

TENSIONS UNDER CONTROL

Forecasts for the world economy 2004-2005*

The world economic recovery has been back on track for two years. After standing at 4 % in 2003, GDP growth approached 5% in 2004. Expansion has spread all through the world. The «Southern economies» (i.e. the world outside North America, EU and Japan), which now account for almost 50 % of world output, remained buoyant (7% GDP growth) in the wake of China. Japan confirmed its revival, while the US economy, stimulated by a supportive economic policy, narrowed its output gap. Even Europe, for a long time stuck on the sidelines, is now back on the field (graph).

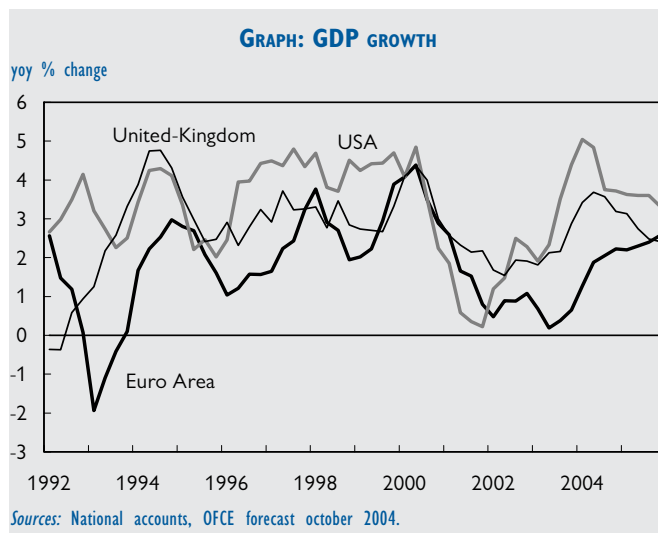
In Europe and North America, the disorders following the bursting of the dotcom bubble are now part of history. After several years' cleaning up, businesses have returned to profit and made considerable productivity gains. Profit margins have been used to cut indebtedness and distribute dividends rather than to invest and recruit. Consequently, household incomes have remained subdued, and in countries where consumption has not been driven by housing-market-induced wealth effects, such as Germany, GDP growth has been slower. In this picture, historically low real interest rates have played a major role, stimulating household spending through borrowing, while despite a high level of private debt in the US, the cost has remained moderate.

In 2005, GDP growth is expected to maintain its momentum, to stand at 4.2%. Output will decelerate somewhat in most of the world, where expansion has been faster than potential growth in 2004: USA, UK, Japan, emerging countries. Conversely, the Euro Area (EA) GDP, still lagging in 2004, will accelerate towards its potential in 2005.

Imbalances (on current account, household indebtedness in the US and in the UK, overcapacity in China) will be reabsorbed

only to a modest extent, but they will not threaten global growth: the world has learnt to live with these imbalances.

The biggest doubts regarding the world economy – and our scenario – concern the level of commodity prices and the potential spillover effect on other prices. All-time records have been reached in autumn 2004, and the consequences of the 1970s oil shocks are in everyone's mind. With the present peak partly due to structural factors, we expect the oil price to remain high by historic standards. Nevertheless, a price of over 50 dollars a barrel contains a sizeable premium resulting from transitory geopolitical tensions, which we assume will ease off in 2005. The barrel is forecast to slip back to 33 dollars by the end of 2005, slightly above its average price in Q1 2004. Another – and even more – important assumption in our scenario is the absence of second-round effects on overall prices. World economies are better armed to overcome an oil shock today than they were 30 years ago.



The US current-account deficit represents another – and long-standing – major concern. Whereas a continuation of the dollar slide would be painful for the euro area, a brutal uncoupling of the currency would be even more dangerous since it would be likely to drive up interest rates, thereby – in the worst-case scenario – triggering a housing market dip.

