OECD warns time is "running out" to correct global imbalances

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The Organisation for Economic Co-operation and Development (OECD) is the latest organisation to warn of the growing imbalances in the global economy caused by the mounting US balance of payments deficit and slow growth in the rest of the world.

The warning comes in its twice-yearly economic outlook released earlier this week. Citing the most important indicator of global imbalance, the OECD said the US balance of payments deficit would climb to nearly $900 billion in 2006, or 6.7 percent of US gross domestic product. A debt of this size would need an inflow of more than $2.5 billion per day from the rest of the world.

A summary of the report presented by OECD chief economist Jean-Philippe Cotis made clear that the continued lack of growth in Europe is causing increased concern. "The smooth scenario where the recovery was expected to spread more evenly across the OECD has not materialised. While some elements of this scenario, such as a relatively successful 'soft landing' in the United States and a rebound of activity in Japan may be in place, what is badly lacking is sustained momentum in the euro zone."

Cotis said that "circumstantial arguments" used to explain the lack of growth in Europe, such as the Iraq war, oil and commodity price shocks as well as currency fluctuations, were "not sufficient to explain the string of aborted recoveries in Europe."

There had been an "encouraging" upswing in the first half of 2004, but growth had weakened in the second half of last year amid falling consumer and business confidence. Two of the biggest concerns are Germany and Italy. In Germany "the problem is one of a persistent fall in domestic demand despite a very strong stimulus from the export side while the traded goods sector of the Italian economy, undermined by years of cost inflation, had been losing market share, thereby laying the ground for the current recession.

"These continuing divergences in domestic demand between Europe and some Asian countries on the one hand, and the United States on the other, cannot be treated with benign neglect," he said. Given the unsustainable US current account position, the pressure to correct the imbalances would grow, possibly taking the form of "an abrupt weakening of the dollar with adverse consequences for the OECD area as a whole."

Cotis told the *Financial Times* (FT): "Were not saying there will be doomsday tomorrow morning ... but because the adjustments (to global imbalances) are relatively slow, we are running the risk an accident will happen. That's where we are. Time is running out—the numbers are getting big, big, big."

The OECD report put forward the usual list of measures that will supposedly return the world economy to a balanced growth path. The United States must increase savings and reduce its payments deficit, Europe needs to boost growth and the Asian currencies should appreciate against the US dollar. But as always there was no proposal as to how these goals should be implemented.

In fact, the failure of the usual prescriptions has led to an admission that those in charge of economic policy have no answer. For some years the prevailing mantra has been that Europe must undergo "structural reforms"—the adoption of "free market" measures, cuts in social welfare and a more "flexible" workforce—in order to boost growth. But, according to a member of the European Central Bank (ECB), these measures do not seem to be working.

Erkki Liikanen, governor of the Bank of Finland, told the *Financial Times* this week that reforms that allowed for increased competition had not overcome poor economic performance. The issue had been discussed in the ECB but “we don’t have an answer. Perhaps the reforms first increase uncertainty.” Liikanen said he was unsure whether the eurozone economy would pick up this year.

One reason for the sluggish domestic demand can be seen in the figures on real wages for the euro area prepared by the OECD. These show that, on average, real hourly rates across the region are falling at the rate of 1 percent, with the largest declines experienced in Italy and Germany. With falling wages putting a dampener on consumption demand, the OECD has called on the ECB to make a significant cut in interest rates, saying that in the context of low underlying inflation and weak aggregate demand, the case for an easing of monetary policy looked “rather compelling.”

The economic stagnation is having significant political consequences. In the words of a *Financial Times* article this week: “A weak economy and political disaffection are pushing the European Union to the edge of a precipice. By this time next week voters in France and the Netherlands may have vented their frustration by killing the EU constitution, plunging the Union into crisis and embarrassing its leaders.”

The decline in the economy is reflected in the fall in the approval ratings of the major political leaders. In Germany, where unemployment stands at 12 percent and the annual growth rate barely reaches 1 percent, the Social Democratic Party of Gerhard Schröder is set for its biggest ever defeat if early elections are held later this year. In France, the approval rating of President Chirac has fallen to less than 40 percent as the unemployment rate has risen to more than 10 percent, while in Italy the government of Silvio Berlusconi is falling apart as the economy enters recession and budget deficits increase.

The FT cited a former senior French official who pointed to the political crisis at the top. “There are no longer leaders in Europe who have the vision or the will or the political charisma” to lead the continent out of its current malaise.