II. The global economy

Highlights

The world economy grew strongly in 2004, supported by expansionary monetary policies and unusually accommodative financial conditions. Sharply rising commodity prices failed to spark generalised inflation, but contributed to a moderation of the global expansion in the latter part of the year. After a synchronised upswing in the first half of 2004, growth differentials widened again as commodity importers experienced a slowdown – with the notable exception of the United States and China – while activity in commodity-exporting countries generally continued to grow apace.

The momentum of the world economy was surprising in a number of ways. One surprise was the strength of growth in the emerging economies, reflecting the ongoing structural shift in the global balance of growth, especially towards emerging Asia. Another surprise was the robustness of the US expansion in the face of rising oil prices. At the same time, renewed economic weakness elsewhere raised questions about the capacity of other advanced economies to adjust to the changing global environment. The large shift in relative prices between commodities and manufactured goods, associated with the emergence of a new group of dynamically growing emerging market economies, is one example of such global changes. Another is the sharp appreciation of the euro and the yen vis-à-vis the US dollar in 2004.

The consensus projection for 2005 is for further robust global growth, generally subdued inflationary pressures and widening international imbalances. However, the combination of diverging cyclical positions for the major economies, unusually low interest rates and structural changes related to the ongoing integration of key emerging market countries into the global economy makes forecasting more difficult. In particular, the strong increase in commodity prices since spring 2004, associated with rapidly growing demand from China and India, has given rise to concerns about global resource utilisation, the inflation outlook and the resolution of international imbalances. Another, related question is whether the current patterns of saving and investment are sustainable – both internationally and at the sectoral level. The need for fiscal consolidation is one key issue in this regard.

Economic growth

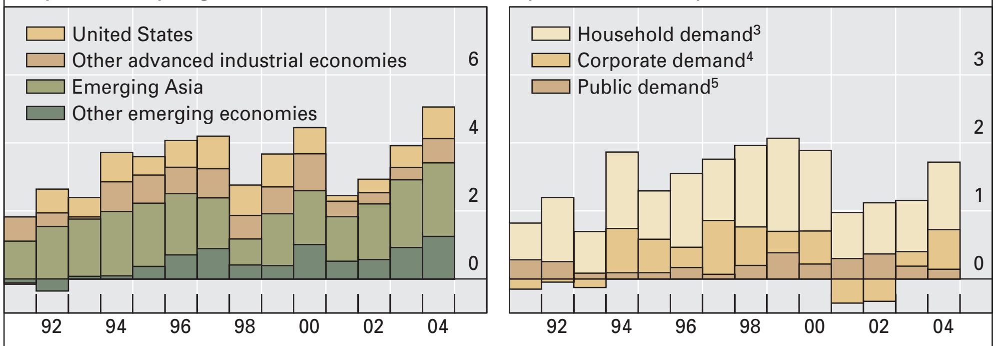
Strong global growth

Strong growth in the United States and emerging Asia …

World output expanded by almost 5% last year, the highest rate for nearly three decades. The United States and emerging Asia accounted for more than half of the increase in global output (Graph II.1). The regional composition of growth

Contributions to world growth[1]

By economy/region | By demand component[2]



[1] In percentage points. [2] Advanced industrial economies. [3] Private final consumption expenditure plus private residential gross fixed capital formation. [4] Private non-residential gross capital formation. [5] Government final consumption expenditure plus government gross fixed capital formation.

Sources: IMF; OECD; national data. Graph II.1

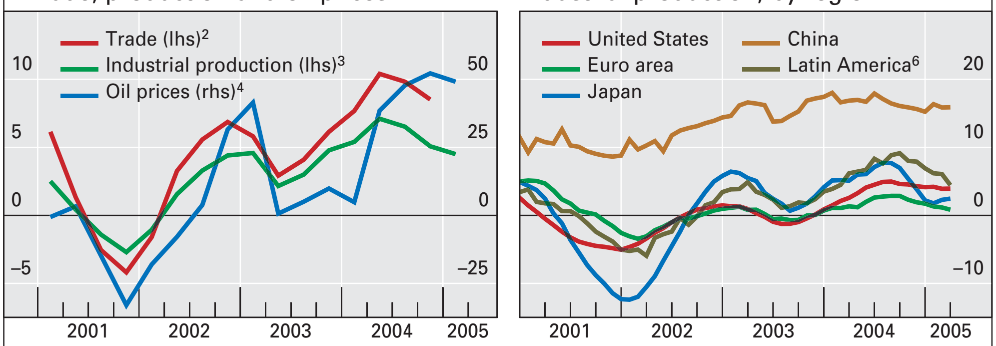
in 2004 was consistent with the notion of an emerging new pattern of global economic expansion: the United States as the engine of growth in the advanced economies; key emerging market economies in Asia and other regions as the second pole of global dynamism; and other large advanced economies with much slower growth.

… was spread through accelerating trade

Strong US demand and the continued rapid build-up of production capacity in China led to a further acceleration of world trade (Graph II.2). The stimulus transmitted through this trade supported a synchronised upswing of production in major economic regions in the first half of last year. The main beneficiaries were the Asian economies, which recorded the strongest growth since the crisis of 1997–98, as well as export-oriented European countries such as Germany, and NAFTA.

World trade, industrial production and oil prices[1]

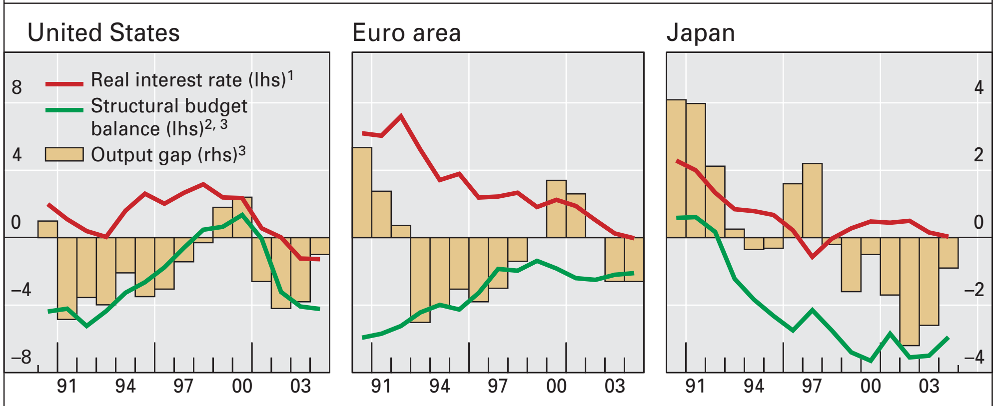
Trade, production and oil prices | Industrial production, by region[5]



[1] Annual changes, in per cent. [2] Exports and imports in goods and services, in volume terms. [3] Weighted average of the economies and regions shown in the right-hand panel plus Canada, India, Korea, Russia, Taiwan (China), Thailand and the United Kingdom, based on 2000 GDP and PPP exchange rates. [4] UK Brent. [5] Uncentred four-month moving average. [6] Argentina, Brazil, Chile and Mexico.

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

Real interest rate, structural budget balance and output gap



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

Sources: ECB; OECD; Eurostat; national data. Graph II.3

Continued supportive monetary and financial conditions

While fiscal policies were less expansionary than in previous years, accommodative monetary policies continued to support the global expansion (see Chapter IV). Inflation-adjusted short-term interest rates remained in negative territory in the United States – notwithstanding the gradual tightening of monetary policy in the second half of 2004 – and stayed around zero in the euro area and Japan (Graph II.3). Financial market conditions remained favourable in the period under review, with long-term interest rates staying unusually low by historical and cyclical standards. Credit spreads for corporate and sovereign borrowers fell to historical lows and equity prices rose strongly. This configuration kept borrowing costs down and lifted asset values across the board. Households took particular advantage of favourable financing conditions, leading to rapid credit growth in many regions. As discussed in more detail in Chapter VI, long-term interest rates, credit spreads and volatility all declined despite monetary tightening by the US Federal Reserve.

A sharp increase in commodity prices ...

