



OECD BUSINESSES EXPECT WORLD ECONOMY TO SLOW BUT AUSTRALIA IS AN EXCEPTION

The Australian Chamber of Commerce and Industry is the Australian member organisation of the Business and Industry Advisory Committee (BIAC) to the Organisation for Economic Cooperation and Development (OECD). A full version of this BIAC article was printed in the (European) Autumn 2006 edition of the BIAC Economic Review which is available at www.biac.org.

GLOBAL ECONOMY IN BRIEF

World Economy Slows Down

The world economy has been expanding with robust pace through much of 2006 but expansion is about to slow down in almost all OECD regions. Based on the BIAC Member Survey from autumn 2006,¹ we anticipate OECD-wide real GDP growth to drop from 3.1% in 2006 to 2.6% in 2007.

North American economic growth continued robustly in 2006. However in the U.S., signs of a slowing caused by the housing market recession are emerging clearer. Real GDP growth in the U.S. and Canada will be about half a percentage point lower in 2007 than in 2006 while Mexico is likely to continue strong.

Europe has been a surprise on the upside. Domestic demand has strengthened and economic expansion has broadened across sectors. In 2006 real GDP growth in the EU25 will be the highest in six years (about 3%), but in 2007 it will moderate. With the exception of Poland, Portugal and the Slovak Republic, all BIAC survey participants from EU countries anticipate economic expansion to slow in their respective countries.

Looking at Asia, GDP growth in Japan has continued to be robust but will slow down in 2007. Less buoyant external demand will limit export growth, as indicated by weak machinery orders, and the currently robust business investment will lose pace somewhat.

In Korea economic indicators point to a slowing of the strong economic dynamic, but despite some moderation, GDP growth will be at about 4% in 2007.

The Australian economy, which is particularly driven by

the commodity boom, shows no signs of slowing and will continue to grow with a rate of around 3.5% while economic expansion in New Zealand lost momentum in 2006 and is likely to slow down further in 2007.

The prospects for major emerging economies remain favourable. Despite the slight growth moderation in the third quarter, China has continued to grow at high speed, driven by strong investment and exports. For both 2006 and 2007, economic growth is likely to reach about 10%, says the IMF. Also in India and in Russia (see non-OECD Area highlight), where the commodity boom continues to fuel the economy, GDP growth will remain high.

The expected economic slowing in most OECD countries makes significant reductions in unemployment unlikely. Based on our survey, we expect the unemployment rates in OECD economies to remain almost stable in 2007 (5.7%) compared to 2006 (5.9%).

Risks for Growth

The risks for the economic outlook are slanted to the downside. Oil prices continue to be a major risk factor for global economic expansion. So far, any negative impact from expensive oil has been contained. Oil price hikes have not yet pushed wage demands, thus allowing central banks to tighten monetary conditions cautiously without choking economic growth. Moreover, crude oil prices have dropped recently.

However, as it takes time before the indirect effects of oil prices are passed on through the production chain, previously strong oil price surges may still translate into upward pressure on prices for producers and consumers. In addition, oil prices may also rise again as spare capacities are low and supply shocks are possible given the uncertain security situation in some oil producing

countries.

For 55% of the BIAC survey participants, oil prices are an “important” and for 39% even a “very important” risk factor for global growth. Another important risk that casts a shadow on the economic outlook is the uncertainty related to the U.S. economic slowdown and its potential wider impact on the global economy. Although most economists expect only a moderate slowing of U.S. GDP growth in 2007, the housing market recession in particular risks cooling down economic growth more abruptly and strongly than so far as anticipated by many.

PERSPECTIVES FOR SELECTED ECONOMIES IN KEY REGIONS

North America

U.S. Slows Down Moderately

U.S. economic growth moderated to 3.3% or less in the second half of 2006, following a 3.6% first half gain, led by business investment and exports. Consumer spending is constrained by higher energy prices and interest rates, a continuing housing recession and relatively high debt levels to net worth. Nevertheless, 3.0% consumer spending is supported near-term by continuing employment gains and a 3.0% rise in private sector compensation. In 2007, continued slower momentum will generate about 2.8% GDP growth after 3.3% in 2006.

