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Hesitant Recovery in the World Economy

So far there has been no far-reaching recovery in the world economy. While the recession of 2001 was overcome at the beginning of last year, demand and output growth has been restrained in spite of expansive economic policies. This is partly due to a mood of great uncertainty, caused not least by geopolitical tensions and declining confidence on the financial markets. Will the dampening effect of these factors ebb away this year and so lead to a marked upward trend in the world economy?

The world economy is currently experiencing an enduring weakness. While the recession of 2001 was overcome at the beginning of last year, the subsequent recovery – which, in some countries, was substantial at first – proved to be unsustainable. In the industrialised countries, aggregate output increased only slightly in the latter part of the year. That the upward trend at the start of the year was to be only temporary in nature is reflected particularly clearly in the development of global trade. In most cases, aggregate output increased at a slower rate than potential output, so that the utilisation of capacity declined and unemployment rose perceptibly. In the second half of the year the worldwide economic climate cooled off once more. The rapid decline in both business and consumer confidence, together with a sometimes drastic fall in share prices, even raised fears of a renewed slide into recession.

Output growth was also restrained in the rest of the world, albeit with considerable regional differences. In the emerging economies of Southeast Asia, aggregate output expanded very strongly, although it slowed down somewhat during the latter course of the year. In much of Latin America, on the other hand, the situation was one of general stagnation. While the transformation economies of eastern Europe have proved to be relatively resistant to the cyclical slump in western Europe, their output growth was only moderate.

Although the recession in the industrialised countries in 2001 was mild compared to similar early cyclical phases, not least as a result of a very swift reaction on the part of monetary policy in the USA, the subsequent resurgence remained unusually weak for more than a year despite the strongly expansive course of economic policy. The central banks had cut key interest rates substantially again following the terrorist attacks of September 11. These measures were accompanied by – variously massive – fiscal support programmes. Contrary to initial expectations, however, these failed to trigger a more vigorous recovery. This was apparently prevented by a number of dampening factors, some of a long-term or structural nature, others short-term, temporary or cyclical. The structural causes include in particular the persistent weakness of the IT sector, where the adjustment processes following the stormy developments of the second half of the 1990s continued. Following very strong expansion with double-digit growth rates in the second half of the last decade demand fell drastically; coming from a low level, it has been recovering very slowly for some time now.

Expansive economic policy was also counteracted by the worldwide slump in share prices. This was partly due to disappointed expectations of an economic upturn. In the USA, moreover, further auditing scandals involving large corporations and the adjustment of output figures for past years raised doubts about the country's growth potential. Finally, geopolitical tensions have been depressing the economy and stock markets since last summer.

Investment the Engine of Economic Growth?

Estimating the influence of individual factors for the persistent world economic weakness is difficult, particularly as their significance differs from region to region. The current geopolitical uncertainties are often considered the primary cause behind the persistent weakness of the real economy. It is doubtful, however, whether the world economy would improve quickly and substantially should this risk factor cease to exist. While a perceptible recovery of the various climate indicators and steadier share prices could be expected, experience of the past year has shown that this alone is no guarantee of an imminent upswing. A possibly marked fall in oil prices would strengthen demand in the oil importing countries. More favourable psychological conditions, diminishing negative wealth effects, a tendency towards better financing conditions and a less pronounced loss of real income in the oil importing countries would improve the chances of recovery. On the other hand, the corporate sector still requires

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Table 1
Real GDP, Consumer Prices and Rate of Unemployment in Industrialised Countries

	Real GDP			Consumer Prices			Rate of Unemployment[1]		
	Changes over the previous year in %						in %		
Year	2001	2002	2003	2001	2002	2003	2001	2002	2003
Western Europe	1.6	1.0	1.6	2.1	1.9	1.8	7.2	7.4	7.6
EMU	1.5	0.8	1.4	2.5	2.2	1.8	8.0	8.3	8.5
USA	0.3	2.4	2.5	2.8	1.6	1.8	4.8	5.8	6.0
Japan	0.3	-0.2	0.8	-0.7	-0.9	-0.4	5.0	5.4	5.4
Industrial Countries[2]	0.8	1.5	1.9	2.0	1.3	1.5	6.0	6.5	6.7

[1]Unemployed in % of the labour force, standardised. [2]Total of countries listed, weighted according to GDP or private consumption or size of labour force in 2001.