Strong economic growth, especially in emerging Asia, led to a large and sustained rise in commodity prices in 2004. By autumn, the average price of crude oil had increased by about two thirds to what was at the time a new record nominal high of $50 per barrel. The prices of non-oil commodities, and especially industrial supplies, also soared. The price of metals, for instance, rose by one quarter. These increases, together with rapidly rising transportation costs and spreading port congestion, suggested that the global expansion was approaching a speed limit. Indeed, in the second half of 2004 global growth slowed to rates that appear more consistent with long-term trends.

... with relatively mild effects on output and inflation

Compared to earlier episodes of sharply rising commodity prices, the impact on global activity and inflation has been relatively mild. One factor is the greater energy efficiency of advanced industrial economies. The oil intensity of OECD countries is now about half of that in the 1970s. Moreover, real oil prices in the period under review remained well below the levels reached during the oil price shocks of the past three decades. Second-round effects of higher oil prices were largely absent due to the limited pricing power of corporations, soft labour markets and firmly anchored inflation expectations. A negative effect on global demand resulted from the redistribution of income from oil-consuming to oil-exporting countries. While the latter could not immediately spend all the windfall profits from rising oil income, their propensity to do so was markedly greater than in the past.

Widening growth differentials

Increasingly self-sustained US expansion …

As global growth moderated in the second half of 2004, growth differentials widened. While US growth became increasingly self-sustained thanks to a pickup in corporate spending and stronger job creation, the euro area and Japan faced renewed weakness. Persistent growth differentials between the major areas led to a significant widening of external imbalances.

… but renewed weakness in the euro area …

The slowdown in the euro area was also accompanied by larger intraregional growth differentials. France and Spain were able to maintain economic momentum on the back of robust domestic demand, but GDP in Germany and Italy contracted in the final quarter of last year. In Germany, both investment and consumption failed to revive as high unemployment and uncertainties regarding the impact of structural reforms weighed further on confidence.

… and Japan

Japan slipped into technical recession. Booming consumption at the beginning of the year and improving conditions in the corporate sector had nurtured the hope that a self-sustained recovery might be under way. However, as in the euro area, domestic demand did not pick up enough speed before export growth slowed down. The downturn was aggravated by a significant adjustment in production in IT-related sectors, which reflected measures taken to reduce relatively large inventories and excess capacity.

Robust growth in other advanced economies …

Other advanced economies were less severely affected. The United Kingdom maintained substantial domestic growth momentum despite decelerating consumer spending. Strengthening domestic demand also ensured a continuation of solid growth in Sweden, while Australia, Canada and New Zealand enjoyed a strong improvement in the terms of trade and robust final domestic demand.

… and key emerging markets

The emerging market regions were also able to maintain considerable momentum (see Chapter III). China's expansion continued apace, despite administrative measures aimed at cooling the economy. Higher commodity prices and greater confidence in macroeconomic policies aided Latin America. Economic activity in central and eastern Europe also expanded faster than initially expected. The accession of eight countries from the region to the European Union on 1 May 2004 attracted capital inflows, while rapid credit growth and declining real interest rates strengthened domestic demand. Improving terms of trade lifted growth in Africa.

Outlook and risks

Robust growth is expected to continue in 2005 …

The consensus forecast for this year is that the global economy will grow by about 4% (Table II.1). With healthy profits worldwide, corporate spending is expected to remain robust in the United States and accelerate in other regions in the course of 2005. Improving labour market conditions, in conjunction with continued low inflation, should in turn support household income and consumption. The expiration of the textile quota system at the beginning of this year has provided a further boost to the exports of major Asian economies, especially China. Solid US growth in the first quarter of 2005 as well as an acceleration of activity in Japan and, to a lesser degree, the euro area from the weak fourth quarter of last year lend support to the consensus view.

… but rising oil prices …

Yet recent developments point to certain risks to global growth. First, oil prices, which rose further in spring 2005, may well remain high for a prolonged period of time. The increase in long-term oil futures prices is consistent with the view that there has been a major upward shift in the equilibrium price of oil. Further rises – if they materialise – may have more severe consequences than currently anticipated. Recent signs of inflationary pressures in the United States underline these risks.

… and the possibility of higher interest rates …

Second, a return of long-term interest rates, which are unusually low, to more normal levels could curtail spending by households, and may dampen residential construction. House prices in a number of countries appear vulnerable to downward corrections of uncertain magnitude.

… underline the need to tackle macroeconomic imbalances

Against this background, the reduction of macroeconomic imbalances remains a third key challenge. One issue is the mounting US current account deficit and growing surpluses elsewhere, especially in Asia. A related development is the continued rise in household debt and low household saving in many advanced industrial countries. Finally, fiscal deficits have remained high.

Growth and inflation

Average annual changes, in per cent

	Real GDP				Consumer prices[1]			
	Average 1991–2002	2003	2004	2005[2]	Average 1991–2002	2003	2004	2005[2]
Total[3]	3.5	3.6	4.8	3.9	12.9	2.9	3.2	3.1
Advanced industrial economies[3]	2.3	1.9	3.1	2.3	2.2	1.8	2.0	2.0
United States	2.9	3.0	4.4	3.4	2.7	2.3	2.7	2.8
Euro area	1.9	0.5	1.8	1.5	2.4	2.1	2.1	1.8
Japan	1.2	1.4	2.6	1.0	0.6	–0.3	–0.0	–0.1
United Kingdom	2.4	2.2	3.1	2.5	2.4	1.4	1.3	1.8
Other[3, 4]	2.7	1.9	2.9	2.5	2.2	2.4	1.6	1.9
Emerging economies[3]	5.1	6.1	7.1	6.3	28.5	4.5	4.9	4.8
Asia[3, 5]	7.1	7.5	7.8	7.2	6.5	2.3	3.9	3.8
Latin America[3, 6]	2.7	2.0	5.9	4.3	64.0	7.0	6.7	6.3
Central and eastern Europe[3, 7]	0.1	5.9	6.8	5.3	88.1	12.2	8.3	8.0
Other[3, 8]	2.1	4.5	4.3	4.5	5.6	3.8	1.0	2.3

[1] For the euro area and the United Kingdom, harmonised index; for Latin America, end-year data. [2] Consensus forecast published in May. [3] Weighted average based on 2000 GDP and PPP exchange rates. [4] Australia, Canada, Denmark, New Zealand, Norway, Sweden and Switzerland. [5] China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand. [6] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [7] The Czech Republic, Hungary, Poland, Russia and Turkey. [8] Saudi Arabia and South Africa.

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

Inflation

Low and stable inflation

Subdued inflationary pressures

Global inflation remained subdued in the period under review despite the sharp increase in oil and non-oil commodity prices, accommodative monetary and fiscal policies and diminishing slack in many economies. In the advanced industrial economies, consumer price inflation increased from 1½% at the beginning of 2004 to about 2½% towards the end of the year. The acceleration of inflation since early 2005, especially in the United States, has not fundamentally changed this picture. The inflationary impact of rising oil prices was more substantial in the emerging market economies, where the dependence on oil is generally higher than in advanced industrial economies (see Chapter III). Indeed, coupled with the impact of a rise in food prices, headline inflation in Asia increased from about 3% at the beginning of 2004 to a peak of almost 5% in the third quarter. The inflation picture also worsened in central and eastern Europe in the course of last year, following several years of disinflation.

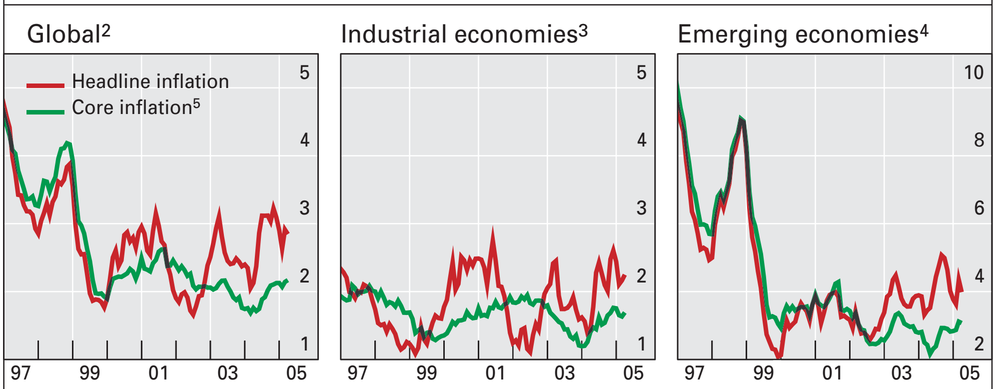
Core inflation broadly unchanged

Nevertheless, underlying inflationary pressures remained contained globally. Core CPI inflation (which excludes food and energy components from headline CPI) was essentially stable in many advanced and emerging economies. US core inflation remained around 1% below headline inflation of about 2½% in 2004. Mild deflation continued in Japan: core inflation was –½% in 2004 compared to zero headline inflation, reflecting a cut in public service prices. Sticky core inflation in the euro area was mainly attributable to the impact of tobacco and administrative price increases in 2004. Core inflation in major emerging market economies has not exceeded 3% since mid-2003. As a result, the wedge between headline and core inflation rates widened in 2004 (Graph II.4).