The environment remains favourable for productivity-boosting investment. Following a 7.5% first half gain, capital equipment spending has slowed to a trend-like

6.5% pace, backed by high corporate profits at 12% of GDP and cash flow at 10% of GDP. However, as overall momentum slows, investment is likely to slip another percentage point in 2007 to 5.5%. Capacity utilization continues to tighten, while capital relative to labour cost is low. Information technology (hard and software) has contributed 50% of total capital spending, accounting for half the current 2.5% business productivity gain.

U.S. companies have been focusing on rising foreign demand. Capital goods lead all exports, rising 14.5% so far in 2006 amounting to 40% of total exports. However, import growth is also robust making for a trade deficit at 6% of GDP, which when combined with a federal deficit of 2.5%, leads to a borrowing rate at 8.5% of GDP.

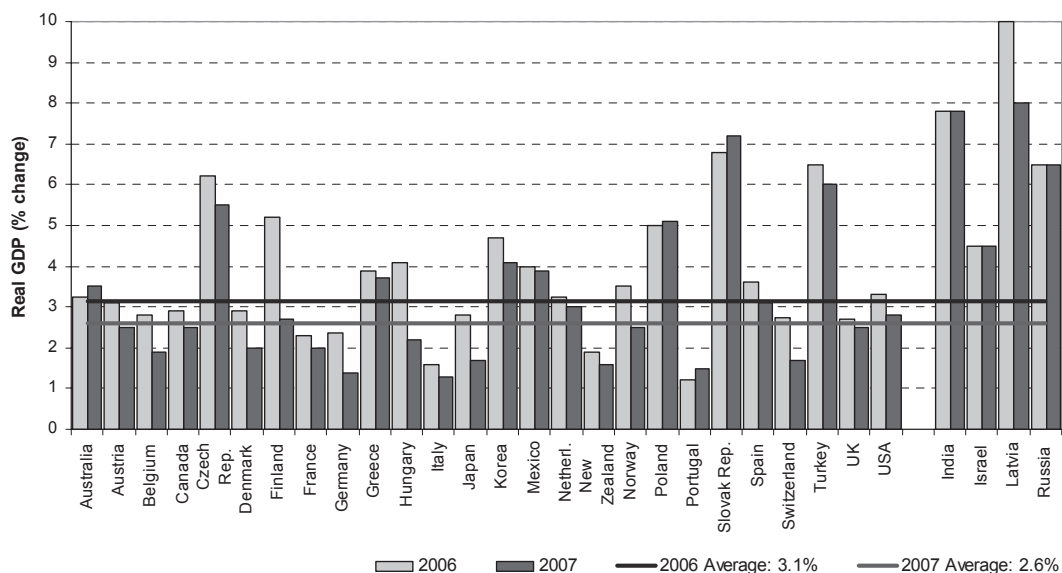
Europe

German Growth Slow in 2007

The German economy will grow in 2006 at about 2.4%. Foreign trade so far continues expanding rapidly, and strengthening domestic demand, driven by business investment, has become a stronger growth driver. In 2007 however, economic expansion will shift back a gear as lower global growth will moderate export activity. The investment growth will continue as previous years’ flat activity requires the modernization of investment stocks and improved conditions for depreciation will continue to facilitate investment.

However, the investment dynamic falls short of that in previous upswings and might slow somewhat in 2007. Long-term structural changes in the economy, including

Figure 1
BIAC Members’ Growth Forecasts



Source: BIAC Member Survey Autumn 2006.

growing outward investments as well as the gradual transition from an industry to a service-dominated economy, have changed the investment patterns over the economic cycle. As to private consumption, the planned increases in the VAT and other mandatory contributions will shave some 25 billion euros of consumer purchasing power. Thus, consumption, also coping with high energy prices and still high unemployment (at about 8.9%), will continue to be the weakling of the German economy. Overall, somewhat less strong exports and slightly reduced investment dynamic, as well as sputtering private consumption, will slow down German growth to about 1.5% in 2007.

UK Growth to Ease to Trend

The UK economy made a strong start in 2006 with a long awaited upturn in fixed investment coupled with solid consumer spending growth pushing GDP expansion above trend. Robust increases in government consumption and fixed investment over the second half of 2006 should see GDP for the year as a whole grow by 2.7%, compared to only 1.9% in 2005. However, increases in energy prices have pushed consumer price inflation up to 2.4% in October compared to twelve months previous. Furthermore, likely increases in food prices after the hot summer, and the impact of the introduction of higher tuition fees, leads the CBI to forecast that inflation will peak at 2.8% in the first quarter of 2007. To bring inflation back towards target, the Bank of England raised interest rates to 5% in November.

