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Slow Recovery in the Global Economy

The weakness of the world economy continued even after the end of the Iraq war, with demand and output showing only modest signs of improvement. Will the expectations of recent months, which have again become distinctly more optimistic, prove to be exaggerated? Or is the global economy, thanks to highly expansive monetary policies in many countries, on the brink of sustained recovery? Is a synchronised upswing probable, or will an economic growth engine again be needed to lead the way forward?

There has been little revitalization in the global economy after the rapid end to the Iraq war. Following the stagnatory tendencies of the last quarter of 2002 and the first quarter of 2003, output growth in the industrialised countries has remained muted. Economic activity in the euro area in particular has continued to be weak. In the USA and Japan, on the other hand, demand has accelerated. Even so, the ongoing decline in employment has meant that, in many countries, the output gap has increased once more. In this respect, the world economic downturn, which began three years ago, is not yet over. At the same time there has been a marked fall in the rate of inflation.

Now that the uncertainties in connection with the Iraq conflict are diminishing, however, the prospects for the world economy are brightening - albeit with considerable regional differences. At the same time, oil prices, which are a particularly sensitive barometer of geopolitical tensions, are still at a high level. Climate and other leading indicators have improved worldwide. The strong increase in share prices from their spring low and the fact that there has been a distinct rise in long-term interest rates in recent weeks are further signs that expectations of recovery are increasing. In addition, following a marked "correction", exchange rate relationships have stabilised in recent weeks. Together with distinctly expansive economic policies almost everywhere, conditions for economic recovery have improved considerably.

Climate indicators and share prices, however, are not entirely reliable leading indicators of further economic activity, particularly if their fluctuations are chiefly caused by political factors. Only last year, optimistic expectations were disappointed.

There are at present, however, a number of reasons why this is unlikely to be another "expectation bubble". Above all, factors that have had a dampening effect on the economy are becoming less significant. Excess capacities accumulated as a result of overinvestment[1] in many countries towards the end of the 1990s are likely to have been dismantled due to weak capital expenditure in the past two years. The fact that investment in plant and equipment has increased in various countries this year is an indication of this. At the same time, the consolidation process in the corporate sector has made significant progress. Following exceptional write-downs, which have been of great magnitude in some cases, the earnings situation has stabilised, albeit often at a low level and primarily as a result of extensive cost-cutting, achieved not least by means of staff reductions. This has been the case for some time now, not least in the field of communications and information technology, which was the mainstay of strong economic growth in the past decade.

At the same time, these developments are improving companies' scope for financing their business activities. As share prices rise, capital increases via new share emissions will again become more attractive, and lower risk premiums will ease loan financing, either on the capital market or with banks. The renewed increase in takeover and merger activities could be not only an indication of a more settled earnings situation and improving financial opportunities, but also of a budding propensity to invest again.

Monetary policy has been instrumental in creating this situation. Even though simple monetary policy rules such as the Taylor rate or monetary expansion have been indicating a distinctly expansive course for a considerable time now, key interest rates were lowered still further. While additional cuts are now improbable, key rates will certainly not be increased again until sustained economic recovery is established. In the USA this is likely to be the case during the course of the coming year. In the euro area, in view of the

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[1] Cf. F. Pelgrin, S. Schich, A. deSerres: Increases in business investment rates in OECD countries in the 1990s: How much can be explained by fundamentals?, OECD, Economics Department Working Papers No. 327, Paris 2002.

favourable prospects for price developments, an upward interest rate move is improbable before the end of next year. The Bank of Japan will probably stick to its zero-interest policy during the forecast period, and will continue its attempts to expand the money supply by means of purchasing assets such as government bonds and, to a certain extent, foreign exchange.