* This article is a summary of the study by the OFCE's Analysis and Forecasting Department that was published in *Revue de l'OFCE* n° 91. The team, headed by Xavier Timbeau, consists of H el ene Baudchon, Odile Chagny, Val erie Chauvin, Guillaume Chevillon, Ga el Dupont, Amel Falah, Eric Heyer, Sabine Le Bayon, Matthieu Lemoine, Catherine Mathieu, Paola Monperrus-Veroni, Herv e P el eraux, Mathieu Plane, Christine Riffart, Danielle Schweisguth and Elena Stancanelli. The forecasts include information available up to 15 October 2004.

TABLE I: MAIN ASSUMPTIONS AND FORECASTS

| | Quarters or half-years | | | | | | | | | | | | Years | | | |
|--|------------------------|------|------|------|------|------|------|------|------|------|------|------|-------|------|------|--|
| | 2003 | | | | 2004 | | | | 2005 | | | | 2003 | 2004 | 2005 | |
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | | | |
| <i>Oil prices in \$¹</i> | 31.3 | 26.1 | 28.4 | 29.5 | 32.0 | 35.6 | 42.2 | 40.0 | 36.0 | 35.0 | 33.0 | 33.0 | 28.8 | 37.4 | 34.3 | |
| <i>Industrial commodities in \$²</i> | 8.5 | 1.6 | 1.9 | 9.8 | 13.4 | -1.0 | 1.9 | -0.5 | -0.5 | -0.5 | -0.5 | -0.5 | 16.9 | 22.9 | -1.1 | |
| <i>Exchange rates¹</i> | | | | | | | | | | | | | | | | |
| 1 € = ... \$ | 1.07 | 1.14 | 1.12 | 1.19 | 1.25 | 1.20 | 1.22 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.13 | 1.23 | 1.25 | |
| 1 \$ = ... yen | 119 | 118 | 117 | 109 | 107 | 110 | 110 | 110 | 112 | 112 | 114 | 114 | 116 | 109 | 113 | |
| 1 £ = ... € | 1.49 | 1.43 | 1.43 | 1.43 | 1.47 | 1.50 | 1.49 | 1.48 | 1.48 | 1.48 | 1.48 | 1.48 | 1.45 | 1.48 | 1.48 | |
| <i>Short-term interest rates¹</i> | | | | | | | | | | | | | | | | |
| USA | 1.3 | 1.2 | 1.1 | 1.1 | 1.0 | 1.1 | 1.6 | 2.0 | 2.3 | 2.5 | 2.8 | 3.0 | 1.1 | 1.4 | 2.6 | |
| Japan | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | |
| Euro area | 2.7 | 2.4 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.4 | 2.4 | 2.4 | 2.4 | 2.3 | 2.1 | 2.4 | |
| United Kingdom | 3.7 | 3.6 | 3.5 | 3.9 | 4.1 | 4.5 | 4.9 | 5.0 | 5.3 | 5.3 | 5.3 | 5.3 | 3.7 | 4.6 | 5.3 | |
| <i>Long-term interest rates¹</i> | | | | | | | | | | | | | | | | |
| USA | 3.9 | 3.6 | 4.2 | 4.3 | 4.0 | 4.6 | 4.3 | 4.5 | 4.7 | 4.8 | 5.0 | 5.1 | 4.0 | 4.3 | 4.9 | |
| Japan | 0.8 | 0.6 | 1.2 | 1.4 | 1.3 | 1.7 | 1.6 | 1.5 | 1.4 | 1.3 | 1.2 | 1.2 | 1.0 | 1.5 | 1.3 | |
| Euro area | 4.2 | 4.0 | 4.2 | 4.4 | 4.2 | 4.4 | 4.3 | 4.3 | 4.4 | 4.4 | 4.5 | 4.5 | 4.2 | 4.3 | 4.5 | |
| United Kingdom | 4.3 | 4.2 | 4.5 | 4.9 | 4.8 | 5.1 | 5.0 | 5.0 | 5.3 | 5.3 | 5.3 | 5.3 | 4.5 | 5.0 | 5.3 | |
| <i>Inflation (consumer prices)³</i> | | | | | | | | | | | | | | | | |