Sources: Eurostat, OECD, national statistics; 2002: partily estimated; 2003: HWWA forcast.

Assumptions

Forecasting geopolitical and financial developments always involves a major degree of uncertainty. The economic forecast for the industrialised countries is thus based on the following assumptions:

- there is no war against Iraq; instead, the situation is much less tense by the spring;
- the price of oil falls from its current level of around 30 dollars a barrel to somewhere in the region of 25 dollars;
- share prices maintain their current level for the time being and tend to become firmer as economic recovery sets in;
- there is little change in the relationships between the major currencies; the euro maintains a position slightly above dollar parity.

substantial consolidation in a situation characterised by low levels of capacity utilisation, an unfavourable earnings situation and a high debt burden. As a result, companies' propensity, and in some cases their ability, to invest are likely to remain restrained at first. In addition, falling stock market prices in recent years have led to a considerable decline in the value of companies in relation to their fixed assets.[1] Changes in this relationship are often followed by similar changes in investments.

Investments will have a substantial role to play in further economic developments, however. In most countries, little stimulus can be expected from private consumption. With disposable income increasing moderately in most cases, the private propensity to consume will probably not increase again until employment prospects become more favourable. In the larger countries – with the exception of the USA – there is little scope for fiscal policy to chart an anticyclical course in view of high or markedly increased deficits. Conversely, external impulses can be expected in many cases. Given the present world economic and economic policy conditions, the USA in particular is again likely to be among the potential sources of new momentum. For most countries, in the short term, recovery will consequently depend to a large extent on the success of a US upswing.

This situation also reflects a core problem facing the world economy: its heavy dependency on the USA, a reliance that was further deepened when the American economy expanded strongly during the second half of the 1990s. While US aggregate output again increased substantially more than in the other large industrialised countries last year, a growth rate of just under 2½ % meant that the USA was no longer the locomotive of world economic growth it had been in the early boom years. At the same time, persistent dependency on the USA reveals the inability of other regions to develop sufficient impetus of their own. In the euro area in particular, whose economic weight is about equal to that of the USA, and in Japan, domestic demand increased little up to last autumn. Only the emerging economies of East Asia have unfurled any significant momentum of their own.

USA on the Verge of a Marked Recovery

The economic prospects for the USA have improved considerably with its plan for further substantial fiscal stimulus. Bringing forward parts of the multi-stage income tax cuts in particular will bolster private consumption. Altogether, the fiscal impulse amounts to 0.6 % of gross domestic product this year. Beyond this, the mere announcement of further supportive measures planned for next year will have a positive effect on the economy. In addition, monetary policy is charting a highly expansive course following a further interest rate reduction of half a percentage point to 1¼ % last November.

Investor and consumer confidence, which are quickest to reflect reactions to economic policy measures, have become stronger than the previous year, albeit recovering from a relatively low level. The latest interest rate step has also made it easier, in principle, for companies to progress with financial consolidation. Profits are also over the worst following substantial ra-

[1] This relationship is known in the literature as Tobin's q; the American economist revealed its relevance in the late 1960s.

tionalisation and cost-cutting programmes, not least by means of layoffs. In earlier cycles, a turnaround in the trend of earnings has proven to be the starting point for investment recovery. However, several factors indicate that any such recovery will be restrained, given that investments in plant and equipment have so far remained weak for a similar length of time as before the recovery in the early 1990s. In the short term, the very low level of plant utilisation in many industries provides companies with the opportunity to service demand even if it rises faster than expected. There will probably be little, if any, expansion of capacity for the time being. Commercial construction investments in particular will thus remain weak at first. Investments in plant and equipment, which have risen again since last spring, will increase further as a result of rationalisation and modernisation. Already they have been one of the main reasons why, in contrast to earlier phases of economic weakness, aggregate productivity growth slowed little as a result of the downturn. Initial investment restraint is further influenced by the need to improve balance sheets in the corporate sector. While the aggregate investment ratio has fallen significantly in the past two years, it is still higher than in the second half of the 1990s when it rose sharply in the wake of the IT boom, and significantly higher than the long-term average. Moreover, the sharp fall in share prices has led to a relative deterioration in corporate financing conditions, particularly as the banks step up their provisioning against risks in times of sharp increases in losses of receivables outstanding and weak earnings.

