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POLICIES FOR A STRONG AND SUSTAINABLE EXPANSION

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1. What began as an uneven recovery led by the United States is broadening into an OECD-wide expansion. Most countries outside continental Europe have experienced strong growth and a gradual absorption of slack. By contrast, the recovery in most of the euro area has been more hesitant. Even so, by the end of next year OECD-wide unemployment could be at its lowest level in four years.

2. Easy monetary policy has stimulated activity in a number of countries, against the backdrop of low inflation and sizeable output gaps. However, with strong growth and diminishing slack, some countries have already taken back some of the stimulus and others will have to follow. This is noticeably the case in the United States, where the current policy stance is far from neutral and the output gap set to close within a year or so. Japan, however, has not yet reached the objective of durable, low positive inflation and will need to pursue its current quantitative easing policy for a while, whereas for the euro area the combination of low underlying inflation, a sizeable output gap and hesitant growth raises the question whether a further cut in interest rates may be warranted.

3. Expansionary fiscal policy in the United States and some other countries as well as strong automatic budget reactions during the downturn in many European countries have been helpful in stabilising activity and preparing the ground for the expansion. Going forward, however, fiscal policies need to change gears in most of the larger OECD economies. The state of public budgets, with an area-wide deficit of 3 ½ - 4 per cent foreseen for the current year, is such that achieving all of the necessary correction will take some time. In addition, impending pressures arising from population ageing and the increasingly robust state of the expansion make it both necessary and possible for medium-term consolidation to begin now.

4. The near-term risks to the outlook appear fairly evenly balanced but policy will still need to remain vigilant in case some of them materialise. On the one hand, it is a common phenomenon to underestimate the strength of activity growth at this stage of an expansion. On the other hand, there are some specific downside risks. These include the adjustments that could be set in motion by large current account imbalances, notably the US deficit at around 5 per cent of GDP, and which could entail turbulence in currency markets. In addition, strong oil demand, boosted by non-OECD consumption, could combine with risks of supply disturbances to drive oil prices higher. Moreover, risk spreads in equity, corporate bond, and emerging market debt markets are currently very low and could widen abruptly, *inter alia* in response to monetary policy tightening. Furthermore, strong momentum and high capacity pressure in some parts of the Chinese economy could eventually lead to a more pronounced cyclical development than currently projected, with implications for OECD countries heavily dependent on the Chinese market.

5. A specific risk to the outlook emerges from the confluence of concerns about jobless growth and outsourcing of activity. While indicators now suggest that employment is picking up in the United States, it remains a risk that weak job creation could sap consumer confidence. More importantly, in many countries public debate has linked a weak job market to the phenomenon of outsourcing. The risk is that confidence in the open, rules based trading system could be undermined and public pressure could emerge for more protectionist policies and policies that hamper adjustment in labour and product markets. This is the case even though the numbers of jobs lost through outsourcing seem trivial relative to normal turnover in labour markets and despite outsourcing being just the latest manifestation of the continuous trend towards international division of labour, which has been a major source of higher incomes and welfare in past decades. The appropriate response to the adjustment pressures generated by outsourcing, limited as they may be, is obviously structural reform to ensure a smooth transfer of resources from declining to expanding activities. Unfortunately, this argument cuts little ice when unemployment is above normal levels. Indeed, concerns about the job losses associated with trade and outsourcing have a very clear cyclical pattern. Nonetheless, while jobs growth could eventually allay these concerns the risk remains that fear of outsourcing during a weak patch in labour markets could lead to policies that permanently reduce income and welfare.

- **What are the current monetary and fiscal policy requirements in view of the broadening expansion?**
- **When, and at what pace, should necessary medium-term consolidation of public budgets begin?**
- **How can concerns about outsourcing and loss of employment through international division of labour best be addressed?**