On the other hand, there has been a turnaround recently in the case of long-term interest rates, which by early summer had fallen to a very low level as a result of the weak economy and repeated cuts in central bank interest rates. The marked increase that has taken place in the past few weeks probably reflects in part a shift in portfolios towards shares. Due to more favourable assessments of the economic outlook, however, price and interest rate expectations are also no longer downward looking, particularly as several countries are showing a marked increase in government budget deficits. A further slight rise in capital market interest rates can thus be expected during the forecast period.

Fiscal policy, in the USA in particular, is strongly geared to expansion. According to OECD estimates, the budget deficit in relation to gross domestic product will rise by a good percentage point to 4½ % this year. Next year, the deficit quota will fall marginally at best. In Japan, fiscal policy is expansive this year despite the drastic increase in public debt that has been built up in recent years; the structural deficit quota is likely to remain unchanged in 2004. In the euro area, on the other hand, fiscal policy is charting a slightly restrictive course in consideration of the Stability and Growth Pact. This course will probably continue next year.

For the forecast it was further assumed that the price of oil falls and finds a level in the middle of the OPEC target corridor (22 - 28 $/b). Foreign exchange rates against the US dollar remain more or less at current levels during the forecast period; thus an average rate - with modest fluctuations - of 1.15 dollars is assumed for the euro.

USA to Lead the Way Again

Prospects are especially favourable for the USA in particular, where economic policy is unusually expansive. Key interest rates are extremely low. At the same time, fiscal policy is tuned to providing major stimulus to the economy. The further increase in the deficit quota is only due to a small degree to the effects of automatic stabilisers. It is above all the result of the costs of the Iraq conflict and the income tax relief in the second half of this year. In addition, the international competitiveness of American producers has improved considerably thanks to the devaluation of the US dollar. Moreover, the fact that profits generated by large corporations have increased again is an indication that the corporate sector has made good progress in adjusting to the structural distortions that arose in the late 1990s.

With an annual growth rate of just under 2½ %, aggregate economic activity in the USA increased faster in the second quarter than it had in the previous six months, and more rapidly than in most of the other industrialised countries. This growth rate unquestionably exaggerates the underlying economic trend: due to the war effort, military expenditure has seen a strong, but temporary, increase; also, purchases that had been postponed because of the Iraq conflict have now been carried out, as can be seen in the case of durable consumer goods in particular. On the other hand, however, favourable expectations are likely to have led to a fundamental strengthening of private household and corporate demand.

High levels of unemployment and related anxieties regarding job security could dampen private household spending. On the other hand, however, given that disposable incomes are increasing at an accelerated rate thanks to further marked income tax cuts, and since the share price recovery has again tended to induce a somewhat faster increase in wealth despite a slowdown in house price increases,[2] private consumption will continue its strong expansion for the time being. The level of debt, however, which in recent years has expanded rapidly in relation to income, will probably expand at a considerably slower rate as a result of higher long-term interest rates; private consumption growth will thus decline again somewhat during the latter part of next year. Following the extensive reduction of excess capacity and a return to more favourable sales and earnings prospects, capital expenditure in the commercial sector can be expected to increase significantly, particularly as the demand increase is largely effective in the home market.

All in all, real gross domestic product in the USA will grow at a distinctly accelerated rate during the second half of the year. While this expansion will tend to slow down during next year as the effects of fiscal stimuli decline, it will remain above the growth rate of productive potential. This will lead to a gradual closure of the output gap, and employment will begin to increase. With competition remaining intense, prices will continue to rise with moderation.

[2] Cf. C. Brück: Konjunkturschlaglicht: Privater US-Immobilienmarkt, in: Wirtschaftsdienst, Vol. 83 (2003), No. 7, p. 476 f.

