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Global Economy in the Doldrums

The USA and Japan have been in recession since last spring, and the events of September 11 have further intensified the global downturn. How quickly can the USA's keenly expansive economic policy succeed in overcoming the paralysing effects of the terrorist attacks? Is the euro area sliding into recession or will we soon see a return to economic expansion here?

The world economy is in a precarious position. The terrorist attacks of September 11 in the USA caused considerable uncertainty among both private households and companies not only in the US, and dealt a further substantial blow to already weak demand and production. The downturn, which had set in with unusual potency at the end of the year 2000, maintained its momentum on a global scale. Aggregate production is declining in numerous countries. The USA and Japan – which together account for around half of global output – were on course for recession even before the attacks, and in the euro area aggregate economic activity had virtually stagnated. Most of the emerging economies in Southeast Asia and Latin America are also suffering a period of pronounced economic weakness. In eastern Europe on the other hand, aggregate production still increased noticeably despite the economic slowdown, and the same is true of the relatively closed large economies such as China.

The economic downturn took place more or less simultaneously worldwide. This is probably only partly a reflection of the structural intensification of international links between the economies that has taken place in recent years. On the one hand, globalisation of the world's financial markets and further intensification of the division of labour between the countries have further deepened the international integration of trade and production and so led to closer connections between national economic cycles. On the other hand, however, the current synchronisation is probably largely due to a number of factors that are all having a dampening effect on the economy everywhere at the same time. The decisive factor for the downturn was the combination of a marked withdrawal of purchasing power caused by the strong increase in oil prices and restrictive monetary policies in many countries. Regional and national factors placed the economy under further strain. Under these circumstances, hardly any country could boast a domestic economy capable of compensating for the loss of the USA as an engine of growth. This is why the significance of the USA for the global economic decline is often substantially underestimated.

Particularly strong dampening influences came from developments in the field of information and communications technology (IT), particularly in the USA. Years of strong investment expansion had led to considerable excess capacity in these technologies, and demand for IT products has thus been falling for more than a year now. The IT industry is currently experiencing an earnings crisis combined with extensive consolidation problems, the result of which has been a marked decline in the propensity to invest. Plummeting demand for IT goods in the United States caused significant fallout throughout the rest of the world. This is because the US is strongly reliant on imports, especially from the emerging economies of Southeast Asia where IT products account for almost half of total merchandise exports. In the euro area, Ireland and Finland were particularly affected by the recession in the IT sector. Here, however, weak demand is also partly due to developments within the euro area itself. In the field of telecommunications, for example, investments are likely to have slackened as a result of the difficult financial situation faced by many large companies due to the immense burden of acquiring UMTS licences.

The terrorist attacks of September 11 therefore hit the USA - but not only the USA - at a moment of economic instability, and have led to a considerable intensification of the anxiety felt among economic agents in all of the industrialised countries. There is also substantial uncertainty regarding the long-term psychological effects of the attacks. Should companies and consumers continue to practise spending restraint for an extended period, the immediate loss of production and demand could even

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prompt the development of a detrimental multiplicative process.

In the USA in particular, the interruption of production processes together with a marked reduction in consumer purchases led to a perceptible drop in output. Given the already fragile state of the economy, a rapid loss of additional jobs ensued. Unemployment has shot upwards as a result. Increasing anxiety regarding job security has a considerable influence on the propensity of private households to spend, however, and up to now private consumption has been a decisive pillar of the economy in the USA.

The extent of the shock caused by the attacks is visible in the drastic fall charted by the economic climate indicators in all the industrialised countries, both in the corporate sector and among private households. On the world's stock exchanges, share prices, which had already been falling for some time, plummeted. The duration of this paralysis will be determined not least by how long fears of further massive attacks or of an escalation of the political situation are sustained. The success of military actions in Afghanistan gives rise to hopes that the general mood could soon begin to recover. The strong increase in share prices over recent weeks demonstrates that the financial markets have great expectations of an economic recovery. However, it is not inconceivable that the markets are overestimating the impulses proffered by economic policy and the speed with which these impulses may achieve the desired results.

Distinctly Expansive Economic Policy

With a view to stabilising private household and investor confidence as well as to counteract the risk of a downward spiral, economic policy everywhere has assumed a strongly expansive character. In the USA in particular, the government and the central bank are implementing massive support measures in an attempt to prevent the downswing from becoming too strongly entrenched. Within the space of a year, key interest rates have been lowered by a total of almost five percentage points; at 1.75 % the key interest rate is at its lowest mark for forty years. At the same time, capital market interest rates have also fallen appreciably. Given that monetary policy is charting a strongly expansive course, the key interest rate can be expected to rise again when firm economic recovery sets in.