| USA | 2.9 | 2.2 | 2.2 | 1.9 | 1.8 | 2.8 | 2.8 | 3.1 | 2.8 | 2.3 | 2.4 | 2.6 | 2.3 | 2.6 | 2.5 | |
| Japan | -0.2 | -0.3 | -0.2 | -0.2 | -0.1 | -0.3 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 | -0.2 | -0.2 | -0.1 | |
| Euro area | 2.3 | 2.0 | 2.0 | 2.1 | 1.7 | 2.3 | 2.2 | 2.2 | 2.0 | 1.9 | 1.7 | 1.7 | 2.1 | 2.1 | 1.8 | |
| United Kingdom | 1.5 | 1.3 | 1.4 | 1.4 | 1.3 | 1.4 | 1.6 | 1.6 | 1.7 | 1.7 | 1.6 | 1.5 | 1.4 | 1.5 | 1.6 | |
| <i>GDP in volume, seasonally adjusted²</i> | | | | | | | | | | | | | | | | |
| USA | 0.5 | 1.0 | 1.8 | 1.0 | 1.1 | 0.8 | 0.7 | 1.0 | 1.0 | 0.8 | 0.7 | 0.7 | 3.0 | 4.3 | 3.5 | |
| Japan | 0.0 | 1.1 | 0.6 | 1.9 | 1.6 | 0.3 | -0.1 | 0.2 | 0.6 | 0.6 | 0.7 | 0.7 | 2.5 | 3.7 | 1.7 | |
| Euro area | 0.0 | -0.1 | 0.4 | 0.3 | 0.6 | 0.5 | 0.6 | 0.5 | 0.6 | 0.6 | 0.7 | 0.7 | 0.5 | 1.9 | 2.4 | |
| Germany | -0.4 | -0.2 | 0.3 | 0.3 | 0.4 | 0.5 | 0.6 | 0.4 | 0.5 | 0.5 | 0.6 | 0.6 | -0.1 | 1.5 | 2.1 | |
| France | 0.2 | -0.4 | 0.8 | 0.5 | 0.8 | 0.8 | 0.5 | 0.6 | 0.6 | 0.7 | 0.7 | 0.8 | 0.5 | 2.5 | 2.6 | |
| Italy | -0.1 | -0.1 | 0.4 | 0.0 | 0.5 | 0.3 | 0.4 | 0.4 | 0.6 | 0.6 | 0.5 | 0.5 | 0.4 | 1.2 | 2.0 | |
| United Kingdom | 0.2 | 0.7 | 0.9 | 1.0 | 0.7 | 0.9 | 0.8 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 2.2 | 3.4 | 2.6 | |
| <i>Merchandise imports in volume, seasonally adjusted²</i> | | | | | | | | | | | | | | | | |
| World | 1.8 | 0.1 | 1.7 | 3.8 | 3.3 | 3.2 | 2.4 | 2.2 | 2.1 | 2.2 | 2.1 | 2.2 | 6.3 | 11.6 | 9.3 | |
| Industrialised countries | 0.5 | 0.4 | 1.0 | 3.0 | 1.2 | 2.8 | 2.0 | 1.8 | 1.7 | 1.8 | 1.7 | 1.8 | 4.4 | 7.9 | 7.6 | |
| Developing countries | 4.7 | -0.4 | 3.2 | 5.6 | 7.6 | 4.1 | 3.2 | 2.9 | 2.9 | 2.9 | 2.9 | 3.0 | 10.5 | 20.0 | 12.7 | |
| <i>Current account, in percentage points of GDP, seasonally adjusted</i> | | | | | | | | | | | | | | | | |
| USA | -5.0 | | -4.6 | | -5.4 | | -5.5 | | -5.1 | | -4.9 | | -4.8 | -5.5 | -5.0 | |
| Japan | 3.0 | | 3.6 | | 3.8 | | 4.7 | | 5.0 | | 5.4 | | 3.3 | 4.3 | 5.2 | |
| Germany | 1.6 | | 3.2 | | 4.2 | | 4.5 | | 4.9 | | 5.3 | | 2.4 | 4.3 | 5.1 | |

1. Average over the period.

2. Period/former period, in %.

3. For quarters, year-on-year percentage change. For years, annual percentage change.

Various sources: oil : brent ; industrial commodities: HWWA index (Hamburg) ; short-term interest rates : commercial paper in the USA, certificate of deposit in Japan, Euribor in the euro area, interbank in the UK; long-term interest rates : 10-year government bonds in the USA, in the euro area and in the UK, 10-year benchmark in Japan ; consumer prices: HICP for the euro area and for the UK.

