



Business and Industry Advisory Committee to the **OECD**

Comité Consultatif Economique et Industriel Auprès de l' **OCDE**

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## **BIAC Statement to the OECD Council Meeting at Ministerial Level**

**Paris, 29 April 2003**

### **A Market Economy in Times of Prevalence of Risk**

BIAC is pleased to submit this statement to the OECD Council meeting at Ministerial level on behalf of the business communities of the member countries.

Our summary view of the economic situation is as follows:

- **The global economy is now on a 2.1% GDP expansion track improving to 2.9% in 2004.**
- **With less war-related uncertainty, global consumer confidence is rebounding strongly.**
- **After a mid-winter pause, the U.S. economy is rebuilding its slow upward momentum.**
- **Canada's economic growth remains above the U.S. pace with a strong labour market.**
- **Continued dependence on U.S. activity to support weak economies abroad is not sufficient to sustain satisfactory longer-term growth.**
- **Europe faces economic policy stimulus limitations in promoting sustained recovery.**
- **Japan is in another round of slow economic recovery, but staying power is uncertain.**
- **SARS will limit near-term activity in A-P less Japan, the region leading global growth.**

### ***Reboost for Globalisation needed***

The global economy is in the midst of a phase of weakness. The global mood is decidedly gloomy. In nearly all industrial countries, but also in the newly industrialising economies and the countries of Central and Eastern Europe, growth of real Gross Domestic Product (GDP) has slowed again during the winter half year. In the United States this basic underlying trend was eclipsed by the spending on the Iraq War.

In line with the escalation of the Iraq conflict and, related to it, the increasing world-wide uncertainty regarding economic and geopolitical developments, the economic recovery has stalled once again. This economic weakness stems from numerous factors such as war, threats of war, terrorism, corporate scandals, sinking equity markets, the complexities of the current business cycle, the depressed investment confidence of businesses and consumers.

In an economic sense this is doubly unfortunate, for globalisation has opened borders to ideas, investment and capital flows, and the movement of people and production according to basic market incentives. People and cultures have interacted in new and expanding ways. Importantly, societal and cultural forces are interacting, reinforced by commercial ties.

Market-based economies facilitate globalisation because of the quest for greater economies of scale and associated efficiencies, lower costs, scarce skills, higher productivity and ultimately profit and other returns to entrepreneurship. In fact, globalisation transmits both good and bad pulses at rapid speed. At the moment we are watching synchronous global

economic stagnation exacerbated by geopolitical events which develop as fast as others are contained or resolved.

***In some detail...***

Global economic expansion is at a stubbornly slow 2.1% pace even as geopolitical uncertainty abates. This is down from the 2.5% GDP growth expected in our last comprehensive assessment in November 2002. There is considerable global dependence on a U.S. economic upswing which remains limited, near-term, due to low capacity use, swelling federal budget and current account deficits and uncertain business commitments on hiring and capital spending. As noted in the second table below, indications suggest capital spending growth at 2.9% for this year rather than the 4.1% expected last November. Growth should gain quarterly momentum into next year.

**GDP Growth Rate Forecast Comparison**  
(Y/Y Annual Percent Change)

	November 2002		April 2003				Consensus*	
	2002	2003	1H03	2H03	2003	2004	2003	2004
World	1.9	2.5	2.0	2.2	2.1	2.9	2.0	3.0
Americas	2.0	2.8	1.9	2.5	2.1	3.2	2.3	3.6
U.S.	2.5	3.0	2.0	2.5	2.2	3.1	2.3	3.6
Canada	3.4	3.2	2.7	3.0	2.9	3.2	2.9	3.4
Latin Am	-1.1	1.7	1.0	2.2	1.6	3.5	1.3	3.7
EMEA	1.2	2.3	1.5	1.7	1.6	2.5	1.5	2.4
Germany	0.2	1.5	0.3	0.6	0.5	1.9	0.5	1.7
France	1.2	2.0	1.1	1.4	1.2	2.2	1.2	2.2
U.K.	1.6	2.4	2.2	1.8	2.0	2.4	1.9	2.4
Italy	0.5	1.9	1.0	1.1	1.0	2.1	1.2	2.1
Asia Pacific	2.5	2.5	2.7	2.3	2.6	3.0	2.2	2.9
Japan	0.3	0.0	0.9	0.1	0.5	0.8	0.8	0.8
ANZ	3.9	3.1	2.9	3.1	3.0	3.4	3.0	3.7
Other Asia	5.7	5.7	5.3	5.5	5.3	5.7	5.4	5.9