Low variability of inflation rates …

From a longer historical perspective, inflation rates have remained low and stable. The monthly variability of inflation rates in advanced industrial countries has fallen, from about 1 percentage point in the early 1980s to 0.2 percentage

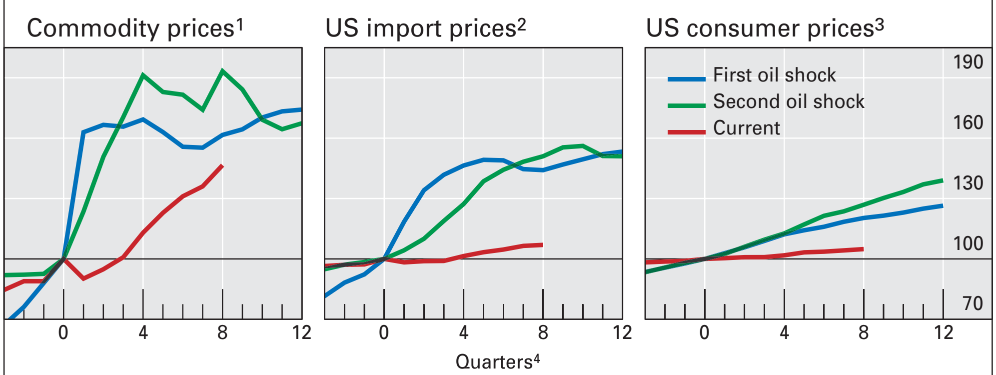
Headline and core inflation[1]



[1] Uncentred 12-month moving averages of annualised monthly changes in consumer prices, in per cent; weighted averages based on 2000 GDP and PPP exchange rates. [2] Industrial and emerging economies cited. [3] Canada, Denmark, the euro area, Japan, Norway, Sweden, the United Kingdom and the United States. [4] Brazil, Chile, China, Hungary, India, Indonesia, Korea, Mexico, Poland, South Africa and Thailand. [5] CPI excluding food and energy components.

Sources: OECD; CEIC; national data; BIS calculations. Graph II.4

Episodes of rising commodity prices and inflation



[1] World market; raw materials; in terms of US dollars. [2] Goods and services. [3] All urban consumers. [4] Zero quarters correspond to 1973 Q4 (first oil shock), 1978 Q4 (second oil shock) and 2003 Q1 (current).

Sources: Hamburg Institute of International Economics (HWWI); national data. Graph II.5

points in 2004. The same is true for the dispersion of inflation rates across countries. In 2004, core CPI inflation rates in advanced industrial economies varied from 0% to 3%. This stands in marked contrast to the early 1980s, when core inflation rates in industrial countries ranged from 4% (Japan) to more than 12% (Norway and the United Kingdom).

... compared to earlier commodity price shocks

The relative stability of inflation rates in 2004 is particularly striking when set against past periods of rising oil prices (Graph II.5). While the increase in oil prices itself was small compared with the past two episodes, that in commodity prices as a whole is roughly equivalent. Despite the sharp depreciation of the dollar, which should have added to upward pressures, import price inflation in the United States has remained surprisingly contained. The effect on consumer prices is almost negligible.

Limited impact on major advanced economies ...

Thus the impact of changes in commodity prices on consumer prices has declined, not only in the United States, but also in other countries. Since the

Inflation pass-through

	From commodity prices to import prices[1]		From exchange rates to import prices[1]		From import prices to core CPI[2]	
	1971–89	1990–2004	1971–89	1990–2004	1971–89	1990–2004
United States	0.29 **	0.21 **	0.48 **	0.18 **	0.25 **	0.10
Japan	0.35 **	0.26 **	0.74 **	0.36 **	0.23 **	0.05
Germany	0.22 **	0.16 **	0.37 **	0.28 **	0.17 **	–0.03
France	0.20 **	0.12 **	0.76 **	–0.06	0.27 **	–0.14
United Kingdom	0.19 **	0.11 **	0.68 **	0.45 **	0.29 *	0.01
Italy	0.33 **	0.25 **	0.56 **	0.41 **	0.32 **	0.46

Note: ** and * indicate that the figures are significantly different from zero at the 99% and 95% confidence levels respectively.

[1] Changes, in per cent, in import prices in response to a 1% increase in commodity prices (measured in domestic currency), or in response to a 1% depreciation in the nominal effective exchange rate. [2] Changes, in per cent, in core consumer prices in response to a 1% increase in import prices.

Sources: OECD; HWWI; national data; BIS calculations. Table II.2

1990s, for major advanced industrial economies, import prices have become significantly less sensitive to changes in commodity prices than in the previous two decades, which included the two large oil shocks (Table II.2).

Low consumer price inflation in the face of sharply rising commodity prices implies a considerable change in relative prices: between 1995 and 2004, the price of consumer goods in the United States fell 30% relative to raw materials. Similar relative price adjustments have taken place in the euro area and Japan.

... associated with a large shift in relative prices

Factors behind low and stable inflation

One factor behind the reduced impact of higher commodity prices on the level and variability of domestic inflation, especially in advanced industrial countries, is the changing composition of imports. Oil accounts for a smaller portion of imports than two decades ago as energy consumption per unit of GDP has declined. Moreover, the share of energy and raw materials in the imports of industrial countries has fallen as the production of manufactured goods has shifted to emerging market economies.

Changing composition of imports ...

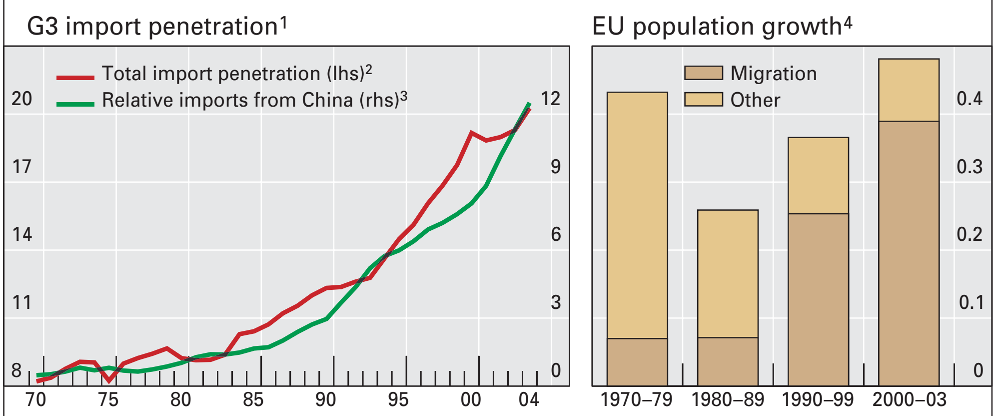
A second factor is changes in the pricing behaviour of producers of manufactured goods. Deregulation and technological progress have increased competition in goods markets and limited the room for raising prices even in the presence of cost shocks. Similarly, the possibility of switching to cheaper sources in the world market has put downward pressure on the markups of current suppliers. The steadily growing import penetration from emerging market countries such as China illustrates this effect (Graph II.6). However, higher productivity, for instance the setting-up of more efficient retail networks in the United States and the United Kingdom, has also allowed firms to maintain profit margins.

... and growing competition in goods markets ...

