

A CONVERTED TRY

World Economic Forecasts for 2005-2006*

The world economy's ability to resist shocks has been challenged since 2000. If growth has been disturbed by the burst of the dotcom bubble in 2000, the World Trade Center's attacks in 2001, the financial scandals or the oil price hike since 2004, it resisted and inflationary tensions remained under control. Growth was particularly strong in the US, due to a vigorous counter-cyclical policy, and in China, where it sky rocketed. In the Euro zone and in Japan, despite a less voluntary policy mix, growth benefited from the rest of the world.

Facing shocks via expansionist policies...

In the US, monetary policy reacted very fast to the economic slowdown at the beginning of 2001: the Federal Reserve lowered interest rates gradually. By contrast, the reaction of the European Central Bank was much more cautious, with a delayed and smaller decrease in interest rates. The picture is darker regarding fiscal policy.

In the US, the fiscal stimulus was clearly positive until 2003. The Federal government first slashed taxes and, following 9/11, increased public spending. Accordingly, the fiscal stimulus was

above 4 percentage points of GDP between 2000 and 2004 (see table 1). In the Euro area, the fiscal stimulus proved half that of the US, because of the Growth and Stability Pact commitments.

The monetary policy was more expansionist in the US than in the Euro area. Moreover, the sensibility of the US growth to interest rates is stronger than in the Euro zone for many reasons. First, US households are more inclined to borrow money. Second, they can use their real estate asset as a collateral to increase their borrowing capacity if this asset has been partially repaid or its price has increased. In the US, housing equity withdrawal is strengthened by the fact that households can use some of the proceeds to finance extra consumption. Moreover, households are able to renegotiate existing mortgage loans to take advantage of a decrease in interest rates.

Household debt has increased in many Euro zone countries, like Spain, because of the surge in housing prices. But the Euro zone average household debt rate (81% in 2004) has remained far below that of the US and the UK (respectively 118% and 144%). Moreover it has risen to a lesser degree (+6.5 percentage points in the Euro zone, +37.5 in the UK and +18.3 in the US) since the sharp decrease in interest rates that started in 2000.

As firms had to tackle with the excess of the late 90s before being able to invest again, the increase in housing prices and debt turned out to be the main instrument of monetary policy. Because of the rise in the liquidity, there has been a larger decrease in saving rates that has directly benefited consumption¹. This rise in housing prices means that accommodative monetary policies work.

... at the cost of disequilibria...

The more vigorous US growth has resulted in a soaring current account deficit. The main risk was a major financial crisis: a collapse of the dollar, a tightening of monetary policy to prevent a capital drain, the end of fiscal stimulation to reduce public deficit, an increase in long term interest rates coupled with a larger risk premium put on US Treasury bonds.

1. For more details about this mechanism, see the OFCE Working paper 2005-16 of October 2005 *L'immobilier, pilier de la croissance ou épée de Damoclès*.

TABLE I. CUMULATIVE FISCAL STIMULUS FROM 2000 TO 2005*

In percentage points of GDP	2000	2001	2002	2003	2004	2005
Euro area	0.6	1.5	2.2	2.4	2.0	2.1
United Kingdom	0.5	1.7	4.1	5.6	5.9	5.7
United States	-0.6	0.2	2.8	4.1	4.3	4.0
Japan	0.5	-1.1	0.3	0.1	-0.9	-1.0

* Fiscal stimulus is the variation of the primary structural deficit.

Sources: National accounts, OFCE estimates and forecasts.

* 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° 95. The team, headed by Xavier Timbeau, consists of Hélène Baudchon, Guillaume Chevillon, Marion Cochard, Amel Falah, Eric Heyer, Sabine Le Bayon, Matthieu Lemoine, Catherine Mathieu, Paola Monperrus-Veroni, Hervé Péléraux, Mathieu Plane, Christine Riffart, Danielle Schweisguth and Elena Stancanelli. The forecasts include information available up to 14 October 2005.