Fiscal policy is also a source of strong stimulus. By bringing forward some of the income tax cuts which were planned to be implemented in a succession of steps, the government had provided considerable relief to the private sector even before the terrorist attacks; this stimulus amounted to 0.4 % of GDP. Further measures include declarations of support for those sectors worst affected by the terrorist attacks such as the aviation industry, as well as additional immediate measures of similar dimensions. Furthermore, the government intends to introduce another support package of additional expenditures, tax relief and transitional aid. However, the political decision-making process is making little progress at present. As far as the forecast is concerned, it is assumed that measures will be adopted with a volume of ¾% in relation to GDP.

In Japan, monetary policy is trying hard to provide additional impetus to the economy. With the key interest rate having been reduced to virtually zero for some time now, monetary policy has exhausted its traditional means of stimulating the economy. As a result, the central bank is now looking to increase the expansion rate of the country's money supply, in particular by purchasing government bonds on the secondary market. Intervention on the foreign exchange market had a similar effect; here, efforts were aimed at counteracting a temporary strengthening of the yen. The government is postponing its intended initiation of public finance consolidation. In contrast to this year, fiscal policy will tend to be a source of dampening effects in 2003.

Monetary policy in the euro area is also charting an expansive course. After the ECB had already cut key interest rates by a total of half a percentage point before September 11, they have since been lowered by a total of one percentage point. The marked acceleration of money supply (M3) expansion in recent months is an indication that the ECB is pursuing a distinctly expansive policy. Given that there is currently little danger to price stability, key interest rates can be expected to be maintained at their current level for some time.

In contrast, fiscal policy in the euro area is the source of very little in the way of economic stimulus. While almost all the member countries are allowing automatic stabilisers to take their course in order to take the edge off the downswing, the budgetary authorities are in most cases running up a deficit as a result. The larger countries, whose public sector deficits are still relatively large, have nonetheless maintained their course of fiscal consolidation. Discretionary measures implemented by some member countries to stimulate the economy are juxtaposed to the further consolidation efforts being undertaken in others. There is likely to be little change in the aggregate structural deficit either this year or next. In Great Britain on the other hand, fiscal policy will bolster the economy with a substantial expansion of public expenditure.

Forecast Assumptions

In contrast to customary procedures, any forecast in the current circumstances must include political assumptions in addition to the usual economic assumptions, for the terrorist attacks of September 11 prompted a wave of global insecurity, the threat of which has still to be vanquished. The forecast is based on the following assumptions:

- The global political situation becomes more relaxed following the surprisingly rapid downfall of the Taliban regime in Afghanistan. This is likely to reinforce the conviction that further large scale terrorist attacks are relatively improbable.
- On the other hand, the crisis in the Near East has intensified. Here, however, it is assumed that the conflict will remain confined to the region and is thus unlikely to lead to any significant uncertainty in the industrialised countries.
- The price of oil will be little affected by the conflict. It will remain low for the time being, primarily due to relatively low demand, averaging 21 dollars a barrel during the year 2002, and 23 dollars in 2003.
- Under these circumstances, consumer and investor confidence will improve significantly in the months ahead. The purchase restraint fuelled by uncertainty will gradually recede and economic behaviour will return to normal.
- The crisis in Argentina remains confined to the region. In contrast to the outbreak of the Asian crisis of the summer of 1997, the Argentine crisis will not lead to turmoil on the financial markets in other emerging economies, let alone in the international financial system.
- The marked devaluation of the yen in recent weeks gradually comes to a halt and does not trigger off a round of competitive devaluation.

Synchronous Recovery

As far as the global political environment is concerned, the forecast assumes that the uncertainty triggered off by the terror shock should gradually subside. This assumption is supported by the fact that in a number of countries, and not least in the USA, economic expectations among consumers and investors have stabilised and have even shown signs of slight recovery recently. Growth in confidence has the effect of encouraging a recovery of demand and at the same time increases the probability that economic policy may gradually unfold its expansive potential. The chances are all the greater given that the contractive processes primarily responsible for the downswing seem to be coming to a standstill. Following last year's substantial dismantling of inventories, stockpile management, for example, will at first cease to be a source of dampening effects, then, during the latter part of the year, will even have a stimulating effect on the economy. Demand for IT goods also appears to be levelling out. In addition, slowing inflation – which is not least the result of the considerable fall in oil prices in recent months – is boosting real disposable income in the oil importing countries.

