

Aportes  
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ISSN (Versión impresa): 1665-1219  
MÉXICO

2002  
OCDE  
ECONOMIC OUTLOOK PRELIMINARY EDITION NO. 70  
*Aportes*, enero-abril, año/vol. VII, número 019  
Benemérita Universidad Autónoma de Puebla  
Puebla, México  
pp. 185-188

## Economic Outlook Preliminary Edition No. 70

OCDE\*

### *Introduction*

The economic slowdown that started in the United States last year, and spilled over to other countries, has turned into a global economic downturn, which has left few countries or regions unscathed. Several factors brought growth in the OECD area to a virtual standstill by the middle of 2001, in particular the severe correction in the high-tech sector and the lagged impact of the rise in oil prices. At the end of the summer, some signs were beginning to emerge that the slump in the United States might be easing and that a return to moderate growth might be expected in early 2002, thanks in part to the resilience of household spending. The terrorist attacks of 11 September and the associated disturbances have, however, inflicted a severe shock to the world economy. Thus, OECD-wide output is now estimated to be contracting slightly in the second half of this year—for the first time in 20 years—and is projected to remain very weak in the first half of next year. Assuming that household and business confidence turns up from current low levels, a significant rebound of activity should take place in the second half of next year. On average, real GDP in the OECD area could grow by about 1 per cent in 2002 and 3 per cent in 2003. Area-wide unemploy-

ment is expected to continue to increase well into 2002, before retreating slightly. Inflation is projected to remain low, thanks in part to moderate oil prices.

For the recovery to occur, it is crucial that the sentiment of insecurity prevailing since September dissipates. Increased risk aversion is encouraging households and firms to become more cautious and postpone spending decisions. Assuming that there are no adverse economic effects from future political and military developments, uncertainty could fade during the first half of 2002. This gradual improvement in private-sector sentiment, in helping to restore an environment of «business-as-usual», should provide an important incentive to reverse the present contraction in production capacity and encourage firms to launch new fixed investment plans. By mid 2002, the effects of the large impulse already provided by monetary policy in many countries, and by fiscal policy in some, should also be felt. Furthermore, the recovery would be helped by the fall in oil

In the current situation, projections of future economic developments are conditional on a crucial set of assumptions. A

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variety of adverse events could occur, including a further sharp fall in consumer and business confidence in OECD countries, lower imports from non-OECD economies, higher oil prices than their currently favourable level and unpredictable exchange-rate fluctuations. Overall, such events would tend to aggravate the present weakness and cast doubt on a speedy and robust rebound. Even though the current projections are subject to a high degree of risk, they nonetheless provide useful discipline in identifying the crucial conditions required for the recovery. In that respect, they shed light on some possible alternative outcomes, and provide a framework to examine appropriate policy responses.

The United States economy has led the global weakening. In the second quarter of 2000, output was still growing at above 5 per cent, but growth then decelerated sharply, and it is estimated that the economy has now fallen into recession. Several forces have been at work, including the contractionary impact of the high-tech correction, the associated collapse in equity values, the adjustment of an inventory overhang and the lagged effects of earlier monetary policy tightening. The slowdown was anticipated, but its depth exceeded expectations, while the September terrorist attacks created a heightened state of uncertainty and risk aversion, which has led to further lowering of business investment, consumer demand and economic activity. With the fading of the main contractionary forces, demand and activity would rebound and the recovery could be strong and fully visible by the second half of 2002.

The aggressive easing of monetary policy was rapid and timely, both before and

after 11 September, and should contribute importantly to this revival. The Federal Reserve has cut its key policy rate by 450 basis points so far this year, bringing nominal (but not real) short-term rates to their lowest level since the early 1960s. Barring unplanned contingencies, the time may have come to observe whether signs will emerge that previous easing is having its expected effects. On the fiscal side, large-scale decisions have been made to cut taxes and appropriate new spending.

Besides the tax cuts legislated in the spring, the federal government implemented a package of \$40 billion immediately following the terrorist attacks to provide emergency and military financing, and an additional \$15 billion package was made available to support the airlines. In addition, the Administration and Congress are negotiating a new fiscal plan, and the projection assumes that measures amounting to \$90 billion will be enacted, with disbursement in 2002 and 2003. If the objective of this new programme is to provide a short-term support to the recovery, the choice between the various tax cuts and extra spending options should be guided by the probability that they would indeed promptly add to domestic demand. This new initiative should be designed so as to avoid longer-term deleterious effects on the public finances. It should also, where feasible, contribute to bolstering the economy's supply potential.