The impact of higher interest rates and lower OECD GDP growth will see UK growth ease to 2.5% in 2007. Consumer spending is expected to grow by 2.3% as the impact of high employment and slightly stronger average earnings growth is offset by large increases in household bills. Government consumption, investment and export

growth are projected to moderate in 2007.

Asia

Japan Will Slow Down

Economic growth in Japan has continued steady through the third quarter of 2006. Robust exports have been driving growth together with firm business investment while private consumption was sluggish.

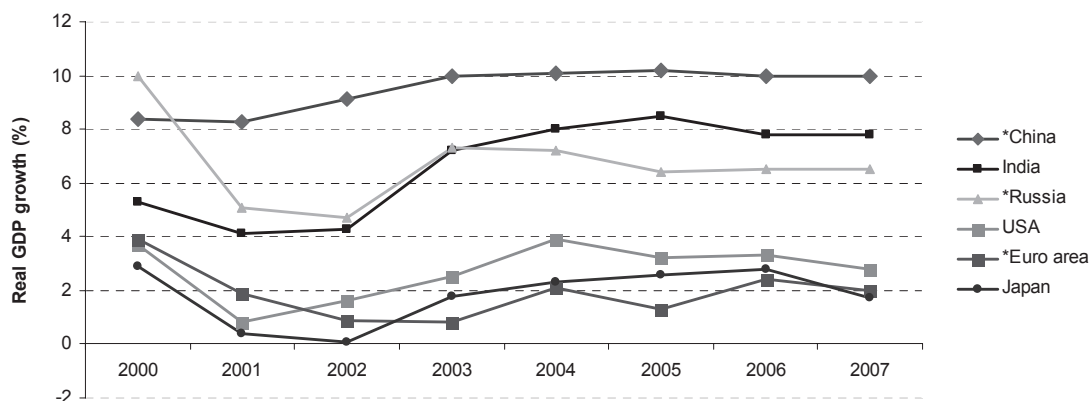
For 2006, Keidanren anticipates 2.8% GDP growth, however the economy will shift back a gear in 2007 and likely grow by only 1.7%. In the months ahead, slowing external demand will dampen export activity and, through this, also somewhat limit the expansion of investment, as already indicated by the recent weak incoming orders for machinery equipment. Despite improving employment, private consumption has not yet recovered sufficiently to become a robust pillar of domestic demand. In 2007, continued strong corporate performance and a steady pick-up in employment are anticipated to translate gradually into increasing wages and, through this, stimulate consumer spending.

Deflation seems to have come to an end with consumer price inflation slightly above zero. The central bank raised its nominal short-term interest rate to 0.25% in July. While many expect a further rate hike for the second quarter of 2007, Keidanren cautions that such a decision must be carefully balanced against the background of subdued inflationary pressure and the current slowdown of the Japanese economy.

Benign Outlook for Australia

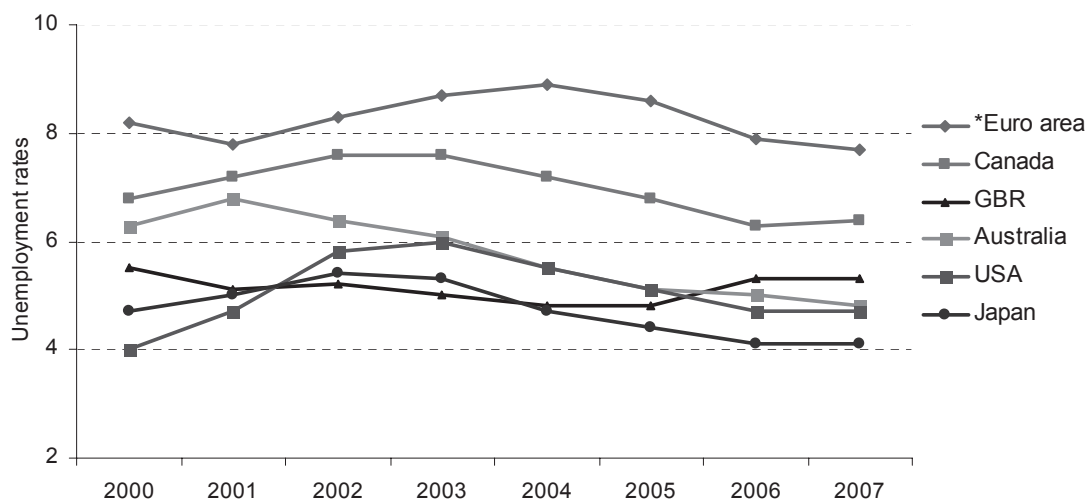
The Australian economy grew by 2.3% in the year to June 2006, and growth prospects remain optimistic based