TABLE 2: FORECAST SUMMARY

	Quarters or semesters												Years		
	2004				2005				2006				2004	2005	2006
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
<i>Oil prices in \$¹</i>	31.9	35.4	41.5	44.1	47.5	51.6	61.5	60.0	60.0	60.0	60.0	60.0	38.2	55.2	60.0
<i>Industrial commodities in \$²</i>	13.4	-1.0	2.1	4.5	10.5	-3.1	0.7	-2.0	-2.0	-2.0	-1.0	-1.0	24.8	12.2	-6.1
<i>Exchange rates¹</i>															
1 € = ... \$	1.25	1.20	1.22	1.30	1.31	1.26	1.22	1.22	1.21	1.20	1.19	1.19	1.24	1.25	1.20
1 \$ = ... yen	107	110	110	106	104	108	111	111	112	113	114	114	108	109	113
1 £ = ... €	1.47	1.50	1.49	1.44	1.44	1.47	1.46	1.46	1.46	1.46	1.46	1.46	1.47	1.46	1.46
<i>Short-term interest rates¹</i>															
USA	1.0	1.1	1.6	2.1	2.7	3.1	3.6	4.0	4.0	4.0	4.0	4.0	1.5	3.3	4.0
Japon	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	2.1	2.1	2.1	2.2	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
United Kingdom	4.1	4.5	4.9	4.8	4.9	4.8	4.6	4.25	4.25	4.25	4.5	4.5	4.6	4.6	4.3
<i>Long-term interest rates¹</i>															
USA	4.0	4.6	4.3	4.2	4.3	4.2	4.2	4.4	4.5	4.5	4.6	4.6	4.3	4.3	4.6
Japon	1.3	1.6	1.6	1.5	1.4	1.3	1.4	1.5	1.5	1.5	1.5	1.5	1.5	1.4	1.5
Euro area	4.2	4.4	4.2	3.8	3.7	3.4	3.2	3.3	3.3	3.4	3.4	3.5	4.1	3.4	3.4
United Kingdom	4.8	5.1	5.0	4.7	4.7	4.4	4.3	4.3	4.3	4.4	4.4	4.5	4.9	4.4	4.4
<i>Inflation (consumer prices)³</i>															
USA	1.8	2.8	2.7	3.4	3.0	2.9	3.5	3.1	3.0	2.5	2.1	2.2	2.7	3.1	2.4
Japon	-0.1	-0.3	-0.1	0.5	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.1	-0.1
Euro area	1.7	2.3	2.3	2.3	2.0	2.0	2.1	2.1	1.8	1.5	1.5	1.5	2.1	2.0	1.6
United Kingdom	1.3	1.4	1.2	1.4	1.7	2.0	2.5	2.2	2.1	2.0	2.0	1.9	1.3	2.1	2.0
<i>GDP in volume. Seasonnally adjusted²</i>															
USA	1.0	0.9	1.0	0.8	0.9	0.8	0.7	0.9	0.8	0.8	0.7	0.8	4.2	3.5	3.2
Japon	1.3	-0.4	-0.1	0.1	1.4	0.8	0.2	0.4	0.5	0.5	0.5	0.6	2.6	2.2	1.9
Euro area	0.6	0.5	0.2	0.2	0.3	0.3	0.5	0.5	0.5	0.5	0.5	0.5	1.8	1.3	1.9
Germany	0.5	0.2	-0.1	-0.1	0.8	0.0	0.2	0.3	0.4	0.4	0.4	0.4	1.1	0.9	1.4
France	0.6	0.7	0.1	0.7	0.4	0.1	0.7	0.6	0.6	0.6	0.6	0.6	2.0	1.7	2.2
Italy	0.5	0.3	0.4	-0.4	-0.5	0.7	0.3	0.2	0.3	0.3	0.2	0.2	1.0	0.1	1.2
United Kingdom	1.0	0.7	0.3	0.5	0.3	0.5	0.4	0.5	0.5	0.6	0.6	0.6	3.2	1.7	2.2
<i>Merchandise imports in volume. Seasonnally adjusted²</i>															
World	2.9	2.9	1.6	2.6	-0.2	2.5	1.9	2.0	1.9	2.0	2.0	2.0	10.9	6.7	8.2
Industrialised countries	1.9	2.8	2.1	1.9	-0.2	1.4	1.3	1.4	1.4	1.4	1.4	1.5	8.5	5.0	5.6
Developing countries	4.9	2.9	0.9	3.8	-0.1	4.4	3.1	3.1	2.9	2.9	2.9	2.9	15.5	9.9	12.8
<i>Current account balance. In percentage points of GDP. Seasonnally adjusted</i>															
USA	-5.4	-6.0	-6.0	-6.4	-6.4	-6.3	-6.1	-6.1	-6.1	-6.0	-6.0	-6.0	-5.7	-6.4	-6.1
Japon	3.4	3.8	3.8	3.2	3.2	3.9	3.9	4.0	4.0	4.4	4.4	4.4	3.6	3.6	4.1
Germany	4.2	5.7	5.7	6.2	6.2	5.3	5.3	6.2	6.2	6.5	6.5	6.5	4.9	5.8	6.4