Oil and commodities: back to long-term considerations

Between 2003 and 2004, industrial commodity prices have soared by 23 % and oil prices by 30% (in US dollars). The rise was driven by geopolitical tensions and limited spare capacity, as well as buoyant demand fuelled by a broadly cheerful economic outlook. In the long run, demand is likely to thrive if the ongoing catch-up process in giant countries like China or India is prolonged. Looking to the future, energy economies, new exploration and the development of alternative sources of energy are necessary and will probably be triggered by the high price of fossil fuels.

Despite these structural factors, the price of oil is expected to edge downwards in 2005. First, the near-coincidence of a crisis in Venezuela, a war in Iraq, threats of terrorist attacks (in the context of the US presidential election), the Yukos conflict in Russia, instability in Nigeria and hurricanes in the Gulf of Mexico is unlikely to be repeated next year. In addition, the world economy will slow down, thereby curbing demand.

For several reasons, the impact of the oil shock is much smaller today than it was in the 1970s. In real terms, its magnitude is much smaller than three decades ago, especially on the Euro Area (EA), partially sheltered by the strength of its exchange rate. Moreover, in industrialised countries, the energy content of production is significantly lower. What is more, the risk of a comeback of inflation stemming from second-round effects on wages and price setting is much smaller. Independent central banks have a strict objective in the form of control of inflation and the credibility to prevent its resurgence. Consequently, wage settings assume low inflation. And businesses are in better financial health than 30 years ago, which allows them to trim their margins.

Finally, other factors are pushing prices down. House prices are likely to decelerate in most countries. Worldwide deflationary pressures, underpinned by the shrinking price of new technologies and the competition from emerging countries, are persisting. China is a pool of productivity and cheap labour. Japan is still in deflation. All these factors are dissuading firms from increasing prices and wages, which have remained moderate in recent quarters. In addition, output is still below potential in most countries, no tension on productive capacities has emerged so far and unemployment is still as high as 9% in the Euro Area. All these elements explain why the inflationary impact of the oil-price hike is limited to its direct effect, which we estimate to be 0.5 of a point in the US and 0.3 in the EA.

In the absence of rising overall inflation, the main consequence of the rise in oil price is a transfer of income – and growth – from energy-consuming economies to energy-producing economies. Overall, according to our oil-price forecast, GDP growth will be reduced by 0.4 of a point in 2004-2005 by comparison with a scenario including a stable oil price at 29 dollars, i.e. its average 2003 level.

Growing trade, persistent imbalances and stable exchange rates

Global trade gathered speed towards the end of 2003 and in the first half of 2004, driven by buoyant economic activity.

Following a 6.3% rise in 2003, world trade growth is set to register 11% in 2004. Emerging Asia is leading the movement, but the US and Europe have also contributed to the acceleration. In 2005, global trade will cool down in line with the world GDP slowdown, but the pace will remain very dynamic (9%).

In 2004, oil prices provided OPEC countries with a levy of some 100 billion dollars, i.e., around 0.3 of a point of OECD GDP. But oil prices were only part of the explanation for the rise in the US current-account (CA) deficit. The oil-price hike cost the US economy 0.4 of a point of GDP, whereas the US CA deficit increased by 0.7 of a point. The discrepancy in output growth between the US and Europe/Japan also pushed the US CA deficit upwards. In 2005, current-account imbalances are set to remain broadly unchanged, with the US spending more than 5% above what it produces. Both the US economic downturn and the European acceleration will be quite modest, while exchange rates are expected to remain steady.

The expected stability of the main exchange rates in 2005 is the consequence of two opposing factors. The US CA deficit pushes the dollar down, but interest- and growth-rate differentials support it through higher expected returns. The euro is projected to remain broadly unchanged at 1.25 dollars. The Japanese yen will slide slightly towards 114 yens for a dollar in a context of uncertain domestic recovery. The stabilisation policy of the Chinese yuan is assumed to be left unchanged in 2005.

