.4	2001	2.7
Japan	1986	4.0	1994	2.0	1985	1.3	1994	0.1
United Kingdom	1985	0.8	1991	2.0	1970	2.1	1984	1.0
Canada	1973	1.2	1998	1.8	1974	0.6	1996	1.6
Australia	1991	2.3	2002	0.3	1992	1.9	2000	0.4
Sweden	1976	1.7	1991	2.3	1976	0.7	1992	1.6
Norway	1980	1.9	1989	2.9	1990	2.9	1996	2.1
All countries	1971	3.5	1977	2.0	1993	0.9	1999	1.4

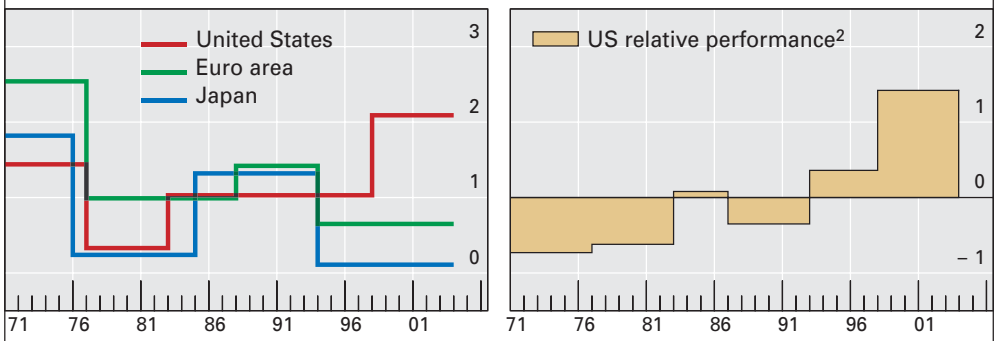
Note: Trends in labour and total factor productivity are estimated by regressing their logarithm on time trends T^i (given that I break trends are allowed in the specification if they are significant at the 95% level) and CY, an indicator of the position in the business cycle (capacity utilisation in industry, normalised). For TFP, for instance, we have $log\ TFP = \sum_{i=1}^{i=I+1} \alpha^i T^i + \beta + \gamma CY + U$, where α, β and γ are the parameters and U is the residual of the estimation.

[1] Business sector; productivity gains are calculated using input of labour, expressed as hours worked. [2] Weighted average of Belgium, France, Germany, Italy, the Netherlands and Spain, based on 2000 GDP and PPP exchange rates.

Sources: OECD; BIS calculations. Table II.4

Trends in total factor productivity (TFP)[1]

Annual changes, in per cent



[1] TFP is calculated using input of labour, expressed as hours worked; business sector; for an explanation, see Table II.4. [2] Trend TFP gains in the United States minus those in the group composed of Australia, Canada, euro area countries (see footnote 2 of Table II.4), Japan, Sweden and the United Kingdom.

Sources: OECD; BIS calculations. Graph II.5

Looking forward

The role of IT investment ...

Whether the growing gap between TFP in the United States and that in other countries will diminish is difficult to judge. What is clear is that the steady improvement in US productivity observed since the 1980s is not just a matter of greater use of IT equipment. IT use has also expanded in other countries without preventing a sharp deceleration in TFP. Instead, much of the acceleration in trend TFP in the United States could well have come from the previous deregulation of markets for goods and services. The resulting increase in competition might have spurred innovation by creating strong incentives to reduce production and distribution costs. Indeed, the United States has seen the emergence of large producers in the IT sector, a sector characterised by both fierce competition and a very high rate of technological progress. Sizeable productivity improvements have also been recorded in wholesale and retail trade, where competition has again been intense. In addition, the US labour market has been helpful; witness the long-term fall in structural unemployment since the 1970s and the ease with which workers move from declining to growing sectors. In short, the implementation of structural reforms might be one key prerequisite for creating stronger market incentives and duplicating the US innovation process.

... and structural reform in raising productivity levels

Will potential growth rise in the longer run?

Nonetheless, some uncertainty remains as to whether recent patterns in productivity growth will be maintained and whether industrial countries will be able to achieve stronger potential growth rates in the future. On the one hand, the recent improvement in US productivity gains may not last indefinitely. In particular, companies' willingness to cut costs, as well as the lagged impact of past large investments in IT equipment, may have raised the level of productivity, and thus its measured growth for a time. Eventually, however, such effects could fade away. On the other hand, the tendency for structural reforms, implemented in the past two decades, to increase the demand for less-skilled labour could also have held down measured overall productivity gains in a significant way in the United States and some European

countries (eg Ireland, the Netherlands and the United Kingdom). A related and positive consequence is that structural unemployment has now come down to lower levels. At some point, such transitory effects might begin to dissipate, possibly revealing higher underlying productivity growth in the coming years. All in all, the discussion above suggests that trend GDP growth rates diverge significantly among major industrial economies. According to several estimates, potential growth might be almost 3½% per year in the United States, compared to around 2½% in the United Kingdom, 2% in the euro area and 1½% in Japan.

Inflation

Fears of deflation eased

Concerns about deflationary pressures emerged in the early part of 2003 before easing in the rest of the period under review. Even in Japan, where both consumer prices and land values have fallen continuously in recent years, a feeling has progressively emerged that a turning point in the battle against deflation might be approaching. The rebound in the price of manufactured goods in 2003 and the spike in commodity prices have contributed to allaying deflationary fears.