Figure 2
Growth Slowdown in Major OECD Regions



Source: 2000-2005, IMF; 2006-2007, BIAC Member Survey 2006.
* China, Euro area and Russia, Source: IMF.

Figure 3
Outlook for Unemployment Mixed



Source: 2000-2005, IMF; 2006-2007, BIAC Member Survey 2006.

* Euro area, Source: IMF.

on forecasts for world growth and strong demand for commodities. GDP growth in the year to June 2007 will likely reach about 3.25%.

For several years, Australia's export performance has been weak despite strong commodity prices. However, recent data shows the trade balance is improving. The continued commodity boom, as well as the implementation of important industrial relations reforms, has helped to reduce the unemployment rate to 4.6% in October, while the participation rate reached 64.7%. Inflation has accelerated to 3.9% in the third quarter of 2006 compared to the previous year, mostly due to high oil prices and massive banana price rises caused by weather damage. Interest rates have risen three times so far in 2006 to be at 6.25% in November. The increased interest rates will help contain upward pressure on prices with inflation likely to fall to about 2.75% for the 2006-07 financial year.

BIAC MEMBER SURVEY POINT BY POINT

Business Climate Stable

Based on its member survey, BIAC expects the business climate to remain healthy over the next six months, although previous optimism regarding the conditions for doing business has further waned.

For the industry sector (manufacturing plus energy), improvements are expected in only six European countries (CHE, CZE, GRC, ITA, NLD, PRT), whereas participants from eleven countries in the spring 2006 survey had been positive about the future climate. In twelve countries the climate will likely remain more or less unchanged, and in another six (CAN, FRA, HUN, KOR, NZL, USA), it is anticipated to deteriorate. Half a year

ago a cooling of the industry climate was only expected in two countries.

For services, the expectations remain somewhat better than for industry, but they are also less upbeat than six months ago. In ten economies (AUS, CHE, CZE, GRC, ITA, JPN, NLD, NOR, PRT, GBR) an improvement of the climate is anticipated while survey participants in five countries (FRA, HUN, KOR, NZL, ESP) anticipate a cooling for services.

Investment Loses Momentum

Business investment expanded significantly in 2006 in many economies, including the U.S., Japan, Germany and France. It is likely to continue robustly but consistent with the reduced optimism regarding the general business climate, the outlook for investment is also less friendly now than previously. Investment will likely lose some momentum over the next six months. Last spring, only one survey participant expected a slowed investment trend in the industry sector, and all experts anticipated an unchanged or increased investment pace for services. Today, survey participants in six OECD economies (CAN, DNK, FRA, HUN, KOR, NZL) believe that investment will slow in both services and industry sectors. In five countries (AUS, AUT, FIN, MEX, USA) business will likely invest with an unchanged pace while in seven countries (CHE, CZE, GRC, ITA, JPN, NLD, PRT) industry and service sector investors will shift into a higher gear.

Financing conditions for investment are still relatively favourable despite the steps towards monetary tightening by the U.S. and EU central banks and the end of quantitative easing in Japan. Profits will also continue to

support investment financing. However, an improved profit trend is only expected in a fewer number of countries than previously forecast. In seven economies (AUT, CZE, DEU, FIN, ITA, JPN, NLD) the profits will increase in industry and services, while in Portugal a boost is only expected for industry. In nine countries (AUS, CHE, DNK, FRA, GRC, MEX, POL, TUR, GBR) profits should remain more or less at current levels, while a slowdown in industry and service sector profits is expected in five economies (ESP, HUN, KOR, NZL, USA) as well as for the industry sector in Canada and Norway.

Job Growth Slows

Job growth has been robust in 2006 in the OECD area. The U.S. economy created a substantial number of new jobs through October. In the euro zone, the gradual employment creation continued, and in Japan the employment situation improved compared to 2005. Moreover, job growth has been strong in Canada and even very strong in Australia. However, perspectives for new jobs in the OECD area are less favourable over the next six months. BIAC Member Survey results indicate that the cooling of economic growth and the slowing of the investment trend will reduce job creation particularly in the industry sector.