Impressive growth in the emerging countries

In **Asia**, the growth momentum remained very strong in the first half of 2004. Exports were fostered by the global economic growth, Chinese imports, and improved competitiveness favoured by the slide in the dollar to which most Asian currencies are pegged. Domestic demand has also been robust, supported for the first time since the Asian crisis by a vigorous recovery in private investment. Growth in Asia ex Japan has therefore been almost as strong in 2004 (7.5%) as in 2003 (8.0 %) (table 2). It will ease back to 6.7% in 2005, partly because of the level of energy prices: the energy-intensity of Asian production is much higher than that of advanced countries.

Japan bottomed out of recession in 2003 and the recovery gathered momentum in 2004, led by exports and private consumption. But structural problems persist and deflationary pressures are still present, so that GDP growth is projected to slow down to 1,7% in 2005.

Following three years at a standstill, **Latin America** recovered in 2003 and gathered speed in 2004. The main factors behind the upturn include the price level of the commodities exported by the region, the vigour of activity in the US and in Asia, and supportive exchange rates. In addition, regional integration has transmitted economic dynamism to the whole of the sub-continent. Growth has helped to overcome internal and external imbalances. Economic activity should slow down somewhat in 2005 with the deceleration of external demand.

In 2003 and 2004, the outlook has been buoyant in **Central and Eastern European countries**, despite lagging activity in most Western European countries, their main trade partners. In 2004, GDP growth has been driven by private investment in Hungary and the Czech Republic, by exports in Poland and by the rise in commodity prices in Russia. In 2005, the new EU members (especially Poland) will suffer from the tightening of

the policy mix and from the price of oil, of which they are ravenous consumers. But the convergence process is under way and the pace of activity will remain at a level their western neighbours can only yearn for.

TABLE 2: INTERNATIONAL GROWTH PROSPECTS

| Annual percentage change | Weight ¹ in the total | GDP in volume | | |
|-------------------------------------|----------------------------------|---------------|------------|------------|
| | | 2003 | 2004 | 2005 |
| Germany | 4.4 | -0.1 | 1.5 | 2.1 |
| France | 3.2 | 0.5 | 2.5 | 2.6 |
| Italy | 3.1 | 0.4 | 1.2 | 2.0 |
| Spain | 1.8 | 2.5 | 2.5 | 2.6 |
| Netherlands | 0.9 | -0.9 | 1.3 | 2.1 |
| Belgium | 0.6 | 1.1 | 1.7 | 2.5 |
| Austria | 0.5 | 0.7 | 1.4 | 2.4 |
| Finland | 0.4 | 2.1 | 2.9 | 3.6 |
| Portugal | 0.4 | -1.2 | 1.8 | 2.4 |
| Greece | 0.3 | 4.3 | 3.7 | 2.9 |
| Ireland | 0.3 | 3.7 | 4.6 | 5.2 |
| Euro area | 15.7 | 0.5 | 1.9 | 2.4 |
| United Kingdom | 3.1 | 2.2 | 3.4 | 2.6 |
| Sueden | 0.5 | 1.7 | 3.3 | 2.9 |
| Denmark | 0.3 | 0.5 | 2.2 | 2.4 |
| EU 15 | 19.7 | 0.9 | 2.2 | 2.4 |
| 10 new member states | 1.8 | 3.8 | 5.0 | 4.6 |
| EU 25 | 21.5 | 1.1 | 2.3 | 2.5 |
| Switzerland | 0.4 | -0.3 | 1.7 | 1.9 |
| Norway | 0.3 | 2.5 | 2.7 | 2.8 |
| Europe | 22.2 | 0.8 | 2.0 | 2.2 |
| USA | 21.2 | 3.0 | 4.3 | 3.5 |
| Japan | 7.1 | 2.5 | 3.7 | 1.7 |
| Canada | 2.0 | 2.0 | 2.9 | 3.3 |
| Industrialised Countries | 54.2 | 1.9 | 3.1 | 2.6 |
| EU candidate countries ² | 1.4 | 5.4 | 7.4 | 5.4 |
| Russia | 2.7 | 7.3 | 7.1 | 7.5 |
| Other CIS ³ | 1.2 | 6.6 | 8.1 | 6.1 |
| China | 12.7 | 9.1 | 8.7 | 7.5 |
| Other Asian countries | 13.5 | 6.9 | 6.3 | 6.0 |
| Latin America | 7.9 | 1.9 | 5.7 | 3.1 |
| Africa | 3.2 | 4.3 | 4.5 | 5.4 |
| Middle East | 3.1 | 6.0 | 5.1 | 4.8 |
| World | 100.0 | 4.0 | 4.9 | 4.2 |