1. Average over the period.

2. Period-on-period percentage change.

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

Sources: oil: brent; industrial commodities: HWWA index (Hamburg); short-term interest rates: commercial papers in the USA, certificates 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; OFCE forecasts.

Had there not been economic partners ready to finance the US deficit, this situation would have been threatening. East Asia, and China in particular, whose growth is based on exports and on a current account surplus, chose to sustain the dollar against their own currencies. Asian central banks bought US Treasury bonds to recycle their current surpluses and thus, financed the US deficit. Thus doing, they also prevented a rise in the long term interest rates, kept their currencies practically steady with respect to the dollar... and maintained their currencies undervalued compared to other currencies, the euro in particular. There is one loser at this game: the Euro zone that let its competitiveness deteriorates.

In fostering mounting imbalances, have the US and China delayed a financial crisis that will turn into a hard landing for the world economy?

... which are reducing

The recent shifts in the US economy disprove such a development. American firms have coped with the excesses of the late 90s. A strong productivity growth together with the recent depreciation of the dollar have had a positive impact on the US current account deficit. The dollar is still sustained by Asian central banks, but it also benefits from improving fundamentals. American firms now have higher profitability and competitiveness. They are gaining market shares, not only on external markets but also domestically. They can invest again, thus attracting foreign capital inflows: investors see the US as a more attractive economy than emerging countries or other growing economies.

Accordingly, the current account deficit stopped growing and, in the beginning of 2005, even reduced. Without taking oil imports into account, the improvement would have been more significant. The Bank of Japan even stopped its massive interventions, because the yen was no longer appreciating against the dollar.

China keeps piling up current account surpluses and foreign currency reserves, rather than opening its financial system and its economy to foreign capital. This commercial surplus implies huge domestic savings. Foreign currency reserves guarantee and sustain the domestic financial system, allowing to recycle this excess saving into national investments. As interest rates faced by domestic agents are lower than those of foreign financial markets, this process will continue. Chinese commercial surpluses with respect to developed countries will keep rising and the Bank of China will continue piling up reserves and financing its main client, ie the US.