About one third of the surveyed economists continue to anticipate an improved trend for industry employment. However, the share of those who expect deterioration has almost doubled from 17% in spring 2006 to 30% in the autumn. For services, the outlook is again more positive than for industry but less benign than six months ago. 57% anticipate an improved employment trend, reflecting a six percentage point drop compared to our spring survey. The share of those who expect the employment trend in services to deteriorate doubled, meanwhile, from 8% to 17%.

Besides the expected slowing of economic growth, additional factors impede job creation in the OECD area. BIAC members in more than two thirds of the participating countries² cite high labour costs as an “important” impediment for more jobs. In Germany, Hungary, and Turkey they represent even “very important” barriers to more jobs, as well as in Australia where the high employment level has boosted wages.

Inflexible labour market regulations which increase companies’ costs for adjustments of their labour force to changes in demand for product and services, are reported to be a problem in all but four (AUS, CHE, DNK, USA) OECD economies and in particular in eight countries (DEU, GRC, ITA, JPN, MEX, NLD, POL,

TUR). Moreover, in numerous economies employment growth is limited by labour shortages. Almost all of the countries where this is found to be a “very important” problem (AUS, CAN, CHE, JPN, NLD, NOR, NZL) have been operating close to full capacity with unemployment rates at 5% or lower. In these circumstances it is more difficult for employers to find additional qualified workers for acceptable wages. In other economies, where labour shortages coexist with high levels of unemployment (e.g. BEL, CZE, DEU, FRA, HUN, PRT, ESP) the main problem is a mismatch of qualifications required by the firms and those offered by the labour force.

Challenges for Monetary Policies

In response to robust economic growth and rising headline inflation, major central banks have gradually tightened monetary conditions. The U.S. Federal Reserve Bank has continued to raise its policy rate through June, and the European Central Bank has increased its rate. The Bank of Japan has moved away from its nominal zero rate policy to a rate of 0.25%. Central Banks in Australia, Sweden and the UK also tightened monetary conditions.

BIAC members are broadly confident with the policies applied by monetary authorities. In 15 countries,³ survey participants are of the view that their central banks (respectively the ECB), are setting their policy rates at appropriate levels thus controlling inflation without threatening to choke economic growth. However, survey members from Hungary, Turkey, Korea and the U.S. suggest that central banks should somewhat loosen their monetary reins in order to limit the expected slowing of economic activity in these countries. In another five countries the opposite would seem appropriate. Business economists from Finland, Norway, Spain and the UK would prefer interest rates to be raised somewhat in order to reduce inflationary expectations more effectively.

Looking ahead, the central bankers’ task of containing inflation may become more challenging. Business economists from 14 countries see a risk potential associated with upcoming inflationary pressures and the interest rate hikes it may take to keep inflation under control. Uncertainties regarding the economic cost to contain rising inflation are particularly felt to be a factor by BIAC members in Australia, Hungary and the U.S. Looking to the U.S., despite inflationary pressure having eased during autumn, the Fed will need to continue to be vigilant, and many believe that further rate hikes will be necessary. In the Euro zone, inflationary pressures also moderated somewhat thanks to the recent decline in oil prices. Together with the expected slowing of economic growth in 2007 this appears to reduce the need for further ECB tightening, although the central bank continues to

stress the upside risks for inflation which include higher administered prices, increases in indirect taxes, and also the risk of a potential renewed oil price surge. The Bank of Japan, when deciding its next policy steps, needs to carefully balance the risks stemming from the currently limited inflationary pressure with the costs of a potential re-emergence of deflation.

Budget Policies

A third of the OECD countries⁴ continue to run structural budget surpluses and this year a number of deficit countries have reduced their structural fiscal imbalances.

According to the IMF, the U.S. structural deficit, which excludes one-off receipts, dropped from 3.6% in relation to GDP in 2005 to 3.1% this year. Norway's reduction of its structural budget deficit from 4.5% to 3.5% of GDP is a significant step forward. In the Euro area, the structural deficit fell from 2% to 1.7% in terms of GDP with Germany and France both having cut their deficits by 0.4%, though Italy achieved no real progress. The UK shaved 0.2% of its deficit ratio while Japan achieved a cut of 0.3% to 5.2%.