1. Based on GDP (PPP) 2002.

2. Romania, Bulgaria, Turkey, Croatia.

3. Commonwealth of Independent States.

Sources: IMF, OECD, National sources, OFCE estimates and forecasts.

The end of the artificial euphoria in the US

Economic growth in the US remained solid in the first half of 2004 (2.0%), although easing off somewhat by comparison with the second half of 2003 (2.8%). In the second quarter, household consumption was held back by the impact of oil prices on real incomes, but investment surged. The contribution of foreign trade was strongly negative in the first half of 2004, despite two-and-a-half years of depreciation in the dollar. The impact of exchange rates on the trade deficit appears to have been considerably delayed and the strong appreciation of the dollar between 1995 and 2001 is still hampering US competitiveness. In addition, demand from Europe remained subdued.

After 4.3% growth in 2004, the US economy should decelerate in 2005 to 3.5%, i.e. roughly its potential growth rate, while partially trimming its imbalances. Past dollar depreciation would eventually have an impact, albeit modest, on the trade deficit. Fiscal tightening policy would permit a cut in the public deficit amounting to 0.6 GDP points. Progressive increases in the Federal Reserve interest rates, to 3% by end-2005, would help to alleviate private indebtedness and the housing market. A less supportive macroeconomic policy and weaker wealth effects from the housing market are expected to dampen household consumption and housing investment. But the improved financial outlook for companies will allow them to invest and create jobs. Improvements on the labour market and some wage rise will, in turn, foster disposable income and consumer expenditure.

Recovery without panache in the Euro area

The Euro Area (EA) has been recovering since mid-2003. GDP gathered momentum to register a 1.1% rise in the first half of 2004. The 2004 annual growth rate is expected to come out at 2.0%. Expansion has spread throughout Europe: for the first time since the beginning of the downturn in mid-2001, the year-on-year growth GDP rate was positive in every country in Q1 2004.

But behind this apparent uniformity, economic outlooks diverge strongly across countries. In some countries, like France and Spain, growth has resulted from dynamic domestic demand, but it has been dampened by the weakness of net exports. By contrast, Germany and the Netherlands have been driven by the reverse forces: brisk net exports only partially offset by the sluggishness of all components of domestic demand. Italy stands midway with a small positive contribution from domestic demand and no contribution from foreign trade. The flourishing outlook of the housing market in France and Spain has spurred credit provision and consumption, whereas in Germany and the Netherlands strong wage restraint, fiscal tightening and social reforms have improved competitiveness, while trimming consumption. As regards foreign trade, Germany is better placed than France from a geographic perspective, with emerging countries among its main customers, whereas France is mainly selling to Western Europe and... Germany.

EA growth is set to continue at roughly the same pace towards the end of 2005. It should come out at an annual average of 2.4 % next year, a figure slightly above potential growth, but below what could be expected in a recovery. Activity will be dampened by past shocks, the recent rise in the euro and in oil prices (even if the former appreciably mitigates the latter). Private consumption is expected to speed up only gradually, since wage growth will be slowed down by delays in job creation, usual in this phase of the cycle. Investment will benefit from the good financial situation of companies after several years' purge.