\* Consensus Economics April 2003

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The benchmark crude oil price has retreated 35% from the pre-war high of near \$40 a barrel and should remain in the \$25-\$28 OPEC target range. This will support improvement in consumer and business outlays as the year proceeds. Nevertheless, both Europe and Japan are mired in flat to sluggish activity with delayed economic and market reforms and limited policy options.

## **UNITED STATES**

First quarter economic activity got off to a strong start but then slowed significantly in mid-quarter due to imminent war with Iraq. Consumer spending has been more cautious even with rising personal income. Weather and late holidays are only part of the explanation. Total consumer debt is at an historic high, at just over 90% of personal income, a legacy of continuing mortgage refinancing. Given low long-term interest rates housing starts rebounded a strong 8.3% in March. Total industrial output fell 0.5% in March, but computer and related equipment (IT) production rose 2.0%. It was up 4.5% in the first quarter over last year's fourth quarter.

Current market-related uncertainties most adversely impact hiring and capital spending decisions. Business capital investment slowed in February after a torrid January. Still, through February, shipments of computer and related products rose 6.5%, while computer shipments alone rose 16.2% in the first two months of the year over the same period a year ago. Continued growth of capital spending is needed to sustain the upswing. But business capacity utilisation remains below 75% and GDP growth at a sub-par 2% will not quickly lift capacity use.

A composite leading indicator of information technology spending does not yet signal sustained upward momentum. The February reading (the latest for all data) rose 2.3% which offset a 2.3% fall the month before. Preliminary March data are looking positive as well.

Current concerns, in addition to geopolitical issues, are a rising federal budget deficit which threatens to squeeze private sector spending, and a current account deficit at 4.5% of GDP, which makes the dollar vulnerable to sharp swings. The Fed is prepared to cut policy rates further if need be, but it would make little difference since rates are already at 40-year lows. A federal tax stimulus, which more than offsets state and local government austerity, is needed to underpin activity, but passage will come hard with a federal deficit already near 3.75% of GDP.

On the positive side, inflation is not a serious threat, oil prices are down, equity markets have wrung out considerable excesses and the war with Iraq has been successful. Inventory investment will support growth this year. Business inventories are up \$55.7 billion at an annual rate in 1Q03, versus \$50 billion in 4Q02. And inventory-sales ratios are at historic low levels.

## **CANADA**

Current data portray a robust expansion underpinned by continued employment and income gains as well as tax cuts. In the first quarter, about 70,000 jobs were added to the economy. This, along with output measures, points to steady growth near-term. Inflation remains a concern. The central bank has already raised rates 50 basis points this year, the latest a 25 basis point hike. Interest rate differentials may lead to further gains in the Canadian dollar. Exports will suffer and some economic slowing is likely in the second half of the year.

## **EUROPE**

The economic outlook has deteriorated from our last review, with a rebound expected in the second half of this year. Little has changed during the first quarter of the year - with continued anemic activity, especially in Germany, which is one-third of the euro-zone

economy. There, bank lending is running at its slowest pace in over half a century. And the services sector contracted in March for the eighth consecutive month.

Euro-zone output did rise 0.2% in February, and January data were revised upward, to 1.3% growth. Nevertheless, labour markets continue to deteriorate. Unemployment rose about 40,000 a month in 3Q02 and the pace quickened to 100,000 in each of the five months since. Consumer confidence is at the lowest level since 1996 but consumer spending still rose 1.5% in 2H02, not enough to unleash the rest of the economy. With the war over a snappy rebound in confidence is expected to boost private sector activity going forward.

