EDITORIAL: A HESITANT RECOVERY

This *Outlook* is published at a time when the world recovery appears more hesitant and less widespread than expected. Activity bounced back early in 2002 but then lost momentum, in a context of weakening consumer and business confidence. This pattern of fits and starts is not unusual in the initial stages of a recovery but it has been associated with a further deterioration of equity and financial markets, which marks a clear departure from past business cycle experience.

The continuation of an already protracted phase of financial correction is not, however, a complete surprise. It underscores the very singular nature of the cycle currently unfolding, with its large initial capital overhang and financial imbalances.

With hindsight, it appears, indeed, that developments over the course of 2002 featured both normal and unique cyclical characteristics:

- The rebound at the beginning of the year was very much a technical recovery in the usual sense, signalling the end of a period of abrupt destocking.

- The subsequent slowdown came as confirmation that sound economic and financial "fundamentals" had not yet been completely restored. The capital overhang had not yet been fully worked through and equity valuations were perhaps still too high.

Recent developments have also featured large growth differences between North America, Continental Europe and Japan, prompting worries that stabilisation policies were not appropriately fine-tuning global demand in certain OECD areas.

A closer examination of available evidence does not point, however, to a marked "cyclical divergence" across OECD countries. To the contrary, the recent cycle seems to have been highly synchronised. What we are witnessing might rather be a phenomenon of "structural divergences", with potential growth in North America far exceeding what can be observed and expected in other OECD regions.

Looking forward, world economic prospects hinge on the answers to three fundamental questions:

- How far are OECD economies from the restoration of healthy financial fundamentals?

- Do stabilisation policies provide the appropriate cushion to prevent economic activity from undershooting in the short run, in the form of a double-dip?

- Have sufficient structural reforms been undertaken for other parts of the OECD area to resume the catch-up process with North America?

The recent spate of corporate scandals and the fears it raised among investors should not mask the progress already realised towards sound stock market evaluations. Price/earnings ratios, for instance, have moved back closer to their historical "confidence band". In the United States, net household wealth relative to income is now close to its historical average, indicating a return to normality.

However, economic agents, both businesses and households, are likely to adjust their spending behaviour to these changing parameters with a lag. This is why the present *Outlook* incorporates a period of sluggish spending in most of the OECD until mid-2003, followed by a progressive strengthening at the 2004 horizon.

This scenario is not without downside risks. In the short run, economies can easily undershoot their medium-term path, especially when confidence is weak. In countries, such as the United States, where strong personal consumption may run out of steam, the recovery of investment may come too late to take over as the main engine of demand. In other countries, where personal consumption remains sluggish, such as Germany or Japan, current problems have an important structural and therefore longer-lasting dimension, with negative consequences for confidence and the strength of the expected recovery.

In such a context, it is of course of utmost importance for macroeconomic policies to provide the appropriate cushioning. In this respect, the scenario put forward in the *Outlook* takes into account the recent loosening of US monetary policy as well as the Federal Reserve's willingness to act again, if necessary. It also incorporates an early 50 basis points cut from the ECB, in a context of weakening inflationary pressures and subdued recovery. Hence, in the near term, monetary conditions are set to remain extremely supportive in the United States and to be broadly accommodative in Europe.

Fiscal policy has been very supportive on both sides of the Atlantic, with Europe relying more on its large automatic stabilisers and the United States on discretionary stimulation. Going forward, it is assumed that, as a general rule, automatic stabilisers are allowed to operate, while discretionary policy errs on the side of caution to preserve the long-term sustainability of public finance, following, in the case of large European countries, a period of ill-timed loosening during the good years of the late 1990s. Indeed, policy-makers in a number of large OECD countries are currently facing a dilemma: because past fiscal policies proved less than principled, there may be, at present, a conflict between the needs of economic stabilisation and the pursuit of long-term sustainability. As a result the task of conjunctural stabilisation may fall disproportionately on monetary policy.

This uneasy outcome presents a number of countries with the challenge of designing better fiscal rules or at least improving their implementation and clarifying their interpretation. The challenge is, indeed, to formulate fiscal rules that are well-designed, transparent, enforceable and likely to work both during upswings and downswings. The perfect rule probably does not exist. But whatever the rule chosen, it should take account of cyclical influences on budget balances, let built-in stabilisers play and focus on achieving long-term sustainability in light of demographic ageing. The present issue of the *Outlook* pays particular attention to this very important question of fiscal rules.

A distinctive feature of the difficulties currently facing a number of large OECD countries is how entangled macro and structural policies are at present. In Japan, decisive structural reform of the banking sector is now overdue in order to restore at least some effectiveness to monetary policy. Deflation will not come to an end without economic reforms, while economic reforms could worsen deflation in the short run if not accompanied by supportive macro policies. Without wholesale implementation, the current plans of the Japanese authorities to restore the fitness of the banking sector will not succeed and potential growth will remain less than modest. In Germany the search for better-functioning labour markets, drawing on the recent successes of other European countries as well as on the findings of the Hartz Commission, will be crucial for lifting potential growth in the medium term. It may also provide a decisive spark for the recovery by boosting household and business confidence and improving the resilience of the economy in the face of future conjunctural shocks.