With a 3.4% GDP growth rate in 2004, the **United Kingdom** is leaning towards its American uncle rather than its European cousins. Expansion has been driven by domestic demand, whereas net exports have been held back by their geographical orientation towards continental western Europe and by falling market shares. In 2005, GDP growth is expected to decelerate to 2.6%. House prices are likely to level off and interest rates to climb, thereby slowing down consumption and investment expenditure.

Policy mix: a gentle tightening?

In 2003, the policy mix was very supportive in the United States and in the United Kingdom, where the fiscal stimulus amounted to 1% of GDP, and to a lesser extent in Japan (table 3). By contrast, in the euro area, fiscal policy and monetary conditions were slightly restrictive despite the lacklustre outlook. In 2004, monetary policies have continued to provide a positive impetus for activity in the US and in the UK. But fiscal policy, while remaining strongly supportive in the US, became neutral in the UK. It slackened somewhat in the EA, and turned strongly restrictive in Japan.

2005 is expected to show a broad convergence of fiscal policies towards neutrality, except in the US where the newly-elected president will launch a deliberate policy of cutting public debt.

In most developed countries, monetary policies are currently very supportive. Short-term real interest rates are nil or negative in the US and in the euro area. Recently, the monetary stimulation has acted through loans for house purchase rather than through increased corporate investment. Low interest rates have boosted house prices, and this in turn has curbed liquidity constraints, to the benefit of overall consumption. In the US and the UK, the very flexible mortgage market has strengthened the transmission belt.

In 2005, assuming the price of oil subsides, inflation will slowly decelerate on both sides of the Atlantic. In this context, and since the risk of a bursting of the housing bubble still exists, monetary tightening will be very gradual and on a modest scale (table 1). By the end of 2005, intervention rates are expected to reach 3%, 2.25% and 5.25% in the US, in the EA and in the UK respectively. They should remain unchanged in Japan. Monetary policy will therefore continue to be slightly supportive, and private agents, especially in the US and in the UK, will be able to reduce their indebtedness without trimming their spending. Despite a bigger output gap in the EA, real intervention rates will remain higher in the EA than in the US, reflecting the European Central Bank's more orthodox stance with regard to the inflation risk.

TABLE 3: FISCAL POLICIES IN EUROPE, IN THE USA AND IN JAPAN

| | 2002 | 2003 | 2004 | 2005 | Average 2002-2005 |
|--|------|------|------|------|----------------------|
| GDP growth, in % | | | | | |
| Euro area | 0.9 | 0.5 | 1.9 | 2.4 | 1.4 |
| USA | 1.9 | 3.0 | 4.3 | 3.5 | 3.2 |
| United Kingdom | 1.8 | 2.2 | 3.4 | 2.6 | 2.5 |
| Japan | -0.3 | 2.5 | 3.7 | 1.7 | 1.9 |
| General government balance, in percentage points of GDP | | | | | |
| Euro area | -2.4 | -2.7 | -3.0 | -2.6 | -2.7 |
| USA | -3.8 | -4.6 | -4.8 | -4.2 | -4.4 |
| United Kingdom | -1.6 | -3.2 | -2.8 | -2.5 | -2.5 |
| Japan | -8.0 | -8.1 | -6.9 | -6.8 | -7.5 |
| Fiscal stimulus ¹ , in percentage points of GDP | | | | | |
| Euro area | 0.7 | -0.3 | -0.1 | -0.1 | 0.1 |
| USA | 3.0 | 1.0 | 0.9 | -0.5 | 1.1 |
| United Kingdom | 2.3 | 1.3 | 0.0 | -0.1 | 0.9 |
| Japan | 1.2 | 0.3 | -0.7 | -0.1 | 0.2 |

Sources: National accounts, Eurostat, OFCE estimates and forecasts.

Long-term interest rates are expected to inch up in 2005. The increase in short-term interest rates and the consolidation of growth are propping them up, but several elements are mitigating the rise. The oil shock is expected to have a larger impact on real growth than on inflation, and petro-dollars are partly recycled in western countries. Central banks have reaffirmed their vigilance as regards price stability.

What if the mechanism seized up?

In our forecast, important shocks and imbalances fail to derail the world economy. Nevertheless, some risks clearly have to be considered, especially with respect to commodity prices, current-account imbalances, housing markets and the outlook for Asia.