Just as the synchronous cyclical downswing was largely the result of various influences working in the same direction, there are now positive supply and demand shocks as well as expansive parallel policies that are all tending to produce a synchronous economic recovery. Although the strength of these factors varies considerably from country to country, the profile of economic recovery will be similar. In most countries, recovery during the first half of the year will remain restrained since the forces of growth are likely to make themselves felt very gradually. During the latter part of this year, however, demand and production growth will accelerate, and we will see a consolidation of recovery in the year 2003. During the recovery, again in much the same way as with the downswing, the economies not only of the industrialised countries but also of the rest of the world will stimulate each other on a reciprocal basis. The countries of East Asia in particular will benefit from a probable return to rising demand for IT products. In response to impulses from the industrialised countries, production in the eastern European countries and in Latin America will also increase again at an accelerated rate.

At 0.8 % for the year as a whole, aggregate production in the industrialised countries will only just reach last year's growth rate. At almost 3 % in 2003, however, it will be only slightly behind the growth rate of the year 2000. Following last year's decline, global trade will gradually pick up again, increasing strongly during the latter part of the forecast period. Due to a considerable negative overhang, however, it will only increase by around 2 % on average this year, following a rise of not even 1/2% last year. A return to growth rates approaching double figures is likely in the year 2003, however, when the worldwide recovery is expected to consolidate. Inflation rates in almost all the industrialised countries will continue to contract for the time being. Since the production potential is far from being utilised to capacity as a result of the strong downturn, no significant tension will develop as the output gap narrows again next year. Wages will also continue to rise with moderation in most countries. Price increases will, for the most part, remain within the boundaries regarded as being compatible with economic stability.

Forecast Contains Great Uncertainties

It should be borne in mind, however, that the uncertainty of the forecast is unusually great. In particular it is unclear as to how quickly there will be a lasting recovery in consumer and investor confidence, which fell so sharply in the aftermath of September 11. In any case, it is likely to remain fragile for some time to come. Unfavourable political events or economic developments can therefore be expected to cast a darker shadow on the economic climate than comparable factors would have had prior to the terrorist attacks. It is also to be expected that the labour market situation, which has deteriorated considerably in most countries since the attacks, will have a stronger retarding effect under these circumstances. These uncertainties come in addition to the risks which have been around for more than two years as a result of economic imbalances, particularly in the USA. A rapid increase in what continues to be a very low savings rate or an abrupt devaluation of the US dollar - which would result should a loss of financial investors' appetite for the American currency combine with the persistently high US current account deficit - would place considerable strain on economic development in the rest of the world. Nor is it inconceivable that the crisis in Argentina could spread to infect other emerging economies.

However, there are also forecast risks in a positive sense. Since it is reasonable to assume that the economy in many countries, not least in the USA and the euro area, has now bottomed out, the current markedly expansive monetary policy could take effect more quickly and with more vigour than expected in what is considered to be the most probable forecast. Having passed certain turning points in the economic cycle, the economy often expands briskly at first.

USA as Pacemaker?

In the USA, the downturn was already particularly pronounced even before the terrorist attack. The transition from boom to recession within a year was the result of a combination of several factors, all of which had a contractive effect on the economy. Restrictive monetary policy co-incided not only with an erosion of real disposable income caused in particular by the sharp rise in oil prices during 1999/2000, but also with negative wealth effects brought about by a sharp decline in share prices. What is more, the IT boom came to an abrupt end towards the end of the year 2000. The recessive developments intensified after September 11. Firstly, production was directly affected as a result of the attacks. Subsequently, consumer and investor spending was exceptionally restrained as a result of the psychological shock, but also because of the uncertainties regarding the further development of the economy.

Economic policy reacted swiftly and resolutely to the "hard landing". This is true of the central bank in particular, which in the USA is equally responsible for maintaining price stability and stabilising the economy, and which carried out a massive reduction of interest rates. These steps were aimed not least at boosting confidence. With a cut in income tax rates and an immediate package of measures implemented directly after the attack, fiscal policy also adopted a markedly expansive course which is expected to continue this year with an additional package of stimulating measures.