With a growth rate of almost 3% during the course of last year, private consumption remained very robust, although the savings rate among private households increased by around two percentage points; on paper, a large portion of the tax cuts went into savings. The loss of wealth resulting from further falls in share prices had no more than a moderate restraining influence on private consumption, partly because the related negative effect was largely offset by a further marked increase in house prices. Moreover, private households have taken advantage of lower mortgage interest rates in recent years to restructure their debt. While these positive effects are likely to tail off gradually, the dampening effects of share price-related wealth losses should also weaken as the stock markets stabilise, as is assumed here. Above all, however, there will be an accelerated increase in disposable income in the wake of further substantial cuts in income taxes. Furthermore, since the recovery of private sector investment will gradually lead to an improvement in employment prospects, any further increase in the savings rate is unlikely. A stronger expansion of private consumption can thus be expected in the course of the year.

The external sector as a whole will make a negative contribution to economic growth in the USA. The depreciation of the dollar will soften this effect only slightly as imports will probably continue to increase at a faster rate than exports given the ongoing development of the US economy. In view of the restrained economic development in the rest of the world, there will be only a gradual acceleration of export growth. Even so, there will be no significant increase in the negative external component. With currency depreciation worsening the country's terms of trade, however, the current account deficit will climb to 5%. Not until 2004 can we expect a year of "real" economic upturn.

Altogether, economic recovery in the USA will strengthen during the course of this year; should the uncertainty surrounding a war against Iraq recede, we could see accelerated growth in the shorter term. Compared to the previous year, real gross domestic product can be expected to increase by around 2¾%. This corresponds more or less to the growth rate of potential output. In this situation there will be no more than a slow fall in unemployment. In view of what continues to be a low level of utilisation of output potential, a level that will not increase at first, inflation should remain moderate, especially as oil prices are expected to fall once more.

In the short term, economic policy in the USA thus achieves the goal of strengthening demand and output. However, an expansive course of this nature cannot be maintained over a prolonged period of time. It is doubtful whether this policy mix will prove successful in the medium term. True, once an upturn takes place, monetary policy will tighten the reins again quickly and flexibly. Inflationary risks thus appear limited from this angle. However, it is uncertain whether fiscal policy will shift to a course of consolidation fast enough once recovery sets in. On the other hand, such a swift expansion of the public deficit as is currently the case is only possible for a limited period. Given the necessity of a return to a sustainable fiscal policy course it cannot be ruled out that the US economy could temporarily slide into a political cycle, particularly as the next presidential election is due in 2004.

Only Slight Recovery in Japan

The prospects of economic recovery in Japan remain relatively unfavourable. There has been no strengthening of the expansionary forces within the domestic economy. Monetary policy will maintain its markedly expansive course with a continuation of the country's zero interest rate policy and a substantial expansion of liquidity supported by unconventional measures, such as the extensive purchase of government bonds in particular. However, in view of the ongoing structural problems in the financial sector as well as in the rest of the corporate sector, these measures are still unlikely to trigger a sustained recovery. Moreover, following the sharp increase in public debt – which has climbed to 140% of gross domestic product – in recent years, fiscal policy is no longer capable of providing impulses via an increase in deficit spending. On the contrary, in order to avoid jeopardising confidence in the stability of the country's public finances, a transition to a course of consolidation is planned. In order to prevent a negative fiscal shock, however, the deficit is to be reduced by just a small amount at first, to 7% of gross domestic product.

Hopes of economic revival are pinned on exports; these increased strongly in the first half of 2002, but have seen little growth since then. As the world economy recovers there will be a marked increase in exports, encouraged by the regional structure, with the USA – at the forefront of international recovery – and the emerging economies of East Asia as Japan's most important trading partners. On the other hand, however, the international competitiveness of Japanese suppliers worsened again during the course of last year. Despite the considerable appreciation of the yen against the dollar there has yet to be another intervention in favour of a lower exchange rate.