Despite earlier expectations that the global downturn would affect Europe only marginally, GDP growth in the European Union has weakened considerably during 2001. Reflecting the sluggishness of trade, led by reduced demand of capital goods, export growth has contracted markedly and

business investment has stopped increasing. The 11 September attacks aggravated this deterioration by eroding confidence. Against this background, the main policy interest rate of the European Central Bank has been lowered by 150 points and that of the Bank of England by 200 points since the start of the year. The balance of risks remains skewed on the downside, however, especially in the euro area. Should signs of additional slack appear in labour and product markets, as implied by the projections, additional easing of the policy stance may become warranted. On the budgetary side, many governments face widening deficits in 2001 and 2002. This largely reflects cyclical weakening of budgetary revenue and provides some conjunctural cushion. The scope for active fiscal policy support is limited, however, by the need to ensure fiscal sustainability in the medium term. The current episode illustrates the importance of generating fiscal surpluses and building cushions during fast-growth periods, so that the resulting room for manoeuvre can be used following adverse shocks.

The return to sustainable growth would be facilitated by efforts to reform labour and product markets. More needs to be done, particularly in high unemployment countries, to reduce rigidities, encourage labour supply, lower structural unemployment and improve the entrepreneurial climate. Product markets are also still too segmented and financial markets not well integrated, including for banking services and insurance. The present economic sluggishness and the deterioration in the job market are likely to bring some pressure to reverse a number of achievements, however, in particular regarding the implementa-

tion of a more forceful competition policy. It would be important to resist such pressure, as increased state subsidies would be difficult to phase out, advantages created for incumbents would be wasteful, and renewed rigidities would add to the risks to long-term growth.

The Japanese economy had entered a new period of weakness before the events of September, and the short-term outlook is one of further sluggishness. The economy has been affected by the reversals in the high-tech sector, which have spread to other parts of the economy. Deflation persists for goods and services, financial assets and land. In this context, traditional monetary policy has limited room for manoeuvre to provide support, as short-term rates are close to zero. The authorities have recently sought to add extra liquidity to the banking system, but nevertheless bank credit has continued to contract. Further action by the Bank of Japan could include a broadening of the range of assets it purchases, not excluding foreign assets. The scope for fiscal policy to directly support aggregate demand is also very limited. The government already has the highest gross public debt to GDP ratio among OECD countries, and discretionary fiscal actions are likely to be offset by higher household saving, due to increased concerns about long-term fiscal sustainability. In this regard, articulation of a clear strategy to strengthen the effectiveness of government spending and eventually restore sound public finances could underpin confidence and thus support demand.

The limited scope for traditional macroeconomic instruments is not a basis for inaction. On the contrary, vigorous and

comprehensive structural reform strategy is urgently needed to establish conditions for renewed growth. Priority should be given to the problem of non-performing bank loans, which may imply some macro-economic costs in the short run, but is necessary to restore a healthy banking system and encourage corporate restructuring. Lack of action in this area would lead to further financial fragility and loss of credibility. Structural reforms outside the financial sector could also provide a temporary boost to demand by opening new market opportunities. In this respect, abolishing redundant urban planning regulations, as well as taxes that restrict real estate developments, should be seen as priorities. It is also important to reinforce competition policy, including in utilities, where incumbent firms are inhibiting entry.

Beyond the short-term outlook, the challenge is to address the long-term economic repercussions of the 11 September attacks. The terrorist actions have led to a sentiment of insecurity, a tightening of border controls and higher transaction costs for international trade. Insurance companies have raised their premiums, and in some cases cancelled policies deemed too risky. Firms may also have to incur additional costs to protect their premises, duplicate critical computer systems and increase inventory levels, which may adversely affect productivity and growth. In this environment, the increases in costs and the risks to trade openness will have to be assessed and monitored. It will also be important that governments sustain their commitment to an open global trading system, to free competition among industries and to strict limits on state interventions in cases of market failure. The recent

governments' determination to maintain the process of reform and liberalisation of trade policies and to launch an expanded negotiating agenda is a timely expression of this commitment. All countries can gain from this, including developing countries who stand to benefit from greater openness to agricultural and textile trade. Finally, it would be crucial to pursue the efforts made to increase the effectiveness of other anti-poverty policies.

15 November 2001