The effectiveness of these massive economic policy impulses is being enhanced by endogenous forces. There are signs, for example, that demand for IT goods has stabilised. The dismantling of stockpiles is expected to come to a standstill. Moreover, the slight improvement of certain economic climate indicators registered since November suggests that the US economy has reached the bottom of the cyclical trough. Furthermore, the marked share price recovery means there is less danger of a rapid increase in the very low savings rate among private households. On the other hand, however, the loss of wealth caused by the decline in share prices since the middle of the year 2000 has so far only partially trickled through to affect demand decisions. Companies' sales and earnings expectations also continue to be relatively unfavourable, and there is considerable excess capacity around in many industries. As a result, a great number of companies will continue their cost-cutting efforts, leading to extensive redundancies. The inclination to save could thus increase.

Under these circumstances, overcoming the cyclical weakness of the US economy is likely to be a very gradually process. Private consumption in particular will be boosted by further tax cuts. Strong increases in public expenditure for military and security purposes are likely to induce a perceptible increase in demand for IT products; however, a return to the kind of extraordinary expansion seen during the country's lengthy boom period is not to be expected, even in the latter part of the forecast period. Corporate investment activity will probably also recover again during the latter part of the year. Altogether, this year's increase in real gross domestic product will be as low as that of 2001 at 1.2 % in spite of a marked acceleration during the course of the year. In 2003, on the other hand, growth is expected to reach 3¾%.

Deep Recession in Japan

In contrast to what appears to be happening in the USA, massive macroeconomic stimulation has failed to overcome Japan's ongoing economic doldrums. Indeed, the country has plunged into recession once again. The weakness of the global economy led exports to fall significantly despite the considerably lower exchange rate of the yen. Investment activity declined again, moreover, as industrial output crumbled during the course of the year. With incomes falling and with precautionary savings presumably on the increase, private consumption has also been tending to weaken for some time now. At the same time there has been a continuation of the fall in prices that began in 1999.

With the concurrent emergence of deflation and recession it is clear that there are limits to the ability of traditional economic policy to stimulate aggregate economic activity in Japan. The central bank is now using unconventional means to intensify the expansion of the country's money supply in order to break through the persistent trend towards deflation. At the same time, the government is postponing its intended initiation of public finance consolidation. This move is also aimed at softening the impact of the considerable dampening effects emanating from reforms to the country's political, structural and legal framework to which the government has committed itself in view of the previous failure of macro-policy to effectively influence economic development.

Given this economic policy environment, the recessive tendencies will continue for the time being. The fundamental weakness of domestic demand leaves Japan dependent upon the impetus generated by foreign trade. With Japanese suppliers enjoying improved international competitiveness as a result of the marked depreciation of the yen that has taken place in recent weeks, Japanese companies in particular will benefit from the global economic recovery in the latter part of the year. Overcoming the recession will be a very gradual process. Aggregate economic activity will remain restrained even in 2003.

Gradual Recovery in the EMU

In the euro area, too, the economy suffered an unexpectedly sharp decline last year. Real gross domestic product showed virtually no further growth at all during the second and third quarters of the year. Preliminary indicators such as consumer and business confidence suggest that the weakness of aggregate economic activity has continued into this year. Here too, meanwhile, the conditions for recovery have improved.

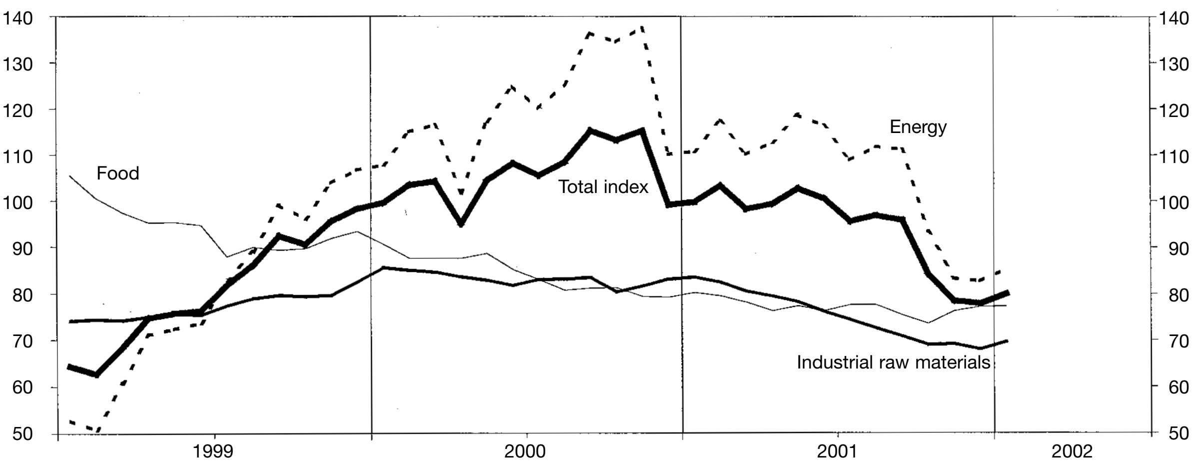
With a rapid slowdown in the rate of price increases becoming apparent, the ECB found it easier to lower its interest rates significantly since last May. Monetary policy is thus back on an expansive course, a further indication of which is the expansion of the monetary aggregate M3, which has accelerated considerably since last spring. In October, it was 7.4 % higher than a year previously and thus well above the ECB reference value of 4.5 %. The ECB explains this sharp expansion primarily with shifting portfolios, a development intensified by the terrorist attacks. The marked slowdown in loan expansion is a further indicator. However, it is virtually impossible to determine the exact degree of "exaggeration".