Global inflation remains low

Nonetheless, global inflation remains low. An important factor has been the influence of negative output gaps. The associated downward price pressures have been reinforced recently by the productivity gains discussed above, and subdued developments in wages. To a certain extent, an exception has been the euro area, where inflation has been slow to respond to a widening and negative output gap. Inflation has remained close to the ECB's 2% threshold, partly reflecting in some places the lagged effects of the introduction of the euro and, more importantly, sticky labour costs as well as governments' attempts to boost revenues by raising indirect taxes and charging more for public services.

Anchored inflation expectations

Inflation expectations have also remained well anchored at low levels. The difference between yields on index-linked bonds and those on traditional bonds suggests that inflation expectations out to a 10-year horizon have stayed in a range of 1½ to 2½% in the euro area and the United States during the period under review. This relative stability has persisted despite marked shifts in the outlook for growth as well as sharp adjustments in exchange rates. Indeed, in the larger industrial economies, the influence of currency movements on prices appears to have been very limited thus far. Consumer price inflation has remained at low levels in the United States despite a weaker dollar. Similarly, inflation has not come down in the euro area nor deflation increased in Japan, although currencies have strengthened. Nevertheless, the deceleration of consumer prices following the exchange rate induced decline in import prices in Canada and Australia has renewed debate about the size and dynamics of the pass-through in smaller open economies.

The inflation outlook

Inflation is expected to remain low despite higher commodity prices

The main proximate risk of inflation, if any, would seem to come from soaring commodity prices (Table II.5). Should industrial production in China continue to expand rapidly and major industrial countries start to grow synchronously,

World trade and prices[1]

Average annual changes, in per cent

	1991–2000	2001	2002	2003	2004[2]
Trade volumes	7.3	–0.5	3.1	5.2	7.1
Trade prices (in US dollars)	–0.8	–3.5	0.9	11.6	6.1
Manufactures	–0.9	–2.8	2.4	14.5	7.7
Oil	2.1	–13.8	2.5	15.8	3.8
Other commodities	–0.5	–4.0	0.5	7.1	7.6
Terms of trade, advanced economies[3]	0.0	0.4	1.1	1.3	0.3

[1] Goods only. [2] IMF forecast. [3] Advanced industrial countries plus newly industrialised Asian economies (Hong Kong SAR, Korea, Singapore and Taiwan, China).

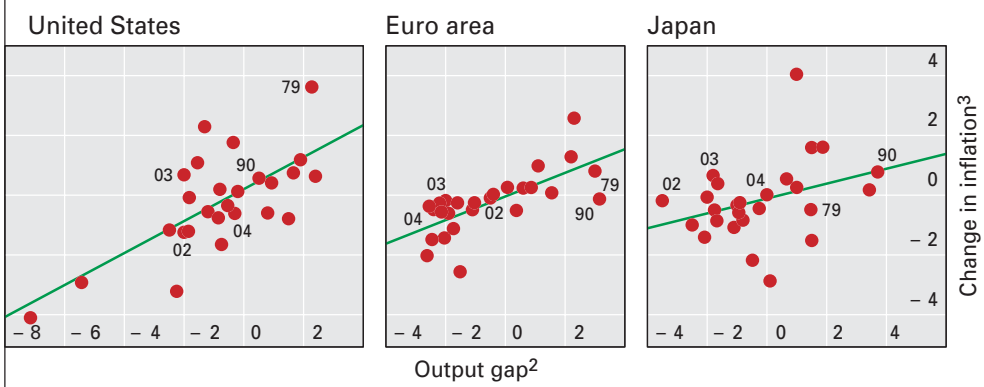
Source: IMF, *World Economic Outlook*. Table II.5

commodity prices could well climb further. In addition, the prices of raw material-intensive exports from China could rise in turn. However, non-oil commodities represent a very small percentage of total costs in the advanced economies; the impact of higher commodity prices in US dollars is much weaker in countries with appreciating currencies; and a substantial part of the recent surge in oil prices has already been felt. Some observers have also pointed to rising liquidity in the global economy, which could spur inflation or lead to higher asset prices (see Chapters IV and VII). The fact that growth in monetary aggregates has slowed recently in the main industrial countries is more comforting.

Disinflationary forces are still working at this stage of the cycle

Another view is that underlying disinflationary forces will continue to exert their influence for some time. Historical patterns suggest that negative output gaps should be accompanied by a decline in inflation (Graph II.6). Spare capacity is particularly large in manufacturing and may be even larger than is suggested by national measures given increased global integration and the rapid expansion of Asian production capacity. A substantial degree of slack also remains in the main labour markets, suggesting that the growth of unit labour costs will stay moderate, notably in those countries where productivity gains have been strong.

Inflation changes and output gap, 1979–2004[1]



[1] For 2004, OECD forecasts. [2] As a percentage of potential GDP. [3] In percentage points, where inflation is measured as average annual changes in consumer prices, in per cent.

Sources: OECD; Eurostat; national data. Graph II.6

Private sector balance sheets

Corporate balance sheets

Some improvement in corporate balance sheets ...