From a more general perspective, it seems increasingly likely that structural policies will become an integral part of the policy mix, even in a very short-run sense. As the experience of successful countries amply shows, good structural policies can provide a decisive contribution to short-term stabilisation, thus giving greater room for monetary and fiscal policies to balance more effectively their short and long-run commitments.

Beyond the short run, economic reform remains an essential ingredient for long-term growth. There is, for instance, a strong case for action to raise participation rates among older persons in a large number of European countries. This is important not only for the sake of facing the public finance consequences of ageing but also with a view to raising long-term growth and bringing it closer to the Lisbon objectives. In this area, the printed version of the *Outlook* will show, in a very thorough way, that much needs to be done to provide ageing workers with financial signals that do not discourage them from remaining economically active.

The printed issue of the *Outlook* will also explore in some depth the consequences of increased product market competition on OECD-wide growth and employment, drawing extensively on recent empirical OECD and outside research. Here again, it appears that the importance of good structural policies should not be underestimated.

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Summary of projections[a]

	2002	2003	2004	2002 I	2002 II	2003 I	2003 II	2004 I	2004 II
				Percentage changes from previous period					
Real GDP									
United States	2.3	2.6	3.6	3.5	2.2	2.2	3.7	3.6	3.5
Japan	-0.7	0.8	0.9	-0.1	1.5	0.4	0.7	1.1	0.8
Euro area	0.8	1.8	2.7	0.8	1.4	1.9	2.2	2.9	3.0
European Union	0.9	1.9	2.7	0.9	1.5	1.9	2.2	2.8	2.9
Total OECD	1.5	2.2	3.0	1.7	2.2	2.0	2.8	3.1	3.0
Real total domestic demand									
United States	2.8	2.7	3.8	4.2	2.5	2.2	3.8	3.8	3.6
Japan	-1.4	0.3	0.6	-1.5	1.3	-0.2	0.1	0.8	0.6
Euro area	0.4	1.8	2.6	0.3	1.4	2.0	2.1	2.7	2.7
European Union	0.7	2.0	2.6	0.6	1.6	2.1	2.2	2.7	2.8
Total OECD	1.6	2.2	3.0	1.9	2.4	2.0	2.7	3.1	3.0
				Per cent					
Inflation[b]									
United States	1.1	1.3	1.3	0.9	1.1	1.5	1.3	1.3	1.3
Japan	-1.0	-1.6	-1.4	-1.0	-1.5	-1.7	-1.5	-1.4	-1.5
Euro area	2.2	1.9	1.8	2.4	1.9	2.0	1.9	1.8	1.8
European Union	2.4	2.0	1.9	2.7	2.0	2.0	1.9	1.9	1.9
OECD *less* Turkey	1.5	1.4	1.3	1.6	1.3	1.4	1.3	1.4	1.3
Total OECD	2.2	1.8	1.6	2.6	1.8	1.9	1.6	1.6	1.5
				Per cent of labour force					
Unemployment									
United States	5.8	6.0	5.7	5.8	5.8	6.1	6.0	5.8	5.6
Japan	5.5	5.6	5.6	5.3	5.6	5.6	5.6	5.6	5.6
Euro area	8.3	8.5	8.3	8.1	8.4	8.5	8.5	8.4	8.2
European Union	7.6	7.8	7.5	7.5	7.7	7.7	7.8	7.6	7.4
Total OECD	6.8	6.9	6.7	6.8	6.9	6.9	6.9	6.8	6.6
				Per cent of GDP					
Current account balance									
United States	-4.9	-5.1	-5.3	-4.7	-5.1	-5.1	-5.1	-5.2	-5.3
Japan	3.2	3.8	4.2	3.1	3.4	3.6	4.0	4.2	4.3
Euro area	0.9	0.9	1.2	0.8	0.9	0.9	0.9	1.1	1.3
European Union	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.5	0.6
Total OECD	-1.2	-1.2	-1.2	-1.1	-1.1	-1.1	-1.1	-1.1	-1.2
				Per cent					
Short-term interest rate[c]									
United States	1.8	1.6	3.4	1.9	1.7	1.4	1.9	3.1	3.7
Japan	0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Euro area	3.3	3.0	3.6	3.4	3.3	2.9	3.1	3.4	3.8
				Percentage changes from previous period					
World trade[d]	2.6	7.7	8.8	4.5	6.7	7.6	9.0	8.9	8.5

Note: Apart from unemployment rates and interest rates, half-yearly data are seasonnaly adjusted, annual rates.

a) Assumptions underlying the projections include:
- no change in actual and announced fiscal policies;
- unchanged exchange rates as from 4 November 2002; in particular 1$ = 122.50 yen and 1.003 euros;
- the cut-off date for other information used in the compilation of the projections is 8 November 2002.

b) GDP deflator.

c) United States: 3-month eurodollars; Japan: 3-month CDs; euro area: 3-month interbank rates. See box on Policy and other assumptions underlying the projections.

d) Growth rate of the arithmetic average of world merchandise import and export volumes.

Source: OECD.