There is an obvious risk of higher commodity prices. Should the **price of oil** remain unchanged at 50 dollars throughout 2005, growth in industrial countries would be further eroded (by 0.6 of a point, allowing for a monetary policy response). Developing economies would suffer even more. Oil-producing countries are likely to increase their imports and reintroduce petrodollars on financial markets, thus stabilising international interest rates.

There are also uncertainties about **exchange rates**. Concerns over the sustainability of the US current-account deficit or reduced interventions by Asian central banks could well drive down the dollar. China is close to overheating, and it might be a sound strategy to let the yuan appreciate so as to cool activity and inflation and lower the cost of energy.

The most likely scenario would be a progressive and controlled slide of the dollar. Once this had happened, expectations regarding the euro/dollar and euro/yen rates would stabilise at levels regarded as matching the fundamentals of the economies, including the sustainability of current-account balances. The US economy's competitiveness would come out improved after a while (J curve), and the US CA deficit would narrow. In this scenario, the slide of the dollar would be more or less at the choice of the US authorities, with a view to encouraging job creation and curbing external indebtedness. Interest rates would remain broadly unchanged as long as inflation remains subdued.

GDP growth would be somewhat slowed down outside the US. For instance, a sudden 10% slide in the dollar versus the euro in the early part of 2005 would cut the Euro area's growth by 0.4 points in 2005 and by 0.8 in 2006. Hence, the main cost of the reduction in current-account imbalances would be borne by the European economies. Stronger domestic demand in the EA would be a better way to cut the US CA deficit. But public spending in the EA is limited by the Stability and Growth Pact and private demand continues to be hesitant.

A gloomier and more unlikely scenario with regard to exchange rates would be a violent self-fulfilling mistrust of the dollar. If the long-term structural exchange rate of the dollar is projected to be much lower than the current exchange rate, it will be increasingly difficult to justify costly interventions – in terms of returns in dollars and expected exchange rate losses – by Asian central banks. And the euro could well emerge as a competitor reserve currency. In order to limit inflationary pressures, support the dollar and attract capital flows, despite

losses on the exchange market, short- and long-term interest rates would pick up in the US, which would strongly dent activity.

But a collapse of the dollar somewhat similar to what happened to numerous emerging countries' currencies over the last decade is very unlikely, since world central banks have the clout and the interest to prevent such a sombre scenario from occurring. Moreover, the US continues to be the world locomotive for consumption and innovation.

In the US, as well as in many European countries, buoyant **housing** markets have supported consumption growth in recent years. In view of the supply conditions, Spain seems to be the only country where an actual housing market bubble has appeared. But we expect a soft landing rather than a crash. However, if interest rates were to increase following ever-rising energy prices or a collapse in the dollar, housing markets could well dip in many countries and negative wealth effects could then be expected.

A pick-up in **interest rates** might well trigger a sharp rise in savings ratios, especially in the US and in UK, where household debt has reached historic highs. The systemic risk for banks and insurance companies is lower than at the end of the 1990s, since financial institutions' balance sheets are less exposed. Today, the final risk lies with households. It is likely that the main impact of a rise in interest rates and/or a housing-bubble burst would be a severe downturn in consumer spending.

Is there a risk of an **Asian crisis**, comparable with the one that occurred in summer 1997, spilling over to other emerging countries around the world? Dubious debts and excess capacity are still present in the region. But the overall outlook for emerging Asia is driven by China, and a broad distrust towards these economies, with sudden capital flights, is quite unlikely as long as China's economic activity remains buoyant. In China itself, the risk of a financial crisis through the balance of payments is small since hot money flows have not been liberalised. However, state-owned companies are highly indebted and in many cases insolvent. Despite the recapitalisation of two big banks in early 2004, the ratio of doubtful loans remains high. Over-accumulation is still rampant, and measures aimed at curbing investment (factory closures, credit squeeze towards overheating sectors, increases in bank reserve requirements) have not been very effective so far. Hence, a financial crisis stemming from the necessity of stronger measures to cool the Chinese economy is still possible. ■