Significant export growth is likely to facilitate a turnaround in commercial investments, which have been in decline since the beginning of 2001. Private consumption, which recovered substantially last year, can be expected to maintain its positive trend. All in all, real gross domestic product for the year will increase again for the first time in two years, although growth will be modest at 1% due to the low basis. Unemployment will remain high. Competition will remain tough as the expected increase in the utilisation of capacity will be slow. Since there will also be little increase in wages, but a faster rise in productivity due to the economic situation, prices will fall still further in the short term despite the sharp expansion of the central bank money supply. Even so, there will probably be a gradual improvement in the deflationary situation.

Few Impulses for the Euro Area

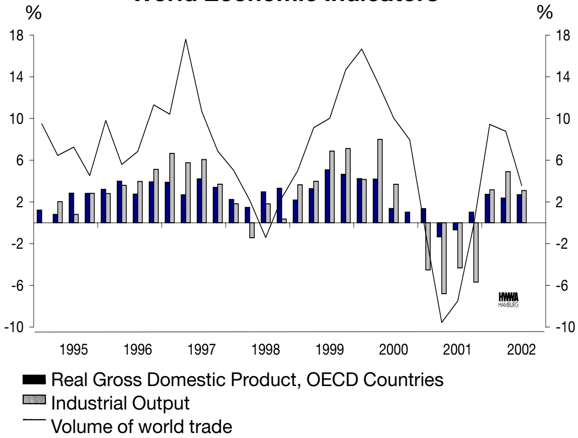
In the euro area, too, the economy is lagging well behind developments in the USA. With little in the way of growth stimulus from foreign trade, domestic demand growth was sluggish. Investments in plant and equipment have declined markedly since the spring of 2001. This was due to a considerable degree to the weakness of investment propensity in Germany, not only with regard to the further decline in construction investments, but also for capital expenditure on plant and equipment, which has fallen considerably more sharply than in the rest of the euro area. Investments in plant and equipment in the euro area stabilised during the summer, albeit at a low level.

Monetary policy has been charting an expansive course since the autumn of 2001. An indication of this is the expansion of the money supply, which, at a year-on-year rate of over 7%, continues to exceed the ECB's reference value of 4.5% – which is valid for this year too – although this is due in part to exceptional factors. In addition, the short-term interest rates are well below the Taylor rate;[2] the long-term rates are also comparatively low, even in real terms. Even so, and despite the fact that with consumer price inflation in excess of 2% the target of price stability has not been met for some time now, the European Central Bank last December again lowered interest rates by half a percentage point to 2¾%. The main reasons for this step were the continuingly modest short-term economic prospects and the considerable risks facing the economy, but it was also made easier by a more favourable price outlook. The recent appreciation of the euro helps bolster expectations of stability. At the same time, however, it also lessens the improvement in monetary conditions spawned by the interest rate step. Under these circumstances and in view of the continuing sluggishness of the economy, the ECB can be expected to maintain its interest rates at the current low level for the time being.

Fiscal policy, which last year was still charting a pronounced expansive course, is restrictive in character this year. This is due to the consolidation efforts in Germany and Portugal in particular, where last year the state deficit was well in excess of the 3% ceiling in relation to gross domestic product agreed in the Stability and Growth Pact. Without substantial intervention, these deficits would again exceed the ceiling by a significant margin this year. However, France and Italy are also a long way behind the consolidation projections presented in their 2002 stability programmes. While the goal of a virtually complete dismantling of the state deficits by the year 2004 is now obsolete, the "problem countries" have committed themselves to reducing their structural deficits by at least 0.5% annually as of this year (France as of 2004). In the other member states, the automatic stabilisers are fully functional and some governments even chose to implement expansive policy measures. Given their modest weight, however, their effect is too insignificant to compensate for the contractive fiscal effects emanating from the consolidating countries. Altogether, fiscal

[2] Cf. E. U. Fieber: Konjunkturschlaglicht: Geldpolitik deutlich expansiv, in: Wirtschaftsdienst, No. 12, 2002, pp. 755f.

Figure 1
World Economic Indicators[1]



[1] Changes over the previous quarter, extrapolated to annual rates; some of the values for the 2nd and 3rd quarters of 2002 are estimated.

Sources: OECD, IWF; HWWA calculations.

policy in the euro area is charting a slightly restrictive course.

The intention of the Stability and Growth Pact is to ensure that, by establishing an institutionally secured soundness and sustainability of national – decentralised – fiscal policy, the euro area's centralised monetary policy is not counteracted. With the slightly restrictive course of fiscal policy in the euro area for this year at least, the expansive monetary effects will be weakened. In the light of this policy mix it is unlikely that macro policy will generate any significant economic stimulus.