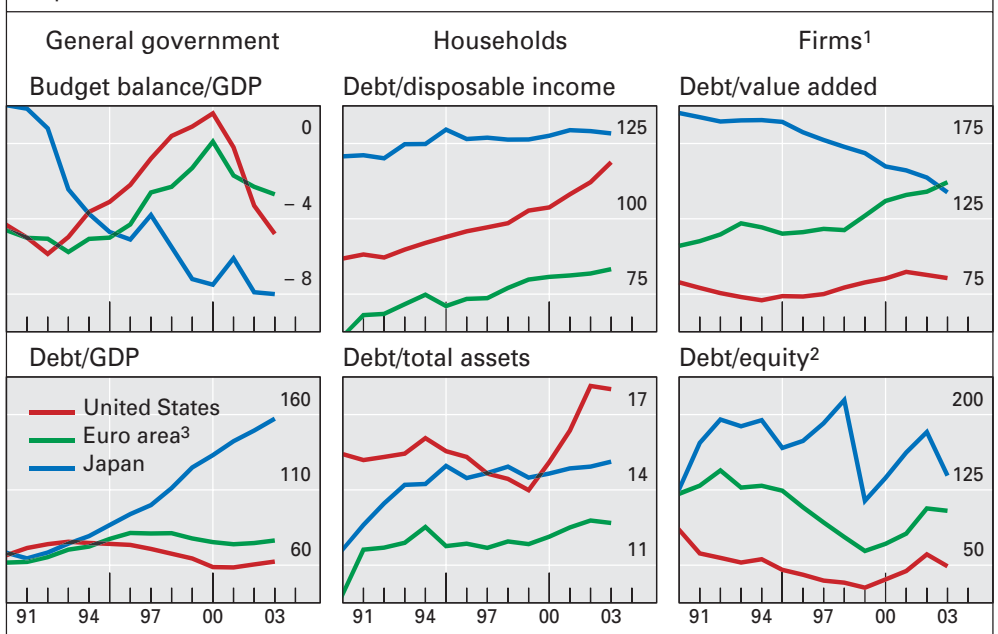
Reducing debt burdens became an important objective for many firms after the recent downturn, and much has been achieved at the global level. Higher demand, limited hiring, restrained wage increases and (perhaps) greater pricing power have helped boost profits. Firms' reluctance to spend on fixed assets, allied with the impact of low interest rates on the costs of debt servicing, has also improved their financial balances. Corporate balance sheets have further benefited from the rebound in financial asset prices; debt/equity ratios have generally fallen (Graph II.7), although they remain well above the levels observed when equity prices were at their peak.

... especially in Japan

This improvement has been particularly pronounced in Japan. Despite a marked pickup in investment, the financial surplus of enterprises surged to 7% of GDP in 2003. Corporate debt fell to around 140% of business value added, down from almost 200% in the early 1990s. A strengthening of financial positions has also been visible in the United States. Strong productivity gains have fed directly into earnings, and the profit share recently reached its previous peak of 1997 – well above its long-term average (see Graph II.2, left-hand panel). The expansion of corporate debt (more than 10% per year at the end of the 1990s) has slowed, reducing debt/value added ratios to levels closer to the 1990s average. In the euro area, on the other hand, corporate profitability has failed to improve significantly, reflecting weakness of demand, the appreciation of the currency, sticky labour costs and low productivity gains. As a result, debt/value added ratios have risen further.

Sectoral indebtedness

In per cent



[1] Non-financial corporations. [2] Equity defined as the market value of outstanding equities. [3] For households and firms, weighted average of France, Germany and Italy.

Sources: OECD; national data; BIS calculations. Graph II.7

Risks remain

While the corporate situation has improved since the last downturn, several uncertainties remain. First, large sectoral differences still exist. In the United States, the sectors that have benefited the most from higher profits are financial institutions and IT firms. In contrast, profits have barely changed for trade, utilities and producers of non-IT durable goods. In Japan, the improvement has been concentrated on large export-oriented manufacturers. Second, credit conditions for small and medium-sized firms have remained difficult in both Japan and some European countries. A third source of concern is that both equity values (and thus debt/equity ratios) and debt servicing have benefited from unusually low interest rates on risk-free assets. Finally, uncertainty about the size of firms' pension liabilities and recent accounting scandals further cloud the outlook.

Household balance sheets

Household liabilities have been growing ...

The picture for household balance sheets is still more mixed. The ratio of household debt to personal income has risen steadily in the main OECD countries over the past decade. The bulk of this increase has reflected the large growth in mortgage debt in a context of continuing financial innovation. The growing importance of mortgage debt suggests that increases in household liabilities have generally been matched by rising household assets, with no effect on aggregate household net wealth. For instance, US home ownership went up by almost 5 percentage points from the mid-1990s to 2003. Moreover, the rise in debt should be seen against the backdrop of the secular downward trend in interest rates, which has raised households' "affordable" debt levels.

... while saving rates have steadily declined

The rise in household indebtedness has occurred in tandem with marked declines in household saving rates in most industrial countries over the last decade (see Graph II.2, right-hand panel). Attention has centred on the United States and the United Kingdom, where private consumption has recently been the most dynamic. Indeed, their household saving ratios look quite low in comparison with the rest of the OECD area. From a historical perspective, however, the fall in saving rates has also been sharp in Australia, Canada and Japan. The main exception to this global trend is the euro area. The French household saving rate has increased steadily since the late 1980s. Household saving ratios in the rest of the euro area have also rebounded over the last few years. This rebound has possibly reflected higher perceptions of inflation following the introduction of the euro, as well as adverse developments in labour markets, but also uncertainties regarding pension systems and public finances and the adoption of structural reforms more generally.