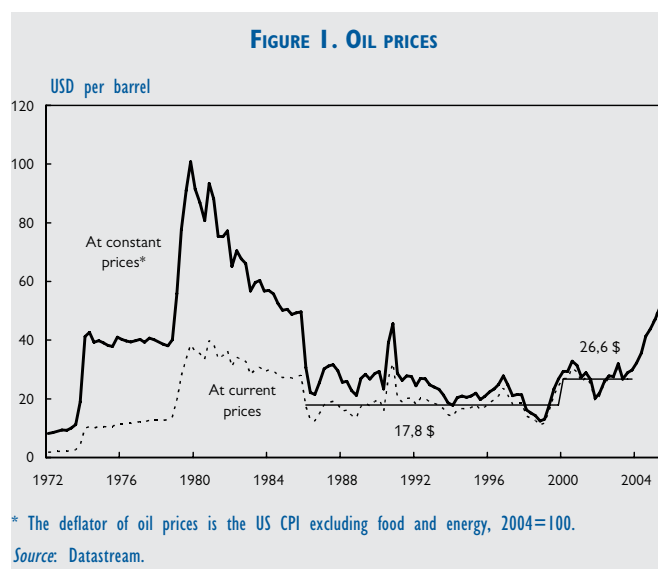
Oil: a shock with a non visible trauma

The Brent price of oil has increased by 50% in current dollars since the beginning of the year. In the third quarter of 2005, it stood in average above USD 60 (see figure 1). This rise is in line with a long-term trend: prices increased from USD 17.8 per barrel between 1986 and 1999 to USD 26.6 over 2000-2003, before hiking at the beginning of 2004. So, prices have risen by 250% with respect to the 1990s average. Yet, the world economy has been growing at above 4% per year since 2003 and doesn't seem to suffer much from this shock. Such a crisis could well have had devastating consequences.

The rise in oil prices (+180% in constant prices since 1999) is higher than that of the second oil shock (+120%), but much lower than that of the first shock (+350%). But, these shocks, no matter how much prices go up, cannot really be compared as far as their consequences are concerned.

Firstly, the present shock, spread over several years and not just over a few quarters, allows gradual adjustments. This was not the case during the previous shocks, when agents were constrained to react very quickly, with a negative impact on the economic system.

Secondly, at the time of the previous shocks, inflation was much higher and an inflationary shock could easily turn into a wage-price spiral. Nowadays, indexation mechanisms no longer exist and the hike in oil prices barely has an effect on economies with strong deflationary pressures. As inflation forecasts remain practically unchanged, there has been no extra shock on interest rates. Finally, global oil consumption per GDP unit is half the level reached in 1973. It underlines the fact that developed countries are less dependent on oil.



At first sight, the oil shock does not seem to have an economic impact. However, some adjustments are at work. The rise in inflation, caused by the price of oil, has clearly weakened household purchasing power. Furthermore, soaring oil prices have increased intermediate consumption prices. Because of growing competition (strong euro exchange rate, low wages in less well developed countries), firms in industrial economies were constrained to cut other production costs, including wages. Such deflationary adjustments explain why there has been no impact on core inflation. This shock could eventually bring down household consumption if there were no further decrease in the saving rate or less household debt.

Growth on the east, on the west, on the north and on the south...

Following an outstanding growth of 5% in 2004, the world economy should grow at a pace closer to its potential, ie 4.2% in 2005 and 4.1% in 2006 (see table 3). Emerging countries, and China in particular, should keep sustaining world growth. Although they represent less than half the world GDP, they

account for 68% of growth in 2005. And China alone contributes to 28%. As for industrialised countries, growth in the US will remain the strongest, thus contributing to more than half the OECD growth and to 18% of world growth.

In 2004, US growth proved very vigorous (4.2%). In 2005 and in 2006, it is expected to be back to potential (3.5% in 2005, 3.2% in 2006). Whereas the difference with the Euro zone narrows, US performances should remain well above Europe. Moreover, contrary to previous years, US growth is less dependent on policy mix and thus more autonomous. Growth is no longer underpinned by fiscal stimuli and still benefits from low long-term interest rates, which have not reacted yet to the tightening of monetary policy. Investment has become the real engine for growth since 2004, also sustained by household consumption which hasn't been affected by the surge in oil prices. No "second round" effects of the oil shock on inflation have been observed yet. Therefore, an acceleration of the tightening of the Fed's policy is not to be expected. The impact of the recent hurricanes seems to be very limited on US growth. A fall in housing prices, which would induce a sharp rise of the households' saving rate, is unlikely to happen.