Under these circumstances economic momentum in the euro area will pick up only gradually. Stimulus is most likely to come from outside, and the strengthening of the US economy in particular will have a positive effect on the euro area. However, these impulses will be dampened by what in the meantime has become a substantial appreciation of the euro,[3] be it directly as European suppliers lose market shares, or indirectly as exporters attempt to maintain market shares by lowering their euro prices. The resulting decline in profit margins weakens the propensity to invest. On the other hand, the appreciation of the euro helps improve terms of trade and strengthens incomes remaining within the euro area. The – dampening – net effect of the currency appreciation is thus considerably less significant.

In view of an export/GDP ratio of around 14%, the effects emanating from foreign demand are limited. As the economic outlook and climate improve worldwide, however, so too will there be a brightening of mood in the euro area. Even so, investments in plant and equipment, which are usually quickest to follow more favourable export developments, will increase only gradually again in view of the low level of utilisation of production capacity. Private consumption is normally slower to react. As disposable income, despite lower inflation, will continue to be slow to increase in view of poor short-term employment growth and various increases in taxes and social security contributions, and as labour market prospects still remain unfavourable, private consumption will probably not gain momentum until later in the year. Under these circumstances, aggregate output growth, at 1½%, will again be lower than that of potential output. The utilisation of capacity will actually decline at first. An assertive upswing is unlikely before 2004.

Given the low level of utilisation of production potential, and as a result of the substantial appreciation of the euro, competition within and from outside the euro area will be intense. Together with a return to a slower increase in unit labour costs and the – expected– decline in oil prices, this will lead to a perceptible relaxation of inflationary pressure. The rate of inflation will average 1.8 % for the year.

This year, economic development in the euro area will be accompanied by increasing diversity between its individual member countries. This is partly the result of economic policy influences. With a single nominal interest rate for all the member states, countries with above-average inflation rates "benefit", in the short term at least, from a lower real interest rate compared to members with a lower rate of inflation. This effect is currently heightened by the fact that the latter group includes countries under strong consolidation pressure. However, the varying degree of fiscal policy scope is the result of past consolidation successes or failures on the part of the member countries. For the euro area, this situation – particularly given the current economic slump – represents both a considerable endurance test and an opportunity to prove its worth.

Risks

The forecast of a gradual strengthening of the economy in the industrialised countries during the course of this year is highly sensitive to the assumptions made. Not least the new economic programme in the USA could lead, via more favourable economic expectations and marked rises in stock market prices,

[3] Since the beginning of last year, the euro has increased in value against the dollar by around 18%, to 1.05. While this has led to a considerable deterioration in the international competitiveness of European suppliers, their position is nonetheless still favourable. Various calculations estimate the equilibrium exchange rate at between 1.07 and 1.26. Cf. European Central Bank: Economic fundamentals and the exchange rate of the euro, in: Monthly Bulletin, January 2002, pp. 41 ff. The real effective appreciation of the euro was considerably less pronounced.

to a stronger improvement in the investment and consumption environment than is expected here. The world economy would benefit from such a development. However, the downside risks still appear more substantial. Should the geopolitical tensions, contrary to the assumptions made here, continue beyond the spring, or should indeed a war be waged against Iraq, then the resulting uncertainty would generate further dampening influences. The risk of high oil prices is particularly serious in this case.

The high, and still rising, US current account deficit represents a further risk with regard to the external value of the dollar. Moreover, expansive fiscal policy is accompanied by a fast rise in new government debt. The return of the twin deficits increases this risk, especially as they were often regarded as the reason for the weakness of the dollar in the second half of the 1980s. Confidence in a high dollar exchange rate would also fade should the impression made in various quarters be substantiated that the US government favours a weak dollar for economic reasons. Furthermore, there is considerable conflict potential regarding the Japanese government's interest in a weak yen. Finally, the strong increase in private consumption in some countries, especially in the USA and the UK, is borne along by a substantial increase in house prices which is hardly likely to continue indefinitely. An abrupt end to this wealth effect would weaken private consumption, the strength of which has been decisive in softening the economic downturn in these countries.