This progress in cutting excessive deficits that several countries have achieved is most welcome by business. The share of BIAC survey participants that regard budget policies in their countries as "loose" has dropped from 50% to 35% in one year. However, consolidation efforts still fall short of what is necessary to make government budgets sustainable and to prepare public households for challenges, including the costs of ageing societies. Business economists in eight countries (AUT, CZE, ESP, GBR, GRC, NZL, NOR, POL) qualify governments' running of their budgets as "loose" and suggest that deficits be reduced. These countries need to set more ambitious budget objectives. More effective consolidation includes reducing excessive public spending for social security and, in particular, containing the healthcare costs.

In some other countries however, government budgets are already tight, and additional steps to reduce deficits would risk further dampening economic expansion. This is, for example, the case in Germany and also in Hungary. In Australia, where the government is running a surplus, net debt is zero, and corporate taxes as a proportion of GDP are at historical highs, capital gains and personal income tax rates should be reduced to better support continued robust economic growth.

Structural Reform Needs

Bringing government budgets in balance is impossible

without effectively addressing deep-seated issues that require thorough structural reforms. Governments need to conduct reforms that improve the legal, regulatory and institutional framework for product, services, labour and capital markets. Through well designed and effectively implemented structural reforms, governments increase the efficiency and growth potential of their economies. In turn, higher economic growth will relieve public budgets from both the revenue and the spending side. It increases tax revenues and limits social expenditures (e.g. by reducing unemployment). Recent OECD analysis on the impact of structural reforms on government budgets in the euro zone clearly confirmed once more that budgetary upfront costs associated with structural reform are small in comparison with the long-term benefits for public expenditure savings.

Given the importance of structural reforms, it is disquieting that BIAC members in eleven countries⁵ regard the quality of the reforms conducted by their governments as "low" with Hungary being the country where reform quality is perceived to be "high". Principally, in many countries, decisions regarding structural reforms are not being based on substantive economic evaluation but rather politically motivated with the end consequences not being properly examined. Moreover, 80% of our survey participants are of the view that their governments are taking too much time to design and implement major reforms. According to BIAC members, reforms are generally pursued with adequate pace only in Hungary, the Netherlands and the U.S. In the UK, the government may be well advised to take a step back, re-think its reform programs, and give quality priority over pace. According to CBI, structural reforms are sometimes defined and enacted by politicians even before previous reforms have been implemented. The National Health Service, prisons, border control, education, street cleaning and public order are struggling to cope with the pace of initiatives and regulatory change, often superimposed on prior reforms. The result can be confusion and diversion of professionals into much greater regulatory compliance.

Reform Priorities

High priority areas for reform in almost all OECD countries include social security, taxes, labour costs, and labour markets. Social security is a "very important" reform area in 15 OECD economies and "important" in all other countries. Governments need to do more to guarantee the long-term sustainability of the social security systems, in particular in the areas of healthcare and pensions, even under the upcoming additional cost pressure coming from ageing populations.

A reduction of excessive corporate taxes and a

simplification of overly complex tax systems is “very important” in eleven countries in order to improve the business environment. An attractive investment environment includes a tax regime that reflects the realities of current business models and transactions, which in turn stimulates job creation on both the supply and demand side.

Reductions in labour costs are deemed to be “very important” in six OECD economies and important in an additional 16. Policies need to assure that wages adjust flexibly in response to supply- and demand-side pressures in order to support high levels of employment in a constantly changing economic environment. Thus, countries need to reduce the administrative extension of collective contracts and where minimum wages exist they must not be set too high in order to avoid affecting the employment opportunities for workers with low productivity. Additional important priorities include reforms that increase competition in product and services markets as well as measures which effectively reduce excessive red tape.

ENDNOTES

- 1 See BIAC survey information on page 13.
- 2 AUT, CHE, DNK, ESP, FIN, FRA, GBR, GRC, ITA, JPN, KOR, MEX, NLD, NZL, NOR, PRT.
- 3 AUS, AUT, CAN, CHE, CZE, DEU, FIN, FRA, GRC, ITA, MEX, NLD, NZL, POL, PRT.
- 4 AUS, BEL, CAN, ESP, FIN, IRE, KOR, SWE, DNK, NZL.
- 5 CAN, DEU, ESP, GBR, GRC, JPN, KOR, MEX, NZL, NOR, POL.