Third, higher energy prices have not led to greater wage pressure. Unit labour costs in the business sector of OECD countries increased by ½% in 2004 compared to an annual average of about 4½% in the 1980s. Many

... as well as labour markets

Indicators of globalisation



¹ The United States, the euro area and Japan; in per cent. ² Weighted average of the ratio of real imports of goods and services to real GDP, based on 2000 GDP and PPP exchange rates. ³ Goods imports from China as a share of total goods imports. ⁴ Contributions to population growth in the EU 15; annual averages, in percentage points.

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

observers believe that the widespread relocation of production, the outsourcing of some services and the increased mobility of labour across borders have curtailed the bargaining power of workers and trade unions in many industrial countries. For instance, hourly labour costs in most western European countries exceed those in the new EU member states by a factor of five to 10. This has encouraged the migration of workers from new member states to western Europe (often with a second wave of migration from the countries further east to the new member states). The steady growth of remittances from industrial to developing countries (in particular to Latin America and emerging Asia) suggests that similar developments are taking place in other parts of the world. Even where actual migration is limited, the threat that higher wages will lead to a relocation of production has had a similar effect on wage behaviour. In Japan, this has contributed to a growing number of part-time workers. In Germany, several large firms have recently negotiated contracts that contain a job guarantee in exchange for real wage cuts.

Enhanced credibility of monetary policy

Finally, changes in the inflation process itself may have reduced the immediate effect of rising commodity prices. Many observers have argued that, because of firmly anchored expectations of low inflation and the greater credibility of monetary policy, cost shocks in industrial countries are now more likely to be perceived as temporary (see Chapter IV). Under such circumstances, firms may hold their prices constant for a significant time.

Reduced pass-through as a broad phenomenon

These factors may also explain a lower pass-through of exchange rate movements into import and consumer prices (Table II.2). The lower share of raw materials in imports has reduced not only the direct impact of higher commodity prices on inflation, but also the impact of exchange rate changes as raw materials tend to exhibit a high exchange rate pass-through. In addition, the greater contestability of markets and a commensurate reduction in the market power of dominant firms have mitigated inflationary pressures arising from depreciation. For exporters, wage moderation has provided leeway to keep prices in the importer’s currency stable and maintain profit margins despite an appreciation of the domestic currency. In Germany, for instance, real unit labour costs have fallen by almost 20% over the past two decades. Finally, by reducing the persistence of inflation, the greater credibility of monetary policy may have increased the readiness of firms to absorb exchange rate shocks that are perceived as temporary.

Outlook

Low inflation is expected to continue …

Inflation is expected to remain low in 2005 (Table II.1). This prospect is broadly consistent with the expected cyclical position of the major economies: a slowdown of US growth to rates closer to potential, combined with a moderate deceleration in productivity growth; continued spare capacity in the euro area; and declining slack in Japan.

… and downward pressure on prices is possible …

Further downward pressure on consumer prices might come from the structural changes discussed above. For instance, the removal of textile quotas in North America and Europe this year has boosted imports from China and India. Yet it is too early to assess the effect on the prices of clothing and textiles, although the experience of countries such as Japan and Norway,

Output gap and inflation[1]							
	United States	Japan	Germany	France	United Kingdom	Italy	Canada
1971–89	0.11 **	0.37 **	0.10 **	0.18 **	0.10	0.17 **	0.11 **
1990–2004	0.07 **	0.08	0.09	0.05	0.28 **	0.05	0.09

[1] Changes, in per cent, in core consumer prices in response to a 1 percentage point change in the output gap. ** indicates that the figures are significantly different from zero at the 99% confidence level.

Sources: National data; BIS calculations. Table II.3

which had not imposed textile quotas or had lifted them earlier, suggests that it might be significant. More generally, the large reduction in the relative price of manufactured goods vis-à-vis commodities could be seen as an indication of a high elasticity of supply in those emerging economies that have become key exporters of manufactured goods.

... as is a diminished impact of domestic factors

Increased globalisation could well mean that domestic factors have become less of a determinant of inflation in individual countries. In particular, the integration of countries with abundant labour supply may have reduced wage pressures in the global economy as a whole. Indeed, estimates of the Phillips curve show that coefficients of output gaps, which largely reflect domestic supply and demand conditions, have become smaller for most industrial countries, even if not decisively so for some of them (Table II.3).

Uncertainties remain

Nevertheless, the impact on inflation of smaller domestic output gaps, in combination with unused capacity at the global level, remains uncertain. The increase in core goods prices in the United States around the turn of the year might indicate that firms have regained some pricing power. Looking further ahead, higher incomes in emerging economies might lift the demand for goods and services. Eventually, capacity constraints on labour supply will reappear at the global level, as they have always done at the national level.

Current account developments

Widening external imbalances

Larger current account imbalances ...

Global current account imbalances increased further in the period under review. The growing external deficit of the advanced industrial economies primarily reflects a further widening of the US current payments gap, which reached about $670 billion or over 5½% of GDP in 2004 (Table II.4). In contrast, the current account surpluses of net commodity exporters rose. Several major Asian economies also continued to run sizeable surpluses, despite deteriorating terms of trade and rapid growth. Japan, with a surplus of about 3½% of GDP, accounts for about half of the Asian external current account balance. While China's net surplus was not large in 2004, it has recently been increasing sharply. The euro area again posted a small current account surplus in the order of ½% of GDP in 2004; while Germany had a surplus of almost 4% of GDP, Spain recorded a deficit of about 5%. The current account positions of other advanced economies changed little, with the United Kingdom and Australia again recording considerable deficits. Central and eastern European countries also continued to run significant current account deficits while, in contrast, Latin America maintained the trend improvement that began in the late 1990s.

… in part due to rising commodity prices …

One major factor behind the growing global imbalances was the sharp rise in commodity prices. Higher prices added more than $100 billion or ¼% of GDP to the net oil imports of OECD countries. This is comparable to the effect of the oil price increases in the 1990s, but much less than during the two earlier oil price shocks. High commodity prices boosted export revenues in the Middle East, Russia and other net exporters of commodities. One notable exception to this picture was Australia. It recorded a larger deficit, despite the considerable improvement in the terms of trade, in part because exports were apparently held back by capacity constraints.

… and continued US-led growth

The second factor explaining the global pattern of current account balances was that the United States continued to lead the recovery in the advanced industrial world. Weak domestic demand growth in other major economies restrained the demand for US products abroad, while imports accelerated due to buoyant US consumption. This was essentially a continuation of the pattern observed since 2001. In addition, firmer business investment in the United States was associated with some strengthening of imports of capital goods in 2004.

International saving and investment imbalances

National saving and investment balances by definition mirror current account positions. Growing surpluses in Asia and the oil-exporting countries in 2004 reflected a further increase in aggregate saving rates in these regions. Investment rates in emerging Asia also increased, but remained well below the

Current account balances

In billions of US dollars

	Average 1991–2000	2001	2002	2003	2004	*Memo: 2004*[1]
United States	–153	–386	–474	–531	–666	*–5.7*
Euro area[2]	20	13	54	26	36	*0.4*
Japan	107	88	112	137	172	*3.7*
Other advanced industrial economies	–7	36	33	52	42	*0.8*
China	13	17	35	46	69	*4.0*
Other emerging Asia	9	74	96	124	124	*4.6*
Latin America	–49	–54	–16	7	16	*0.8*
Central and eastern Europe	–12	–17	–24	–37	–51	*–5.0*
Russia	10	34	29	35	60	*12.2*
Saudi Arabia	–8	9	12	28	52	*20.7*
Rest of the world	–14	25	10	30	65	*3.9*
Memo: World[3]	*–84*	*–161*	*–133*	*–83*	*–81*	…

[1] As a percentage of GDP. [2] Sum of the balance of individual euro area economies. [3] Reflects errors, omissions and asymmetries in balance of payments statistics.

Sources: IMF; national data. Table II.4

levels seen prior to the Asian crisis – with the notable exception of China. The widening of the US current account deficit in 2004 had its counterpart, for the first time since 2000, in growing private investment rather than a decline in national saving. The latter remained broadly unchanged at a historically low level.