Saving ratios might not have to go up ...

The fact that OECD household saving rates are so low from a historical perspective could suggest that some past demand might have been "borrowed" from the future, and that a return to "normal" behaviour would reduce spending. However, historical norms might no longer be appropriate. The steady rise in household net wealth over the past few decades in most countries could imply that the equilibrium level of household saving has fallen. An important exception is Japan, where the saving ratio has halved since 1991 while the level of net wealth has significantly declined. Recent trends in saving might also reflect a more efficient provision of mortgage credit, notably in the

United States and other economies where households can more easily extract equity from their homes and borrow against unrealised capital gains. The availability of such collateral can greatly reduce the cost of credit and improve intertemporal smoothing of consumption, thus increasing welfare in the economy.

... but households are vulnerable to adverse shocks

Nevertheless, it cannot be ruled out that homeowners might have overestimated their wealth and, through greater indebtedness, heightened their vulnerability to shocks (see Chapters VI and VII). One concern is the possibility of sudden increases in interest rates, which would particularly expose homeowners in the United Kingdom, Australia and Spain, where mortgages are mainly at flexible rates. However, if higher interest rates were to reflect expectations of stronger output, higher household income growth and lower unemployment, this would make household debt more sustainable.

The fiscal outlook

Concerns about weak fiscal positions

The use of fiscal policy to support global growth in recent years has raised concerns about the sustainability of public debt. In only three years, the US general government fiscal surplus has turned into a deficit equivalent to 5% of GDP. Fiscal balances have also worsened in Europe, albeit to a much lesser extent. In Japan, the general government fiscal deficit has remained very substantial, at close to 8% of GDP.

Public deficits have helped cushion the downturn ...

While fiscal deficits always require careful monitoring, recent levels are not unprecedented – the main exception being Japan. In addition, fiscal policy has been used in a timely (though perhaps fortuitous) fashion to cushion the recent downturn. However, this very flexibility underscores the importance of a medium-term framework for fiscal discipline that ensures restraint in good times so that the public authorities can react countercyclically in bad times. Fortunately, the recent rise in public deficits has mainly occurred in those countries that had created sufficient room for manoeuvre during the previous expansion, in particular the United States and the United Kingdom.

... and debt levels are not yet clearly excessive

Public debt levels in many countries are not yet clearly excessive. US general government gross liabilities, as a percentage of GDP, are still significantly lower than in the early 1990s. In the euro area, the situation has actually improved in those countries where public debt sustainability was most at risk (eg Belgium); all the same, public liabilities have risen on average in the past decade and now exceed the Maastricht ceiling of 60% of GDP in the three largest economies. In Japan, public debt is expected to reach 160% of GDP this year, and it is still growing by around 5 percentage points of GDP per year.

But public liabilities cannot grow without limit ...

It is self-evident that public sector debt cannot grow without limit. Weak fiscal positions can raise long-term interest rates and crowd out private investment if markets do not expect them to be corrected. If the government were to seek to offset such a process through monetary stimulus, inflationary pressures could rise. The lesson of the past few decades is that the longer

fiscal consolidation is delayed, the greater is the need for a severe adjustment later on. The fiscal consolidation implemented in some highly indebted European countries, such as Belgium and Italy in the 1990s, required painful restraints on public expenditures and substantial tax increases.

... raising the need for fiscal consolidation at some point ...

From this longer-term perspective, budget balances in many large countries must improve significantly in order simply to stabilise current net debt/GDP levels (Table II.6). In addition, interest rates are at present very low and their return to levels more in line with historical averages would increase the cost of servicing a still growing debt stock. And some precautionary room for manoeuvre also needs to be restored, notably in those countries where structural deficits are relatively high. This need is compounded by the over-optimism of official fiscal forecasts, so evident in recent years, and the uncertainty about potential growth trends discussed above.

... and for credible medium-term frameworks

Several governments have already expressed their intention to cut public deficits in the coming years, assuming the current recovery endures. Yet some of these plans look rather ambitious and markets might well find them

Fiscal indicators in 2003

	Financial balance	Structural balance[1]	Cyclical balance[2]	Net debt	Gross debt	Debt stabilisation effort[3]	Risk on interest payments[4]
United States	–4.9	–3.9	–1.0	47	63	2.7	0.6
Euro area	–2.8	–1.6	–1.2	55	76	0.6	–0.3
Germany	–4.0	–2.4	–1.6	52	65	2.7	–0.5
France	–4.1	–2.9	–1.2	43	70	2.5	–0.8
Italy	–2.4	–1.4	–1.0	94	117	–1.5	0.4
Spain	0.3	1.0	–0.7	36	63	–2.6	0.9
Netherlands	–3.2	–2.1	–1.1	43	54	1.4	–0.8
Belgium	0.2	–1.0	1.2	93	102	–4.4	0.3
Austria	–1.2	0.1	–1.3	45	67	–0.6	–0.3
Greece	–2.7	–2.6	–0.1	...	103	–4.5	1.7
Portugal	–2.8	–0.9	–1.9	...	60	0.3	–1.6
Finland	2.1	2.8	–0.7	–47	53	–0.7	–1.4
Ireland	–0.3	1.0	–1.3	...	32	–2.0	–2.4
Japan	–8.2	–7.2	–1.0	79	155	9.2	1.1
United Kingdom	–3.0	–2.7	–0.3	32	54	1.3	0.3
Canada	1.2	1.8	–0.6	35	76	–3.3	1.1
Australia	–0.6	–0.5	–0.1	3	18	0.4	–0.2
Sweden	0.2	1.2	–1.0	3	63	–0.3	0.8
Denmark	1.2	2.3	–1.1	5	51	–1.4	–0.7
Norway	9.3	–3.0	12.3	–90	24	–5.3	–1.2
New Zealand	2.4	3.7	–1.3	15	38	–3.1	–0.2
All countries[5]	–4.1	–3.2	–0.9	50	79	2.5	0.4

Note: All data are for general government and expressed as a percentage of GDP.