Within the framework of the ECB's monetary policy concept, further interest rate cuts - which many observers are demanding in view of the unfavourable economic development - could only be justified by the second pillar of monetary policy strategy, i.e. price perspectives. The increase in consumer prices has slowed markedly since last spring, primarily as a result of falling oil prices. Even if oil prices are unlikely to fall any further during the coming months, the inflation rate will now quickly fall below the 2 % mark and will be well below this value as from this spring. Deflation, however, though expected by many, is unlikely. Such concerns fail to recognise that the current sharp drop in inflation is largely due to one-off effects – mirroring the acceleration seen over the past two years. Under these circumstances it is assumed here that there will be no further reduction in interest rates. In contrast to monetary policy, fiscal policy in the euro area member states – following considerable stimulation this year - will chart a more or less neutral course on the whole.

With an expansive monetary policy, an inflation rate which will continue to fall at first, and markedly improved terms of trade, we will see a gradual recovery of the euro area economy. Demand from third countries will also be a source of stimulus in the latter part of this year. With lower inflation spawning an increase in purchasing power, private consumption will return to stronger growth once more in spite of an initial drop in employment. Business investment in plant and equipment will pick up again in the latter part of this year as sales and earnings perspectives gradually improve. Under these circumstances aggregate output will gather momentum in the second half of the year and continue at a relatively fast pace in 2003. This will be accompanied by a return to appreciable improvements in the labour market situation. A continuation of wage rise moderation can be expected as the level of unemployment remains high. The emergence of tensions jeopardising stability is highly unlikely. Import prices, too, are not expected to be a source of significant inflationary impulses even into the year 2003.

HWWA Index of World Market Prices of Commodities[1]

(1990 = 100)



Commodity Groups[1]	2001	July 01	Aug. 01	Sep. 01	Oct. 01	Nov. 01	Dec. 01	Jan. 02
Total Index	94.3 (–10.9)	95.5 (-9.4)	96.8 (-10.7)	95.8 (-16.9)	84.2 (-25.7)	78.4 (-31.9)	77.8 (–21.5)	79.9 (–19.9)
Total, excl. energy	75.8 (–9.2)	75.2 (-9.4)	73.8 (-10.5)	72.0 (-13.1)	70.1 (-13.0)	70.9 (-12.4)	70.3 (–14.4)	71.6 (–13.4)
Food, tropical beverages	77.1 (–8.6)	77.6 (-6.5)	77.5 (-3.9)	75.4 (-7.1)	73.6 (-9.5)	76.3 (-3.9)	77.2 (-2.6)	77.3 (-3.7)
Industrial raw materials	75.3 (–9.4)	74.3 (-10.4)	72.5 (-12.7)	70.8 (-15.1)	69.0 (-14.1)	69.1 (-15.2)	68.0 (–18.2)	69.6 (–16.6)
Agricultural raw materials	73.7 (–10.2)	72.8 (-11.2)	71.1 (-13.9)	69.2 (-14.4)	67.4 (-14.1)	66.5 (-18.7)	64.1 (–22.8)	65.9 (–20.3)
Non-ferrous metals	72.7 (–12.4)	71.1 (-14.1)	68.5 (-17.0)	66.3 (-23.6)	63.7 (-21.7)	66.1 (-16.3)	67.1 (–18.3)	69.2 (–15.8)
Energy	106.4 (–11.7)	108.8 (-9.4)	111.8 (-10.7)	111.3 (-18.4)	93.3 (-30.6)	83.3 (-39.4)	82.7 (–24.9	85.3 (–23.0)

[1] On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.

Further information: http://www.hwwa.de → Commodity Price Index