Adjustment mechanisms in the real economy

Previous patterns of external adjustment

Past current account reversals in advanced industrial economies typically involved a combination of exchange rate and interest rate adjustments as well as a rebalancing of global growth. For instance, the dollar depreciated sharply in broad real effective terms before the US current account deficit began to narrow in 1987 (Graph II.7). The resulting shift in relative prices in favour of US tradable goods was then followed by a sharp acceleration of US exports. The effect was accentuated by the stronger income growth for major trading partners relative to the United States. High real interest rates in the United States helped to raise private savings in the early 1980s, thereby limiting the impact of a growing fiscal deficit on the current account. Fiscal tightening in the late 1980s supported the current account reversal.

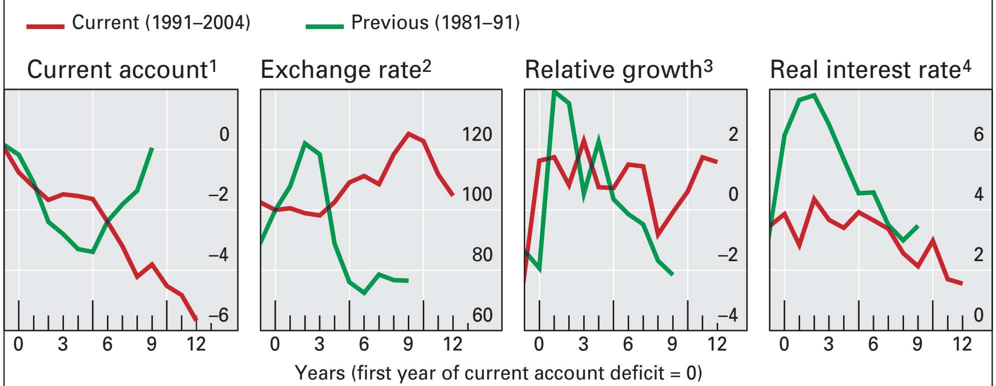
US export growth picked up …

All of these adjustment mechanisms were considerably muted in the period under review. First, the dollar has depreciated in broad real effective terms by about 20% over the past two years. This is much less than in the mid-1980s, when it fell almost 50% between 1985 and 1988 in terms of relative unit labour costs. While US export growth accelerated in 2004, exports still lacked the dynamism seen in the second half of the 1980s.

… but US imports grew faster …

Second, growth in the major trading partners provided little stimulus to exports. The fact that US import growth has continued to outpace exports in the past few years – even taking into account the effect of rising oil prices – is in part the mirror image of the relative strength of US domestic demand vis-à-vis that of major trading partners. Projections for this year and 2006 show only a gradual and incomplete convergence of growth rates. An aggravating factor is that, to

Periods of US current account deficits

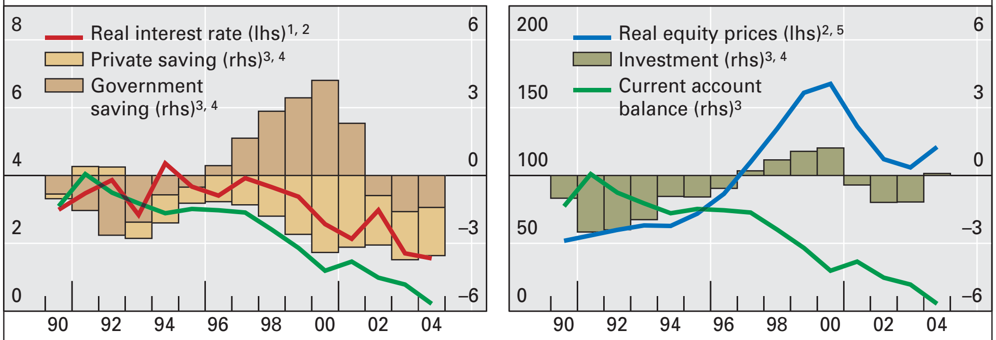


[1] Current account balance as a percentage of GDP. [2] Real effective exchange rate, in terms of relative unit labour costs; first year of current account deficit = 100. [3] Annual change in US real GDP less that in four main trading partners (weighted average based on 2000 GDP and PPP exchange rates). [4] Long-term interest rate deflated by annual consumer price inflation.

Sources: National data; BIS. Graph II.7

US asset prices and current account

Interest rate and saving | Equity prices and investment



[1] Ten-year Treasury notes and bonds. [2] Deflated by consumer prices. [3] As a percentage of GDP. [4] Cumulative changes from 1989 level, in percentage points. [5] S&P 500; 1990–2004 = 100.

Source: National data. Graph II.8

date, the slower pass-through of exchange rate movements into import prices in the United States may have blunted the incentives to reallocate spending from imports to domestic goods, and to invest in the production of tradable goods.

... as low interest rates hindered adjustment

Third, the unusually low level of long-term real interest rates also seems to have contributed to the US current account deficit in the past few years (Graph II.8). Low interest rates have meant lower borrowing costs and an associated increase in asset values (especially residential property; see below). This has also facilitated the financing of growing US fiscal deficits, which in large part resulted from tax cuts. Both channels have contributed to higher household demand for imports. These developments stand in sharp contrast to the late 1990s, when the growing US current account deficit reflected higher business investment on the back of rising equity prices.

Policy measures to facilitate adjustment

Enhancing the effectiveness of the adjustment mechanisms in the real economy will require a combination of several policy elements in deficit and surplus countries. The general elements of such policies are largely undisputed: higher household saving and fiscal consolidation in the United States in particular (discussed below); structural reforms that generate stronger growth in the non-tradable sectors in Europe and Asia; and greater exchange rate flexibility in emerging Asia (see Chapter V). All these measures would enhance the effectiveness of equilibrating mechanisms at the global level, which could reduce external imbalances in the medium term.

Private sector saving and investment

Trends

Growing global saving

Global saving continued to grow in 2004. World national saving rose to 25% of GDP, about 1 percentage point more than the annual average for the current decade and 2 percentage points above that for the 1990s (Table II.5). This increase was driven by higher saving in the developing world. The major contributor was Asia, especially China, where the national saving rate rose to

Global saving and investment trends

As a percentage of GDP

	Average 1990–99	Average 2000–02	2003	2004	*Memo: 1991–2004*[1]
World saving	22.9	23.4	23.9	24.9	*1.7*
Advanced economies[2]	21.3	20.6	19.1	19.4	*–2.8*
United States	16.3	16.2	13.5	13.7	*–2.5*
Euro area	21.5	21.3	20.3	20.9	*–1.1*
Japan	31.6	27.8	27.1	27.6	*–6.8*
Emerging economies[3]	25.3	27.2	29.8	31.5	*6.9*
Developing Asia	31.0	32.6	36.5	38.2	*9.5*
China	40.3	39.9	45.5	48.0	*9.6*
Latin America	18.3	17.8	20.0	21.0	*1.9*
Central and eastern Europe	20.6	18.8	18.6	19.1	*–7.0*
World investment	24.0	23.2	23.5	24.6	*0.1*
Advanced economies[2]	21.8	21.0	20.0	20.7	*–2.5*
United States	18.7	19.4	18.4	19.7	*1.1*
Euro area	21.1	20.9	19.5	20.2	*–2.9*
Japan	29.3	25.3	23.9	23.9	*–9.0*
Emerging economies[3]	27.2	26.1	27.9	29.2	*2.8*
Developing Asia	32.2	30.8	33.6	35.5	*5.1*
China	38.5	37.9	42.4	43.9	*8.7*
Latin America	20.9	19.8	19.0	19.8	*0.3*
Central and eastern Europe	23.3	23.1	23.2	23.8	*–2.9*

[1] Cumulative change, in percentage points. [2] Including Asian newly industrialised economies (NIEs). [3] Emerging economies other than Asian NIEs.

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

48%. Little is known about sectoral saving patterns in China and possible shortcomings of national accounts statistics, but a largely unchanged fiscal deficit suggests that the rise is primarily attributable to the private sector. Growing saving by oil-exporting countries as a consequence of higher export revenues was the next major contributor to higher saving worldwide in 2004. The immediate effect was probably primarily on public saving, as about two thirds of oil income boosted fiscal revenues.