[1] Cyclically adjusted financial balance; for Norway, excluding revenues from petroleum activities. [2] Financial balance minus structural balance. [3] Change in financial position necessary to stabilise net debt (gross for Greece, Ireland and Portugal), if nominal GDP were growing at its potential rate. [4] Potential minus actual gross interest payments; potential interest payments are those that would arise if the spread between the nominal GDP growth and the apparent interest rate on gross debt (net for Greece) were equal to its 1994–2003 average. [5] Weighted average of the countries shown, based on 2000 GDP and PPP exchange rates.

Sources: IMF; OECD; BIS calculations. Table II.6

unrealistic as well as possibly insufficient. This has strengthened the argument for adopting a credible medium-term fiscal strategy in the main industrial economies, although such frameworks should also leave some space for discretionary policies. The recent relaxation of fiscal rules, which had been instrumental in achieving budget consolidation in the 1990s, is thus a matter of concern. In the euro area, for instance, the deficit limits set by the Stability and Growth Pact have been breached by several countries. In the United States, the authorities have abandoned the system of caps on discretionary spending introduced in the 1990s. And there is a growing need for adopting a long-term strategy in order to address the rising public debt in Japan.

The issue of ageing

Fiscal consequences of ageing populations are a major concern

There has been reluctant but growing recognition that the commitment of governments in the industrial countries to pay for pensions and medical care for the aged cannot be honoured without additional policy actions. This problem should be viewed in the broader context of the macroeconomic consequences of ageing. Assuming that current trends in birth rates and immigration remain unchanged, the active/inactive population ratio will worsen dramatically in the coming decades. Hence, the claims of future pensioners are expected to rise sharply. The risk this entails is that the implied tax burden on a relatively smaller future generation of workers will become excessive, leading to sweeping and disruptive cuts in such benefits or their effective reduction through higher inflation.

Three types of action could be considered in order to avoid this. The first and most crucial is to raise public awareness of the simple arithmetic. This suggests a full recognition of the implicit liabilities stemming from ageing, which often remain hidden under current public budget accounting. A second response, building on the first, is to cut promised benefits in an orderly way, thus limiting transfers between current and future working generations. A third measure often proposed is to complement public commitments with private savings, although a change in pension arrangements would be of little help in addressing the problem of previously acquired rights.

The key issue is to raise average living standards

The key issue, however, is to increase the pool of resources (ie national incomes) from which future social benefits will be drawn. A first proposed solution is to raise saving rates, and therefore the capital available to support future workers, through a greater reliance on privately funded savings schemes. It is true that these schemes are often regarded as being better prepared to deal with the consequences of ageing, but whether national savings will effectively rise in aggregate, and whether this will effectively raise future incomes, is still a matter of debate. In addition, countries that will be facing the consequences of ageing earlier (ie European countries and Japan) already have a relatively high level of private savings, and still higher investment might not be very effective in raising potential output. A second proposed solution is to increase the labour force in the future, ie at the time when higher public transfers will have to be made. Many countries have already adopted measures to raise the retirement age, and some might well consider allowing more foreign workers to enter. Past experience suggests

that policies aimed at curbing structural unemployment and raising labour force participation could also have a substantial impact on the level of potential output. A third proposed solution is to raise the amount of output generated by a given input of labour and capital. Higher gains for total factor productivity would leave more resources available for consumption by a declining group of working and an expanding group of non-working citizens. Assuming that it continues, the divergence in trend productivity gains noted above suggests that the United States is in a better position in this regard than most other industrial countries.

Current account developments

Widening global current account imbalances

The US current account deficit ...

Large current account imbalances continued to characterise the global economy in 2003 (Table II.7). The US payments gap increased to almost $550 billion, around 5% of US GDP. Current account surpluses were found mainly in Asia but also in parts of Europe (essentially Germany, Switzerland and Norway). Statistical shortcomings imply that more than $100 billion of global deficits were not accounted for in 2003. This has been a persistent pattern since the late 1990s that clouds any analysis of present current account positions.

... has tripled since the mid-1990s ...

Since the mid-1990s, the US deficit has more than tripled in percentage points of GDP, with emerging markets (particularly in Asia) accounting for the bulk of the corresponding increase in surpluses. The picture has been relatively more stable for the other main industrial economies. Sizeable and regular current account surpluses of around 2 to 3% of GDP have been recorded in Japan. The euro area has also been in a comparatively stable position, with only a slight surplus on average over the past decade.

In the United States, strong demand growth and the high value of the dollar widened the imbalance in the late 1990s. In recent years, however, a continued widening has occurred despite the weakening of the dollar.