On the positive side, capacity utilisation is only slightly below its long-term average while consumer spending relative to GDP is only modestly above its long-term average. This means that once the environment improves (fewer uncertainties, better U.S. growth), the chances of a robust cyclical upswing remain high. An ECB policy rate cut would help at this point.

The surge in the euro will impact growth this year and next. The trade-weighted value of the euro has gained almost 15% in the past year, and the negative growth impact from a loss of competitiveness could be magnified by weak external demand.

### **Capital Equipment Spending Forecast Comparison** (Y/Y Annual Percent Change)

	November 2002		April 2003			
	2002	2003	1H03	2H03	2003	2004
World	-1.6	4.1	2.4	3.3	2.9	4.9
Americas	-2.8	4.7	3.1	3.2	3.2	4.9
U.S.	-3.3	4.8	3.0	3.1	3.1	5.0
EMEA	-2.7	3.9	0.3	3.1	1.7	5.0
Germany	-9.3	2.7	-1.3	2.3	0.5	4.0
U.K.	-8.9	3.7	-2.4	3.5	0.5	4.5
Asia Pacific	1.3	3.6	3.9	3.8	3.8	4.6
Japan	-7.2	-3.9	-5.0	-2.3	-2.5	-2.0

#### **ASIA-PACIFIC**

Japan's near-term outlook is weak, but it has improved from no growth expected last November to 0.5% now. Unfortunately, bursts of economic activity have been shortly followed by relapses bordering on recession. A key reason is that the ongoing banking sector capital adequacy crisis sops up liquidity as fast as the Bank of Japan can provide it. Deflation continues. While nominal interest rates are near zero, inflation-adjusted rates are relatively high. An "Industrial Revitalization Corporation" will open next month in the latest attempt to end the decade-old bad-loan problem which amounts to 9% of GDP.

The three tailwinds that sustained and drove Australia's economy through the global slowdown - housing construction, wealth effects from rising home prices and an undervalued

currency - are turning into headwinds. Even so, the domestic economy remains robust with strong employment gains. Consumer confidence surged in March, ascribed to victory in Iraq and falling oil prices. And business surveys continue to report solid business investment intentions.

SARS, severe acute respiratory syndrome, will negatively impact growth in several countries. Travel, tourism, hospitality, retail and entertainment spending are down sharply in the entire region with airlines the first and hardest hit. Compared to Hong Kong where GDP growth is cut nearly one percentage point, the impact in China is more muted given its sheer size and relative isolation. Singapore is also particularly hard hit with GDP reduced by 0.5 percentage point. And New Zealand exporters claim that meat and seafood exports have largely stopped due to SARS.

China's GDP soared about 9.0% in 1Q03, the largest y/y growth in six years. Industrial output surged 17% and exports grew an even stronger 34%. FDI is continuing to gain, up 56.7% in the first quarter, as the economy restructures to reap the gains from WTO membership.

India's economy softened in 4Q02 due to a drought-induced 27% q/q plunge in agricultural output. However, industry grew 9.4% and services 9.7%. The worst of the drought is over. Growth averaging 5.0% - 5.5% a year will resume. India benefits from a highly educated population, which has led to imports of high-skill work. Dollar-salaries for software developers were pegged by the Aberdeen Group to be just 9% of the 2001 U.S. average level.

## **LATIN AMERICA**

Economic recovery depends on the pace of global recovery. Both trade and foreign investment are crucial. Foreign investments fell 33% to \$56.7 billion in 2002, the third straight annual drop and a further drop is likely this year. Direct investments in the Mercosur trade bloc - Argentina, Brazil, Paraguay, Uruguay, and Chile, an associate - dropped \$1.5 billion from an average of \$10.7 billion during the prior six-year period. In addition to slow global growth and rising risk premiums, the drop off in privatisation plans reduces foreign investment.