Marginally higher saving in advanced economies

National saving in the advanced industrial economies increased in aggregate for the first time since 2001, although only marginally. However, saving rates remain well below the averages of the past two decades. The slight reduction in fiscal deficits was the main factor behind the recent stabilisation. Higher corporate saving in the form of retained profits, a development that has been observed since 2000, also contributed to rising saving rates. At the same time, the trend decline in household saving continued, although with considerable variation across countries. While household saving rates in the United States declined further, they increased moderately in a number of European countries and Japan. Increases were most notable in countries where there was uncertainty about employment prospects and pensions, particularly in Germany and the Netherlands.

Buoyant residential investment ...

Aggregate investment (including residential and business capital formation) picked up in most advanced industrial and emerging market economies. The rate of acceleration varied, with China and the United States recording the largest increases (Table II.5). One common feature seems to be the global strength of investment in residential housing. In OECD countries, such investment grew in real terms by more than 6% in 2004, the highest rate since the mid-1990s.

... but business investment also picked up

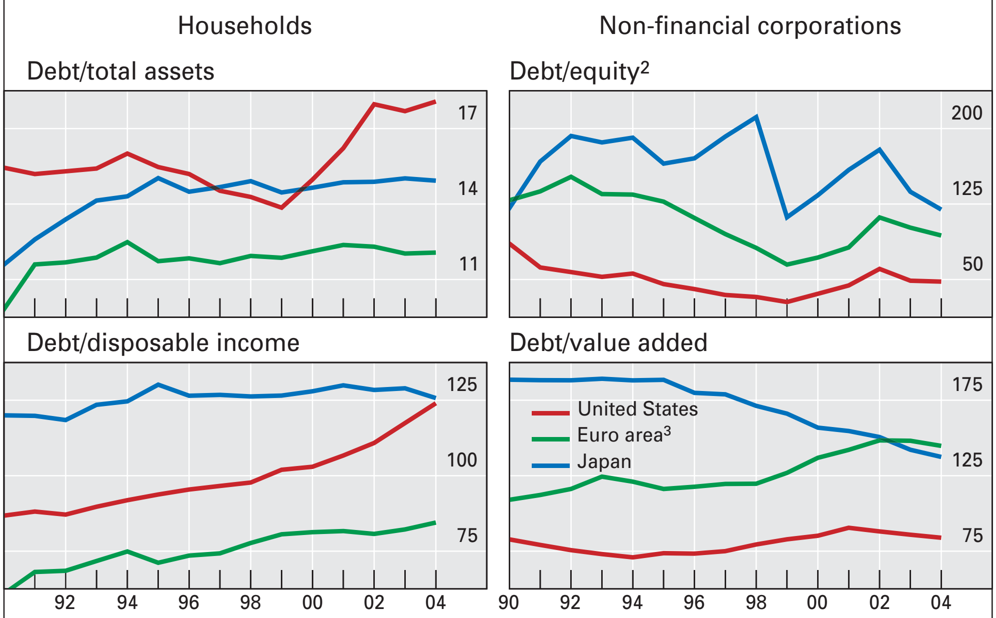
Business investment also gained momentum, especially in the advanced industrial countries, after a slow recovery from the cyclical trough in 2002. This was primarily a reflection of firming corporate spending in the United States in the course of 2004. Corporate spending in the euro area expanded after two years of contraction, although at a modest pace. Investment rates in Japan remained stable. Overall, however, corporate investment in advanced economies was still below that of the second half of the 1990s, both in terms of growth rates and as a share of GDP.

Corporate balance sheets and investment

Stronger corporate balance sheets ...

Corporate balance sheets improved in the three major currency areas in 2004. Debt declined relative to equity and value added across the board, although US corporations still appear stronger than those in the euro area and Japan (Graph II.9). Robust profit growth supported this improvement of corporate balance sheets. The marked rise in profits was a global phenomenon (Graph II.10). In the United States, both the profit share and margins were close to record levels in 2004, while in Europe profit shares were near the levels of the mid-1990s, and in Japan the situation improved substantially.

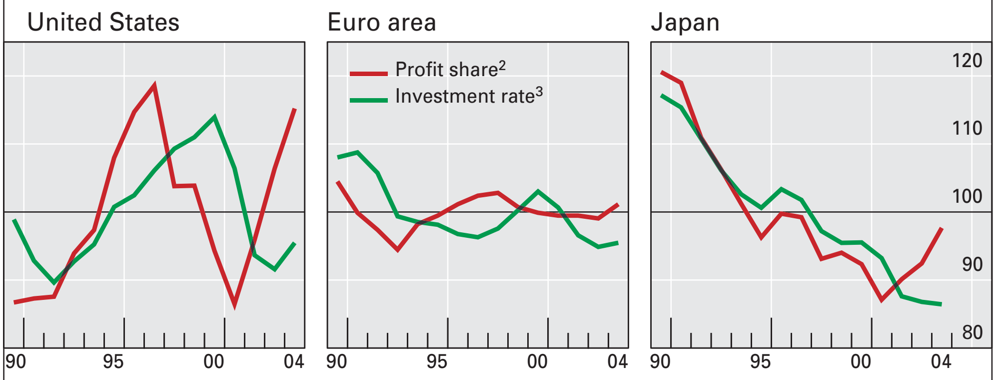
Private sector assets and debt[1]



[1] In per cent. [2] Equity defined as the market value of outstanding equities. [3] Weighted average of France, Germany and Italy, based on 2000 GDP and PPP exchange rates.

Sources: OECD; national data; BIS estimates. Graph II.9

Profit share and investment rate[1]



[1] 1990–2004 = 100. [2] Property and entrepreneurial income/GDP (whole economy); for the United States, corporate profit/business GDP. [3] Investment/GDP; for the United States, business sector.

Sources: ECB; OECD; Eurostat; national data. Graph II.10

... but relatively sluggish investment ...

Given a background of unusually high profits and favourable supply side conditions, the relative sluggishness of corporate investment was something of a surprise. Low real interest rates, tight credit spreads and rising equity prices kept the cost of capital down. Moreover, labour productivity in the business sector grew by about 3% in the OECD countries, although the euro area was lagging considerably.

... attributable to risk aversion ...

Increased risk aversion shown by corporate management after the equity market collapse appears to have restrained fixed capital formation. Firms had focused primarily on the restructuring of balance sheets, visible in the efforts to reduce debt ratios and in "cash hoarding" (see Chapter VI). The focus on the reduction of leverage probably reflected concerns about continuing vulnerability to changes in financial market conditions. Greater caution on the part of corporate management regarding the accessibility of credit under adverse economic conditions, against the backdrop of changes in bank behaviour in the past few years, seems to have been an additional financial consideration in Japan and some European countries.

... the sectoral composition of profits ...

In the United States, the sectoral composition of profit growth also played a role. Many service sectors – such as retail trade and financial services – have recorded relatively high and stable profit growth in the past few years. In contrast, profits in manufacturing dropped by almost 70% in 2001–02. The share of manufacturing profits in total profits declined from 25% to less than 10%. Manufacturing profits recovered in 2004, although they remained well below their late 1990s level, both in dollar terms and as a percentage of the sector's value added. Investment declined in line with profits in 2001 and 2002. Even after recovering in 2003, business spending in manufacturing was only 10% higher than during the 1990s, while investment in the business sector as a whole was up almost 50%.

... and subdued growth of home markets

In the euro area and Japan, the uncertain outlook for domestic demand continued to weigh on corporate spending. Surveys carried out in the euro area revealed the ongoing pessimism of corporations, especially regarding the prospects for domestic markets. In an environment of sluggish growth, rising profits have been associated with moderate increases in compensation and persistently high, and in some countries growing, unemployment. One reason for this has been the continued emphasis of corporations on capital deepening and labour shedding, primarily in manufacturing, where global competition is particularly fierce. Measures to increase potential growth – especially in the service sectors – and more flexible labour markets are key to improving employment prospects and in turn demand.

Household balance sheets and spending

Household wealth rose …

Rising house and equity prices increased the wealth of private households in many countries in 2004. In the advanced industrial economies, for which data on household assets and liabilities are available, household wealth grew both in absolute terms and relative to disposable income (with the notable exception of Japan). The prices of residential property, which accounts for the lion's share of household assets in most economies, rose sharply across a broad range of countries. In many cases, house prices at the end of 2004 were at, or close to, historical peaks (Table II.6).