Current account balances in major regions

In billions of US dollars

	Average 1991–2000	2001	2002	2003	2004[1]
United States	–150	–394	–481	–542	–496
European Union	9	–6	67	36	48
Japan	107	88	113	138	144
Other advanced industrial countries	4	56	46	41	44
Emerging Asia	22	90	132	148	128
Rest of the world	–72	–3	13	58	33
World[2]	*–80*	*–169*	*–110*	*–121*	*–99*

[1] IMF forecast. [2] Reflects errors, omissions and asymmetries in balance of payments statistics.

Sources: IMF, *World Economic Outlook*; national data. Table II.7

A classical J-curve effect (whereby the trade balance worsens in the initial phase of exchange rate depreciation) may have been at play, as well as the higher price of oil. However, developments in US import prices have been rather moderate, reflecting the widespread practice of pricing to market by foreign exporters. Indeed, the US trade deficit seems to have been driven by the fact that the US economy has been growing faster than most of its trading partners and by an apparently higher elasticity of imports to domestic demand in the United States, compared to the elasticity of US exports to external demand.

... reflecting a growing gap between investment and saving

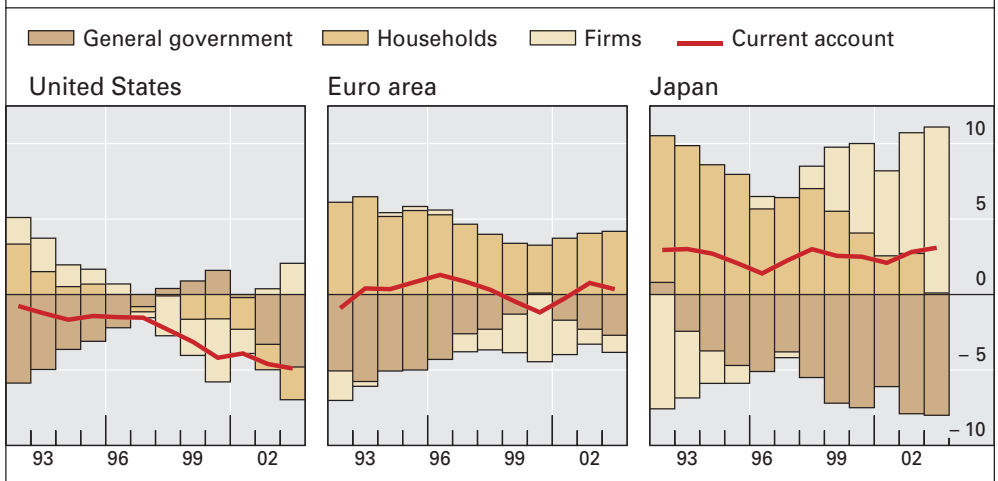
By definition, the marked rise in US external borrowing needs since the mid-1990s has been associated with a growing gap between investment and saving. Before the last downturn, saving by households fell and investment as a proportion of GDP increased. These two factors drove the current account deficits up, in spite of a sharp improvement in the fiscal accounts (Graph II.8). Following the recession, this picture changed as investment was cut back and business sector saving rose. Nevertheless, US foreign borrowing continued to increase as a large public sector saving deficit emerged. This raised concerns that a "twin deficit" problem had reappeared, echoing developments in the 1980s. However, a more persistent trend has been the association of large current account deficits with continued low levels of household net saving.

Patterns in saving and investment outside the United States

Patterns in saving have been somewhat more stable in Europe, although significant changes have occurred within the euro area since the mid-1990s. A large German current account surplus has emerged as investment has fallen. The ratio of investment to GDP has been steadier in Italy, but a substantial current account deficit has built up as household saving has declined. Japan has continued to experience a steady and parallel decrease in both saving and investment (Table II.8). In emerging Asia, investment was scaled back following the 1997–98 financial crisis and has risen only modestly in recent years, while saving rates have rebounded. Other emerging economies have

Net sectoral financial balances

As a percentage of GDP



Sources: ECB; OECD; Eurostat; national data. Graph II.8

Saving/investment balances

As a percentage of GDP

	Investment			Current account			Domestic saving		
	Change		Level	Change		Level	Change		Level
	1997–2000	2000–03	2003	1997–2000	2000–03	2003	1997–2000	2000–03	2003
United States	1.0	–2.4	18.4	–2.7	–0.7	–4.9	–1.6	–3.2	13.4
Euro area	1.7	–2.1	19.9	–2.0	1.6	0.4	–0.4	–0.5	20.3
Other European countries[1]	0.4	–1.8	16.6	–0.4	0.5	2.0	–0.1	–1.3	18.6
Other advanced countries[2]	0.1	0.9	22.1	2.5	–1.3	–1.1	2.5	–0.4	21.0
Japan	–2.4	–2.3	24.0	0.2	0.7	3.2	–2.1	–1.6	27.2
Emerging Asia, main economies[3]	–3.9	1.4	30.7	2.3	0.9	4.0	–1.6	2.3	34.6
Other main emerging countries[4]	–1.0	–1.2	20.6	1.3	2.0	0.7	0.2	0.8	21.3
Total	–0.2	–1.8	21.0	–0.9	0.4	–0.5	–1.1	–1.3	20.5

[1] Denmark, Norway, Sweden, Switzerland and the United Kingdom. [2] Australia, Canada and New Zealand. [3] China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand. [4] Argentina, Brazil, Chile, the Czech Republic, Hungary, Mexico, Poland, Russia, South Africa and Turkey.