Argentine exports are powering recovery from the harsh five-year recession, thanks to a 65% currency devaluation. The current account surplus was \$13.3 billion, or 12.9% of GDP, last year. The peso has rebounded from its low, boosted by the large trade surplus, better economic growth, low inflation, tight liquidity and high interest rates.

Brazil's policies please investors only months after fears of default on the huge public debt. The February primary fiscal surplus means that the IMF target will be met. Inflation is still a concern, squeezing real personal income and cutting into business sentiment. Unemployment is rising from 11.2% in January to 11.6% in February. Economic activity is carried by strong exports. A 35% depreciation of the currency to the dollar has cut already competitive production costs. After rising 3.7% last year exports are expected to rise 9% this year. The export base has become more diversified with exports to Asia up 26.5% last year, led by soy to China.

## ***No Excuses***

The prevalence of heightened risk should not serve as an excuse to avoid overdue market reforms which will promote greater economic opportunities and competitiveness ahead. In some countries domestic demand continues to decline due to very "classical" policy

defects. Various factors are significant particularly for the drop in consumption and investment demand, while some of them are more related to a lack of initiative for structural reform than to the impact of world risk agenda:

- The burden of costs on businesses through taxes and social security contributions remains to be too high in many OECD countries.
- Enterprises are containing staffing in view of rising costs for the "labour" factor and the high rigidity of the labour markets in some OECD countries. Contrary to those who focus on the purchasing power theory, there was no impulse on demand. The structural inflexibility of some labour markets has begun to show particularly painfully. In the case of rigid wage systems constraints on jobs remain the only alternative.
- Plans to invest are being revised due to a lack of confidence in future sales opportunities. Uncertainty, as well as declining expectations of investment returns gives rise to enterprises putting aside any plans to invest.
- Lack of willingness to invest is often accompanied by financial bottlenecks. The downturn of the stock market raises the cost of capital pushing companies to raise debt/equity ratios (since debt is cheaper with current low interest rates) but which then diverts cash flow into debt service rather than capital investment.

### ***What needs to be done?***

#### ***Save multilateral co-operation***

Multilateral co-operation needs to be reinforced. There is still a threat that political disagreement will spill over into trade relations between major OECD trading partners. Even the Doha Round of trade negotiations has run into shallow water. BIAC urges Ministers to renew their commitment to the world trading system as the principal path to growth.

- For over 50 years, the disciplines of the GATT/WTO system has made a major contribution to economic growth and improved living standards around the world.
- The world trading system and the open markets that it promotes are essential to sustainable economic growth, supporting and diffusing innovation and technology, and reducing poverty by creating wealth.
- Political differences should not result in self-defeating squabbles that impede the progress of liberalisation. The effects of boycott threats and veiled "sanctions from any WTO party are detrimental to the whole economy.
- On this basis, the business community of the OECD member countries continues to support broad-based, balanced, trade negotiations under the WTO "Doha Development Agenda" as a matter of high priority.
- The OECD has a key role to play in fostering further confidence in and support for the global trading system. It generates important analytical work to enhance the understanding of complex issues dealt with in the WTO, as a base for the negotiations outlined in the Doha Declaration.

- The OECD study “Open Markets Matter” and “The Case for Open Services Markets” present evidence of the tangible benefits of market liberalisation for employment, income distribution, and environmental protection, and clarifies the relationship of trade rules to national sovereignty.

**BIAC urges the OECD to communicate this message consistently across its work.**

- In addition, the OECD’s outreach programmes, or global engagement, provide skilled resources for improving the technical capacities of the developing countries in the field of trade policy. Encouraging and participating in this process is fundamental for the OECD.

***Continue Pressure from Innovation to Growth***

According to the results of the OECD Growth Project, there is evidence of widening disparities in GDP per capita growth rates across the OECD countries over the past decade.