BIAC Indicator Scorecard

BIAC asks its members twice a year (spring and autumn) about the economic prospects in their countries. Thirty three economists from the major business organizations and international corporations in 26 OECD countries participated in the BIAC autumn 2006 survey. Their countries account for 98.5% of GDP in the OECD area. In addition, economists from BIAC observers in four non-OECD countries (India, Israel, Latvia and Russia) contributed to the survey.

Country	GDP (% Change)			Inflation (% Change)			Unemployment Rate (%)		
	2005*	2006 (forecast)	2007 (forecast)	2005*	2006 (forecast)	2007 (forecast)	2005*	2006 (forecast)	2007 (forecast)
Australia	2.5	3.3	3.5	2.7	3.3	2.5	5.1	5.0	4.8
Austria	2.0	3.1	2.5	2.1	1.6	1.6	5.2	4.9	4.8
Belgium	1.5	2.8	1.9	2.5	2.1	1.7	8.4	8.2	8.2
Canada	2.9	2.9	2.5	2.2	2.1	2.0	6.8	6.3	6.4
Czech Rep.	6.1	6.2	5.5	1.8	2.6	2.8	7.9	7.7	7.5
Denmark	3.2	2.9	2.0	1.8	2.1	1.8	5.7	3.9	3.6
Finland	2.9	5.2	2.7	0.8	1.6	1.8	8.4	7.7	7.5
France	1.2	2.3	2.0	1.9	1.8	1.3	9.5	9.0	8.2
Germany	0.9	2.4	1.4	2.0	1.8	2.4	9.1	8.9	8.5
Greece	3.7	3.9	3.7	3.5	3.2	3.0	9.9	9.5	8.6
Hungary	4.1	4.1	2.2	3.6	3.5	6.2	7.2	7.3	7.5
India**	8.5	7.8	7.8	4.0	5.5	5.0	n/a	n/a	n/a
Israel**	5.2	4.5	4.5	1.3	0.1	2.4	9.0	8.7	8.5
Italy	0.1	1.6	1.3	2.3	2.3	2.0	7.7	7.6	7.5
Japan	2.6	2.8	1.7	-0.6	0.7	0.7	4.4	4.1	4.1
Korea	4.0	4.7	4.1	2.7	2.5	2.7	3.7	3.5	3.7
Latvia**	10.2	10.0	8.0	6.8	6.0	5.0	7.8	7.0	6.8
Mexico	3.0	4.0	3.9	4.0	3.2	3.0	3.6	3.4	3.3
Netherlands	1.5	3.3	3.0	1.5	1.3	1.5	4.9	5.5	4.5
New Zealand	2.3	1.9	1.6	3.0	4.0	3.0	3.7	3.6	4.6
Norway	2.3	3.5	2.5	1.6	2.2	1.7	4.6	3.5	3.0
Poland	3.4	5.0	5.1	2.1	1.3	2.3	17.6	15.3	14.3
Portugal	0.4	1.2	1.5	2.1	2.6	2.1	7.6	7.7	7.7
Russia	6.4	6.5	6.5	12.6	9.7	8.5	n/a	n/a	n/a
Slovak Rep.	6.1	6.8	7.2	2.7	4.1	2.6	16.2	13.7	12.5
Spain	3.4	3.6	3.1	3.4	3.7	3.1	9.2	8.6	8.3
Switzerland	1.9	2.8	1.7	1.2	1.2	1.2	3.4	3.1	2.8
Turkey	7.4	6.5	6.0	8.2	9.5	6.5	10.5	10.4	10.0
United Kingdom	1.9	2.7	2.5	2.0	2.4	2.3	4.8	5.3	5.3
United States	3.2	3.3	2.8	3.4	3.2	3.0	6.0	4.7	4.7

* Source: Responses from BIAC Member Survey Autumn 2006.

** Source: IMF World Economic Outlook, September 2006, except where noted above.

*** BIAC Observer, non-OECD Member Country.

Founded in 1962 as an independent organisation, the Business and Industry Advisory Committee to the OECD (BIAC) is the officially recognised representative of the OECD business community. BIAC's members are the major business organisations in the 30 OECD member countries, comprising over 8 million companies. Over the course of 2006, more than 1500 business representatives were actively involved in the work of the OECD through BIAC.