Asia's growth still remains staggering, and it is essentially helped by China. A strong American demand for Asian exports, coupled with modest domestic inflation and current account surpluses have softened the negative impact of the oil shock on Asian economies. As in 2004, Asian growth should keep running, at least, at 7% both in 2005 and in 2006. China should remain the engine for the area, as it is underpinned by consumption and important gains of market shares.

Thanks to the vigorous growth of its Asian partners, Japan has finally benefited from a reversal of fortune in 2004. Growth in the first half of 2005 was well above forecasts: it was fostered by higher household consumption and productive investment. With respectively 2.2% and 1.9% GDP growth in 2005 and in 2006, the Japanese economy should remain dynamic and helped by a recovery of exports, increasingly Asia-oriented. But, it will be hampered by domestic demand, because of the rise in production costs and a tighter fiscal policy.

Soaring oil prices benefit Latin America, which is a net oil exporter. The area should pile up high commercial surpluses in 2005. In addition to the support of a favourable international environment, domestic demand has confirmed its recovery, with a rise in productive investment and a good orientation of private consumption. After an outstanding 6.2% GDP growth in 2004, activity should increase at a lower pace in 2005 and in 2006 (respectively 4% and 3.6%). This slight slowdown is underpinned by the appreciation of real effective exchange rates and relatively tight fiscal policies in the most inflationist countries. Exports should continue to benefit from US and Chinese growth. Indeed, the Asian share in Latin American exports has practically doubled over the last 4 years.

The UK has faced a sharp slowdown since the second quarter of 2004. The good outcome of 2004, ie 3.2%, should therefore not be reached in 2005 and 2006. Growth should fluctuate around 2%. Accordingly, growth in the UK should be closer to that of the Euro zone, after years of "American style" dynamics. The increase in interest rates has restrained domestic demand and no support has come from outside. Household consumption has clearly slowed down and manufacturing industry is practically in recession. The fiscal stance is expected to be slightly restrictive in 2005 and in 2006. But a loosening monetary policy should foster a progressive recovery in 2006.

Central and Eastern European countries should keep on catching up, but at a slower pace than in 2004. Growth in the new EU members should remain dynamic (4.5% in 2006, after 3.7% in 2005 and 4.5% in 2004). Fiscal discipline, high labour productivity gains and the appreciation of effective exchange rates should contain inflationary pressures, but also bring down domestic demand. Fortunately, progressive recovery of the Euro zone's imports is expected to boost the exports of the new members, thus contributing to the acceleration of growth in 2006. By contrast, the economic situation tends to deteriorate in the other countries of this area: Romania and Bulgaria remain in an uncertain macroeconomic environment. Ex-soviet economies suffer from political and economic instabilities. They must implement a tighter control of inflationary pressures. As for Russia, domestic demand should not be able to counterbalance a likely slow down of the progression of energy exports revenues.