- Over the 1990s the United States began to pull away from most other countries in terms of GDP per capita levels. There was a significant speedup of productivity growth in the United States around 1995, considered unusual in a country at the productivity frontier in many sectors. In addition to the United States, only a small number of OECD countries have shown improved or continuing good performance in terms of productivity and/or GDP per capita growth.
- There are important gaps between countries in terms of their status and pace of movement along the various dimensions in which the business environment is changing. It would be desirable to centre the analysis of a phenomenon so central to the economy as the evolution of innovation and productivity squarely within a framework which takes account of each of these dimensions (innovation, flexibility, regulatory quality) and the interactions between them.
- The OECD is well suited to conduct such an analysis, and indeed, focus much of the follow up work of the "Growth project" in this fashion. In particular, the Organisation is well positioned to draw upon the results of its well-known "horizontal" projects: the Jobs Strategy, Regulatory Reform, Sustainable Development, Electronic Commerce and Growth. BIAC believes that there may be a high return to a project which synthesises the knowledge and understanding gained in these separate analyses in terms of how their combination and interaction affects the prospects for innovation and economic growth.

***Good Governance for Governments and Corporations***

High quality regulatory frameworks that promote competition and do not impede trade and investment should be the goal of regulatory reform agendas.

- Integrating joined up regulatory policy into the mainstream of government's strategies and actions, thereby contributing to efficient markets and good governance, is an important goal of the OECD that is shared by business. Regulatory Impact Analysis (RIA) and administrative simplification are key aspects of such efforts.

- The OECD project on E-Government shows that this phenomenon is an important enabling tool to reform the way public administrations operate to result in more efficient customer-focused public administration, that is, responsive and adaptive to changing societies and economies. Developing "seamless e-government services" can be an important contributor to administrative simplification and greater efficiency for both government and business.

Good governance is a constant theme not only for governments but also for businesses.

- The essence of corporate governance is to address investor demands to enhance the transparency of and confidence in the performance of companies and the guarantee of shareholder rights.
- Every national regulatory system has to find its own balance between regulation by governments and self-regulation. The current structure of national systems of national corporate governance, derived from the OECD Principles of Corporate Governance, should be maintained.
- Spectacular business failures in the recent past cannot necessarily be attributed to deficiencies in corporate governance. There are solid regulations in place and some of them have been strengthened very recently, not always for the better.
- In fact, BIAC member organisations have participated actively in the elaboration and revision of national corporate governance systems in the past. Deficiencies can be attributed largely to failures of enforcement, not to the lack of frameworks as such.

### ***Strengthen Growth and Investment in Developing Countries***

Perception counts, and income rules. Economic progress is ultimately constrained when advancement does not permeate all segments of society. A rising tide may lift all boats but not necessarily equally.

- In this regard, infrastructure is paramount, including development of capital markets, roads and mass transportation, water supplies, sanitation and hygiene, housing and education and training. For example, while India gains from its deep technical skills, the economy is slowing due to limited infrastructure. Only 50% of roads are paved while 80% of China is paved which sustains stronger growth and is more likely to diffuse benefits to society.
- The technology exists to monitor and customise efforts to meet specific needs where they exist. Basic education modules in native languages can now be delivered on demand to children and adults in the most remote parts of countries with handheld, mobile devices.
- The emergence of the knowledge economy means there is greater focus upon and recognition of the notion that people and their skills are the key to international competitiveness and sustainable growth. While economic integration, investment, trade and diffusion of technologies support growth, they also induce adjustment by the persons and economies that receive their benefits. A fundamental requirement for addressing these adjustments, which is even more imperative for developing countries, lies with an adequate education system and the availability of training in these basic skills.

- Education - including lifelong learning that is the comprehensive provision of purposeful learning opportunities throughout every individual's life - is essential to enable a society to cope with the inevitable shifts and opportunities in the labour market. The quality of pre-school, primary, secondary, tertiary and life long learning educational, including re-skilling, capacity will drive the success of investors in the future.

**Given the will, governments, companies, and non-governmental agencies can spread global best practices and promote an inclusive standard of living.**

**We look forward to a continuing partnership with the Council, the Secretariat, member missions and national delegates to engage in our mutual stewardship of the world economy.**