… but so did debt

Rising household wealth was associated with a commensurate build-up of debt. As a consequence, the debt/asset ratio of households remained broadly unchanged in the euro area and increased in the United States (Graph II.9). Correspondingly, debt as a share of disposable income continued to rise, especially in the United States. The bulk of the increase in household

Residential property prices and mortgage debt

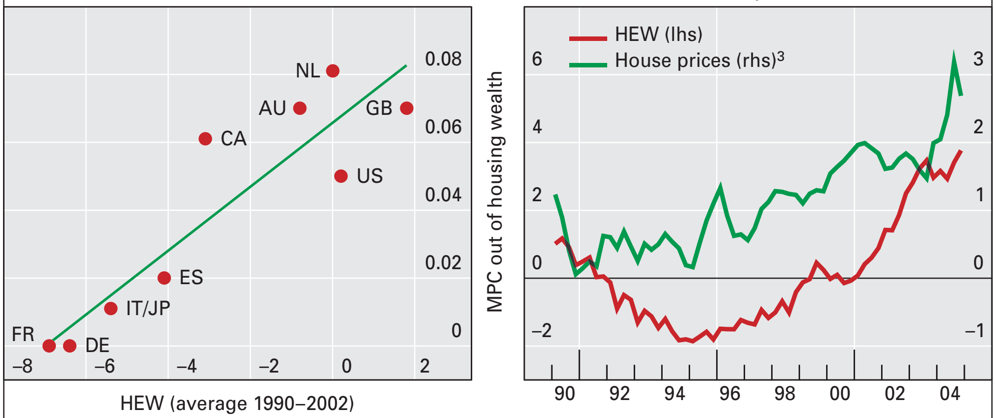
	Residential property prices[1]				Change in residential mortgage debt[2]
	Annual change		Change from peak 2004	Date of peak	
	1996–2003	2004			
United States	6.0	11.2	0.0	2004 Q4	3.9
Japan	–3.3	–6.1	–37.1	1991 H1	–0.8
Germany	–0.1	–1.0	–2.0	2002	–0.8
United Kingdom	11.7	12.3	0.0	2004 Q4	5.2
France	7.2	15.6	0.0	2004 H2	1.9
Italy	4.6	9.7	0.0	2004 H2	1.9
Canada	4.5	7.8	0.0	2004 Q4	1.7
Spain	10.8	17.4	0.0	2004 Q4	4.7
Netherlands	10.2	1.8	–2.5	2004 Q3	4.8
Australia	10.2	2.7	–0.2	2004 Q2	5.4
Switzerland	0.5	1.8	–12.9	1989 Q4	3.4
Belgium	5.8	4.2[3]	0.0	2004 Q2	0.1
Sweden	7.8	10.0	0.0	2004 Q4	2.7
Norway	7.8	10.5	0.0	2004 Q4	2.7
Denmark	6.7	11.3	0.0	2004 Q4	1.8
Finland	8.1	5.6	0.0	2004 Q4	2.7
Ireland	14.4	7.8[4]	0.0	2004 Q3	9.5

[1] End of period; nominal changes, in per cent; for Japan, land prices. [2] Between 2003 and 2004; in percentage points of GDP. [3] Up to second quarter. [4] Up to third quarter.

Sources: OECD; various real estate associations; national data; BIS estimates. Table II.6

Housing equity withdrawal

HEW and MPC[1] — US HEW and house prices[2]



AU = Australia; CA = Canada; DE = Germany; ES = Spain; FR = France; GB = United Kingdom; IT = Italy; JP = Japan; NL = Netherlands; US = United States.

[1] HEW = housing equity withdrawal, expressed as a percentage of disposable income; MPC = marginal propensity to consume. [2] Four-quarter moving average. [3] Quarterly changes in residential property prices, in per cent.

Sources: OECD; *Economics Department Working Papers*, ECO/WKP(2004)17; national data. Graph II.11

debt was attributable to borrowing against housing collateral in the form of mortgage loans.

Housing equity withdrawal supported consumption ...

In many countries, such as France and Spain, increased mortgage borrowing was used to finance purchases of residential property. However, housing equity withdrawal – the extraction of housing wealth through borrowing against housing collateral in excess of investment in residential property – has added substantially to effective purchasing power in a number of other countries in the past few years. These include the United States, the United Kingdom, the Netherlands and Australia. Housing equity withdrawal has been closely correlated with the propensity to consume out of housing wealth since the 1990s (Graph II.11). While a higher cost of housing services should, in principle, have reduced spending on other products by those who do not own houses, this effect is hard to find in the data.

... but poses risks going forward

How vulnerable private consumption is to a future decline in house prices is difficult to judge. The experience of the United Kingdom, Australia and the Netherlands, which have recently witnessed decelerating or even falling house prices, suggests an adverse effect of slowing housing markets on spending. In the United Kingdom and Australia, consumption has decelerated recently. Private consumption in the Netherlands has been weak during the past two years or so amidst rising unemployment. Overall, the impact on spending seems likely to depend on a number of factors, such as a revision of long-term expectations regarding income from labour and pensions or changes in interest rates. One, more comforting development is that the correlation between housing equity withdrawal and house price increases in the United States has recently not been as strong as in the past. The fact that housing equity extraction was on average close to zero during 1990–2002 could indicate that households regard it primarily as a means to smooth consumption over time. Looking forward, some payback might then be expected from the equity extraction of the past few years. A nationwide decline in nominal house prices in the United States, the world's largest market, would, in any event, be without precedent in the last few decades.

Fiscal policy

Recent fiscal performance

Budget deficits remained high in the main industrial countries

Despite a modest tightening of fiscal policies in 2004, the budget deficits of the major industrial countries remained well above historical averages (Table II.7). The widening of deficits was particularly pronounced in Germany, the United Kingdom and the United States, where fiscal positions have deteriorated by 5–7% of GDP since 2000 (Table II.8). By contrast, in the smaller industrial economies (Australia, Canada and Spain, among others), as well as many emerging market economies, fiscal positions have improved in recent years. While some of this improvement reflected favourable cyclical conditions, many emerging market economies also initiated structural fiscal reforms (see Chapter III). There was also some progress in containing the growth of public debt, partly reflecting low interest rates. However, contingent liabilities related to ageing populations will add significantly to future public sector liabilities unless policies are changed. Public debt remains especially high in Italy and Japan.

Deficits are mainly structural

The reasons for larger budget deficits in the major industrial countries are varied but essentially structural (Table II.7). Wider US budget deficits in recent years have, for the most part, resulted from tax cuts and increased spending on the military and on security. The US budget deficit in 2004 was lower than expected because economic growth generated higher revenues and non-defence spending was restrained. Stronger growth and expenditure restraint also reduced the deficit in Japan last year. However, the authorities there have yet to tackle the consequences of large fiscal imbalances inherited from the

A historical comparison of fiscal positions[1]

	Average 1980–2003			2004			
	Financial balance	Structural balance[2]	Gross debt	Financial balance	Structural balance[2]	Gross debt	Debt stabilising effort[3]
Industrial economies[4]	–3.4	–3.4	67	–3.8	–3.5	80	2.1
United States	–3.3	–3.1	63	–4.3	–4.2	64	2.0
Euro area	–3.9	–3.6	66	–2.8	–2.1	78	0.8
Japan	–3.1	–3.2	89	–6.1	–5.9	158	6.8
Emerging economies[5]	–3.0[6]	…	44[6]	–2.5	…	47	…

[1] General government, as a percentage of GDP. [2] Cyclically adjusted financial balance, as a percentage of potential GDP. [3] Change, in percentage points, in financial position necessary to stabilise net debt assuming nominal GDP growth at potential rate. [4] Weighted average of Australia, Canada, France, Germany, Italy, Japan, the Netherlands, Spain, the United Kingdom and the United States, based on 2000 GDP and PPP exchange rates. [5] Weighted average of the 24 largest emerging market economies, based on 2000 GDP and PPP exchange rates. [6] 1998–2003.