Sources: ECB; Eurostat; CEIC; national data. Table II.8

seen an improvement in their aggregate current account balance matched by higher saving or lower investment.

Significant medium-term uncertainties

Risk of protectionism

Widening external imbalances, allied with a perception that employment in developed economies is threatened by the supply of low-cost goods and services from fast-growing Asian economies, have raised the risk of protectionism. Protectionist sentiment might also be exacerbated by the planned elimination of quotas on textile imports and the increasingly publicised outsourcing of IT services offshore (eg to India). These concerns are clearly exaggerated, given the relatively small size of the sectors considered. In addition, many countries have proved able to cope over many years with the secular decline in low-skilled manufacturing jobs. Indeed, structural unemployment in the OECD area has decreased since the mid-1990s.

The funding of US borrowing needs

A second issue is the way external imbalances have been financed (see Chapter V). The composition of US capital inflows has changed in the past few years, from private direct investment and equities towards foreign official holdings of US government debt, notably by central banks in Asia. The weakening of the dollar until February this year might indicate increased dependence on such flows.

How vulnerable capital flows to the United States are to shifts in investor sentiment is unclear. Some observers have expressed the concern that the demand for dollar assets could be undermined should foreign investors begin to worry more about US debt accumulation or by less favourable growth prospects. From this perspective, a key consideration is that, by the end of 2002, net US international liabilities amounted to 25% of GDP (at market values). This ratio is very likely to increase in the years ahead, since stabilisation of the

net debt/GDP ratio would require a large reduction of the US current account deficit, which appears unlikely at present.

There are, however, some more positive elements. Although high by historical standards, US external debt is still lower than in some other industrial countries – eg Australia (60% of GDP). Moreover, the rise in US foreign liabilities has occurred in a context of increased financial liberalisation and the associated development in cross-country ownership of capital stocks. This suggests that the international financing of even large saving/investment gaps is now appreciably easier than in earlier decades.

Valuation effects matter for the net external position ...

It should also be noted that the financial flows stemming from current account balances are not the only source of changes in net investment positions. Valuation effects also matter. For instance, the increase in the US net external debt from 1983 to 1990 (over $400 billion) was less than half of the current account deficits cumulated over that period. This was due in large part to the increased dollar value of US assets denominated in foreign currency, as the dollar depreciated over most of the period.

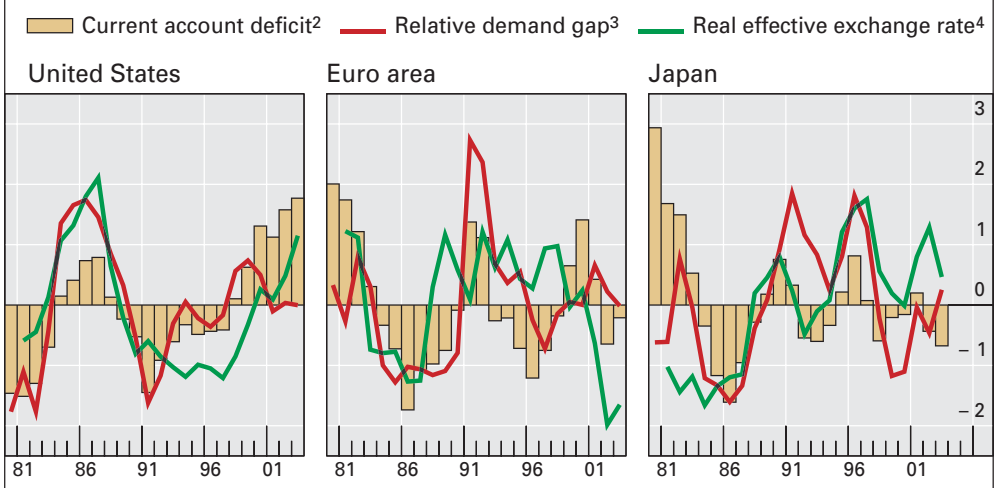
... and the case of the United States is unique ...

Perhaps more importantly, the case of the United States is unique for three reasons. First, the dollar has a prominent international role as an anchor, reserve and intervention currency (see Chapter V). This may have created a structural bias in favour of US assets as countries worldwide increased their holdings of foreign assets. Second, the United States still enjoys a small surplus on its net investment income balance, despite a large and rising foreign debt. Though the current situation of low global interest rates has certainly favoured net debtors at the expense of creditors, a more structural element is that the return on US direct investment abroad has been consistently higher than for foreign-owned assets in the United States. This suggests that US companies long established abroad may enjoy a structural advantage in terms of profitability. Third, the United States has been able to attract sizeable and growing long-term capital flows over the past decade. Looking ahead, the recent significant improvement in US productivity growth relative to other industrial countries might, if sustained, underpin such inflows in the medium term.