TABLE 3: INTERNATIONAL GROWTH PROSPECTS

Annual percentage change	Share ¹ in the total	GDP in volume		
		2004	2005	2006
Germany	4.4	1.1	0.9	1.4
France	3.2	2.0	1.7	2.2
Italy	3.1	1.0	0.1	1.2
Spain	1.8	3.1	3.3	2.9
Netherlands	0.9	1.7	0.7	1.9
Belgium	0.6	2.7	1.3	2.0
Austria	0.5	2.1	1.8	2.0
Finland	0.4	3.5	1.6	4.1
Portugal	0.4	1.2	1.0	1.6
Greece	0.3	4.2	2.8	2.6
Ireland	0.3	4.5	4.7	4.5
Euro area	15.7	1.8	1.3	1.9
United Kingdom	3.1	3.2	1.7	2.2
Sweden	0.5	3.1	2.2	2.4
Denmark	0.3	2.0	2.3	2.2
EU 15	19.7	2.0	1.4	2.0
10 new member states	1.8	4.5	3.7	4.5
EU 25	21.5	2.2	1.6	2.1
Switzerland	0.4	2.1	1.0	1.5
Norway	0.3	3.3	3.8	2.8
Europe	22.2	1.9	1.3	1.8
USA	21.2	4.2	3.5	3.2
Japan	7.1	2.6	2.2	1.9
Canada	2.0	2.9	2.8	2.5
Industrial Countries	54.2	2.9	2.3	2.3
EU candidate countries ²	1.4	8.1	4.9	4.8
Russia	2.7	7.2	5.7	5.4
Other CIS ³	1.2	10.4	6.7	6.5
China	12.7	9.5	9.1	8.5
Other Asian countries	13.5	6.4	5.6	5.8
Latin America	7.9	6.2	4.0	3.6
Africa	3.2	5.3	4.5	5.9
Middle East	3.1	5.5	5.4	5.0
World	100	5.0	4.2	4.1

1. Based on GDP (PPP) 2002.

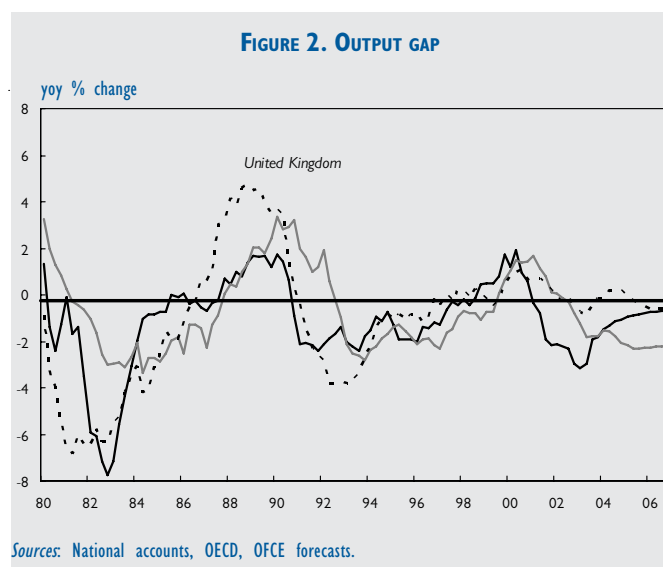
2. Romania, Bulgaria, Turkey, Croatia.

3. Commonwealth of Independent States.

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

... but not in the centre

In the Euro zone, the recovery which started in the second term of 2003 has been impeded by Germany and Italy. Thus, growth in the Euro area is lagging behind the global rate. The economic slow down initiated in the second half of 2004 was confirmed in the first half of 2005 (0.3% in the first and in the second quarter). By contrast with the US, where the output gap has progressively narrowed over the last 2 years to -0.9% of potential GDP, it has kept widening in the Euro zone, to reach -2.3% in the second term of 2005 (see figure 2). European economic policies are far less expansionists than in the US and transmission channels, especially monetary, are less efficient for institutional reasons or because of lower borrowing behaviour. Over the forecast period, this pattern should remain unchanged, with a GDP growth of 1.3% in 2005 and of 1.9% in 2006, following 1.8% in 2004.



EU domestic demand would not boost growth significantly. The progressive improvement of employment and the decrease in the savings rates in 2006 should allow consumption to gather momentum. Yet, it should still stay curbed by a weak purchasing power, especially in Germany. Indeed, because of a competitive disinflationary policy, wages and allowance are weak and cannot sustain domestic demand, despite an upturn in the labour market. Germany gains export market shares by undermining the positions of its European partners, in particular the competitiveness of Italy. Investment growth is yet uncertain. But it should improve over the forecast horizon, thanks to a lower euro exchange rate and a positive contribution of external trade. However, a weak consumption should hamper a recovery based on investment in production capacities. ■