Sources: IMF; OECD; Institute of International Finance (IIF); JPMorgan Chase; BIS calculations. Table II.7

Recent fiscal performance[1]						
	Financial balance			Debt		
	2003	2004	Cumulative change 2001–04[2]	Net 2004	Gross 2004	Gross cumulative change 2001–04[2]
United States	–4.6	–4.3	–5.9	44	64	5
Euro area	–2.8	–2.8	–2.9	53	78	1
Germany	–3.8	–3.7	–5.0	55	70	9
France	–4.1	–3.7	–2.3	46	73	7
Italy	–3.0	–3.0	–2.3	96	119	–6
Japan	–7.7	–6.1	1.4	84	158	24
United Kingdom	–3.4	–3.4	–7.2	36	44	–2
Canada	0.6	1.3	–1.6	31	70	–11
Australia	0.8	0.8	–0.1	2	21	–5

[1] General government, as a percentage of GDP. [2] In percentage points.

Sources: IMF; OECD. Table II.8

1990s. Budget deficits in the euro area are also mainly structural. Despite a smaller cyclical component of deficits than in 2003, almost half the members of the monetary union failed to meet the fiscal criteria of the Stability and Growth Pact (in some cases for the third year in a row).

Little room for further fiscal policy ease

Fiscal expansion over the past few years has thus left many countries little room for further policy ease. Indeed, in the euro area the need for consolidation now coincides with weaker economic activity. Strong output growth and the large current account deficit in the United States make it both easier and more desirable to cut the deficit.

Deficit reduction goals still lack specifics

Against this background, most industrial countries have announced plans to cut budget deficits by the end of the decade (Table II.9). The US administration has committed itself to reducing the fiscal deficit to below 2% of GDP by 2010. In Japan, the authorities aim to achieve a primary surplus (excluding social security) by the early 2010s, and to stabilise the gross government debt at around 150% of GDP. In the euro area, countries with weak underlying fiscal positions have committed themselves to improving those positions by about ½ percentage point of GDP per year until 2007. However, specific policy changes to achieve these objectives have generally yet to be confirmed.

Policy options for fiscal consolidation

Tax reform, including flat tax proposals, gains attention

Tax reform has recently returned to the policy agenda, partly because of the apparent success of earlier tax reforms in Ireland and the United Kingdom. The recent flat tax experiments in Slovakia (which introduced a flat corporate and individual income tax rate and a uniform VAT rate, all at 19%) and elsewhere in central and eastern Europe have also attracted attention. More intense global competition and the possibility of production relocation suggest limited scope for increasing direct taxes, especially for corporations, in the future. Relying on indirect taxes might appear increasingly attractive against this background.

Few changes to expenditure programmes …

Cuts in public current expenditure and entitlement programmes (other than pensions) have not featured prominently in recent reform proposals. In the euro area, a major constraint has been high unemployment. Where steps towards reform of unemployment benefits and health care financing have been taken (for instance in Germany), the authorities have encountered significant difficulties.

… but pension reforms have started

Several countries have taken steps to reform their pension systems. Japan's pension reform, passed in 2004, features gradual cuts in pension benefits and increases in individual contributions as well as transfers from the government to the pension system (possibly including tax increases). These changes are projected to cut the system's long-term deficit. Italy's pension reform, also introduced last year, will raise the effective retirement age starting in 2008. In addition, it will allow workers to top up their mandatory retirement pension by paying contributions into complementary private pension funds. The US administration also announced in its 2005 budget a plan to introduce voluntary pension accounts. In Germany, the ratio of pension benefits to average wages has been reduced, and benefit levels have been linked to the old-age dependency ratio.

Market discipline could provide incentives for fiscal consolidation

Regarding incentives to implement fiscal consolidation plans, pressures coming from government debt markets are expected to play an important role. Somewhat surprisingly, financial markets at present have not built in much of a risk premium for current and prospective fiscal imbalances in major industrial countries. In the euro area, for instance, despite some rating downgrades, the spillovers from large budget deficits or high debt levels to real interest rates or sovereign bond spreads have so far been rather limited. One explanation is that the successes in curbing budget deficits in the mid-1990s have lent credence to recent official statements of intent to cut deficits in the future. Another is that investors see the risks associated with current fiscal deficits as limited, perhaps because the global trend towards deregulation and privatisation

Medium-term fiscal projections[1]

	Financial balance			Structural balance[2]		Gross debt		
	2005	2006	Change from 2004[3]	2005	2006	2005	2006	Change from 2004[3]
United States	–4.2	–4.1	2.0 (2010)	–4.2	–4.1	66	68	–6 (2010)
Euro area	–2.6	–2.4	0.4 (2006)	–1.9	–1.9	79	79	0 (2006)
Germany	–3.3	–2.6	2.2 (2007)	–2.0	–1.7	73	74	2 (2007)
France	–3.1	–2.9	1.7 (2008)	–2.7	–2.8	74	74	1 (2008)
Italy	–3.9	–4.3	2.0 (2008)	–3.5	–4.2	119	119	8 (2008)
Japan	–6.4	–5.7	1.9 (2008)	–6.2	–5.7	161	164	–10 (2008)
United Kingdom	–3.2	–3.2	1.4 (2010)	–3.3	–3.3	47	49	–3[4] (2010)
Canada	1.3	1.1	0.2 (2008)	1.3	1.0	66	62	14[4] (2008)
Australia	0.4	0.3	–0.2 (2007)	0.6	0.6	18	18	4[4] (2007)

[1] General government, as a percentage of GDP. [2] Cyclically adjusted financial balance, as a percentage of potential GDP. [3] Change in balance and gross debt respectively, in percentage points, between the year shown in parentheses and the 2004 outcome. Positive numbers indicate a reduced deficit/increased surplus and reduced gross debt respectively. [4] Net debt.

Sources: IMF; OECD; national data. Table II.9

is thought likely to restrain the role of governments and public spending in the long run. Other explanations focus on the favourable borrowing conditions for all debtors, not just governments (see Chapter VI).

Could consolidation have expansionary effects?

An additional incentive to consolidation, in particular for large euro area countries and Japan, might be evidence that some past fiscal consolidations were positively correlated with economic growth. If consolidation is perceived as implying a permanent reduction in government spending and public debt, it might create expectations of lower taxes and long-term interest rates in the future. About half of the fiscal contractions in the EU 15 countries from the 1970s onwards were in fact followed by stronger growth. Perhaps the most cited episodes are Denmark and Ireland in the mid- to late 1980s and Spain in the second half of the 1990s. Yet much of the expansionary effect in these cases has been attributed to the fact that the contractions coincided with an easing of monetary policy along with real currency depreciation. Borrowing costs at the time were also high, making possible large gains from reductions in interest rates and country risk premia. In contrast, interest rates at present are very low. Nevertheless, fiscal adjustments that reduce the inefficiencies of traditional welfare programmes might well signal a commitment to rein in public spending in the future and could have a positive impact on expectations.

Fiscal consolidation can help moderate aggregate demand

In cases where fiscal imbalances have widened in a period of strong growth, fiscal consolidation should be more straightforward. A combination of higher taxes and lower government spending would help cut budget deficits as well as moderate aggregate demand. In the United States, fiscal consolidation would also help reduce the large current account deficit.

Fiscal rules might support fiscal consolidation, but enforcement is key

Incentives for fiscal consolidation could also be strengthened by relying on fiscal rules. Where domestic budget processes are closely integrated in a medium-term framework, countries may be more likely to meet their fiscal targets. There can be little doubt that numerous EU countries made substantial fiscal adjustments to comply with the Stability and Growth Pact and, before that, with the convergence criteria under the Maastricht Treaty. Fiscal rules have also been successfully used to discipline fiscal policy at different levels of government within countries, as well as in some emerging market economies. Recently, there have been calls in the United States to consider reinstating a rule similar to the Budget Enforcement Act to signal a renewed commitment to fiscal discipline. Yet recent problems with the Stability and Growth Pact indicate that even established fiscal rules can fail if there is a lack of commitment to adhere to them.

Population ageing as a major long-term fiscal challenge

The main impetus for fiscal reforms in the longer run is likely to come from challenges associated with the ageing of populations. The first wave of baby boomers will start retiring over the next decade. This will make increasing demands not only on public retirement schemes, but also on health care provision. Even after taking into account the impact of existing measures designed to cut the level of future benefits, pension- and health-related spending for the OECD countries is projected to rise on average by nearly 7% of GDP over the next four decades. Further policy action will thus become increasingly unavoidable.