... but the US trade deficit needs to fall

Continued large US current account deficits could still be consistent with a stabilisation of the US ratio of net external debt to GDP in the longer run, albeit at a markedly higher level than today. This would push the cost of debt servicing up; moreover, the problem is aggravated by the fact that, over time, the real rate of return on assets held by non-residents in the United States should come closer to the US growth rate, and also closer to the real rate of return on foreign assets held by US residents. Against this background, a stabilisation of the US net external debt ratio would require a more balanced current account position net of investment income, and thus a much lower US trade deficit with correspondingly lower trade surpluses elsewhere. Given its narrower negative output gap, the United States would undoubtedly have a smaller trade deficit were its main trading partners to return to potential. Nonetheless, any meaningful reduction is likely to require a further adjustment in relative prices (eg in real exchange rates) as well as a rebalancing of global domestic demand towards surplus countries (Graph II.9).

Current account, demand gap and real effective exchange rate[1]



[1] Normalised data, measured as the difference between the indicator and its average, expressed in points of standard deviation. [2] As a percentage of GDP. [3] Domestic demand, in real terms; country gap less rest-of-OECD gap. [4] In terms of relative consumer prices; lagged two years.

Sources: ECB; OECD; Eurostat; national data; BIS. Graph II.9

Process of adjustment

Changes in exchange rates

A lower dollar would obviously play an equilibrating role for the US trade deficit. The rest of the world would reduce its trade surplus with the United States and US absorption would fall in relation to output as the US trade deficit fell. However, the size and speed of such adjustments depend on relative trade elasticities. The impact of any currency adjustment might also be smaller than commonly thought, since changes in nominal exchange rates are often only partly matched by movements in competitiveness. For instance, the dollar appreciated in nominal effective terms by 34% between 1995 and 2001, but the US real effective exchange rate (as measured in terms of relative unit labour costs in manufacturing) increased by only 23%. In addition, US exporters started to lose market share only in 1998, suggesting that the impact of the dollar appreciation took quite some time to be felt. Moreover, while US export performance deteriorated sharply from 1998 to 2003, US imports did not grow any more rapidly over the period than would be suggested by historical patterns. Finally, with US imports currently about 50% higher than US exports, a significant dollar depreciation might be needed to narrow the US trade deficit.

Balance sheet implications of any adjustment of the dollar

An adjustment of the dollar could have implications far beyond the United States. A first potential consequence might be weaker demand elsewhere. Many industrial economies have relied on US import demand as the driver of growth, while their demand for non-tradables has not grown in a self-sustained way. In addition, a sizeable dollar drop might trigger inflationary pressures in the United States, possibly leading to higher US and global interest rates, which would lower US net investment income. Finally, too extreme a depreciation of the dollar might generate excessive disinflationary pressures among US trading partners, which could go beyond the direct

impact on prices arising from an appreciating currency. About half of US assets held abroad are expressed in foreign currencies while almost all US liabilities are denominated in dollars. This implies that a dollar depreciation would improve the US net international investment position, despite the United States having net foreign liabilities. Given that the total stocks of US assets and liabilities have soared over the past two decades, to 62% and 87% of US GDP respectively, the valuation effect of a 10% decline in the dollar would lower the net external debt by around 3% of GDP, all other things equal. This would have significant adverse implications for balance sheets in creditor countries, which could slow spending there and impede the adjustment process.

Higher saving in countries with large external deficits

Another way to rebalance domestic demand would be to raise national saving in countries with large external deficits and reduce saving in those recording surpluses. Traditionally, trade patterns have been more responsive to changes in demand than in relative prices. Fiscal policy has an obvious attraction in this context, at least in the United States. In addition, some tightening would help address the longer-term challenges posed by the growing US public debt. But a rapid and strong US fiscal consolidation could also have a global contractionary impact, and the alternative – allowing some fiscal easing in places where saving might seem too high – appears to have only limited appeal in the face of elevated government debt levels in most jurisdictions.

The present constellation of private saving also offers some room for adjustment, though it is more difficult to envisage which specific policy actions might be recommended. Household saving rates are particularly low in countries with current account deficits, such as the United States, the United Kingdom and Australia, but could move upwards, for instance if interest rates were to rise. Symmetrically, household saving might be encouraged to decline in some countries with large current account surpluses, especially in emerging Asia. In the euro area, consumer saving has recently increased and there might be some scope for reversing this trend. In Japan, the household saving rate has already fallen sharply but it is not clear whether this decline can or should be sustained. Finally, there seems to be little scope for an adjustment in investment patterns. The room for a further decline in the investment/GDP ratio seems limited in the United States, given the sharp correction that has already taken place. In Asia, investment/GDP ratios remain relatively high from an international perspective and unproductive investment could easily occur. Higher investment in non-Asian economies that are still in the early stages of economic development could raise their potential output in a decisive way.

Three scenarios of adjustment

The elements discussed above suggest that external imbalances could evolve in three different ways over the next few years. A first, and undesirable, scenario would be a potentially large and disorderly adjustment in exchange rates, say due to reduced willingness among foreign investors to invest in US assets. US consumption of now higher-priced imports would probably slow while long-term interest rates might rise. A second scenario would leave the present picture unchanged, for instance with Asian central banks continuing to

accumulate foreign reserves. However, this would distort the global allocation of capital and, by delaying needed adjustment, might increase the risk of a larger and more disruptive adjustment later on. In any event, sharp movements in a number of bilateral rates might be unavoidable, especially among industrial countries with floating exchange rates. The third and most welcome scenario would envisage a gradual reduction of global external imbalances due to the lagged impact of a moderate dollar depreciation on US trade, somewhat higher US saving (via household saving and fiscal tightening), greater exchange rate flexibility in Asia, and higher domestic demand outside the United States.