Impetus for the Rest of the World

With these developments the USA will lead the way towards global economic recovery. At the same time, though, the impetus for the rest of the world will be checked to a certain extent by the increased international competitiveness of American firms brought about by the devaluation of the dollar. However, given that the US dollar has not moved uniformly in relation to other currencies, foreign trade impulses for other countries vary. Latin American currencies have seen a strong gain in value; with increases of 20 % and almost 30 % respectively from the final quarter of last year to June this year, both the Argentine peso and the Brazilian real have mitigated their own previous, and for a time severe, devaluation. The external value of the yen has also increased considerably against the US dollar. Compared to the euro, the dollar has lost around a third of its value since the spring of 2002. This realignment favours the emerging economies of East Asia and China in particular, whose currencies have seen a similar devaluation against the yen and the euro as has the US dollar. This is because these currencies are effectively - and the Chinese renminbi officially - tied to the dollar.

Nevertheless, the emerging economies in Latin America will also develop more momentum of their own again. Brazil and Argentina in particular are over the worst. With confidence in the economic policies of these countries' new governments increasing once more, the foreign trade situation has stabilised; this represents a fundamental improvement in the general conditions for economic recovery.

East Asia excluding Japan is the only region which last year already uncoupled itself from the economic cycle in the USA and the rest of the world. Expansive macro policies contributed to a strong increase in domestic demand alongside rapid export growth. China in particular proved to be a hub of regional growth, its real gross domestic product further increasing by a good 7 %. Economic activity weakened significantly in the spring in connection with the rise of the SARS illness, though this was only temporary thanks to the swift containment of the epidemic. In other countries, such as South Korea, the central banks have lowered key interest rates. Under these circumstances, demand and output in the region can be expected to increase again at an accelerated rate in the second half of the year and also to grow quickly next year.

Japan's Upward Trend Continues

With an annual rate of just under 2½ %, the increase in Japan's real gross domestic product was unexpectedly strong this spring. The clear upward trend that has been in progress for more than a year is an indication that the country's long-running quasi-stagnation has been overcome once and for all. This is all the more evident given that there has been a perceptible expansion of corporate capital expenditure, promoted by an increase in demand from abroad. At the same time, there was only a moderate increase in private consumption. All the same, the deflationary tendencies continued.

With a key interest rate of zero and a strong increase in the basic money supply, monetary policy thus remains unchanged and clearly expansive. Also, the government has not yet implemented the programme of fiscal consolidation it announced in answer to the dramatic explosion of debt levels in recent years. The upward trend can thus be expected to continue. While global economic recovery will lead to accelerated export expansion during the forecast period, there will also be a marked increase in capital expenditure in the commercial sector. However, the adjustment problems in the financial and commercial sectors, which remain considerable, continue to stand in the way of dynamic economic development and the overcoming of deflation. With unemployment still high and income development moderate, any expansion of private consumption will be sluggish. Moreover, the government will shift to a course of fiscal consolidation should there be a sustained increase in demand. However, with a marked increase in aggregate production, Japan slips out of its long-running rôle as a curb on international economic development.

Gradual Recovery in Europe

In the euro area, aggregate economic activity stagnated during the last quarter of 2002 and the first quarter of 2003 (see Table 1). In the three largest euro countries in particular, domestic demand remained fundamentally weak. In addition, there was even a marked decline in exports due to both the sluggishness of the economy in the rest of the world and the considerably higher external value of the euro, while imports continued to rise. Yet economic recovery in the euro area, too, remains substantially dependent upon foreign trade impulses, for domestic demand - despite various reforms, not least in the labour market - continues to be inhibited by considerable structural adjustment measures in both the corporate sector and the social welfare systems of several countries. Moreover, the three large countries in particular are subject to consolidation constraints in connection with the Stability and Growth Pact. Under these circumstances, the stimulus provided by an expansive

Table 1
Real Gross Domestic Product, Consumer Prices and Unemployment Rates in Industrialised Countries

	Gross Domestic Product				Consumer Prices[1]				Unemployment Rates[2]			
	year-on-year change in %								in %			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
Austria	0.7	1.0	0.8	1.6	2.3	1.7	1.2	1.0	3.6	4.3	4.4	4.4
Belgium	0.8	0.7	1.0	2.0	2.4	1.7	1.5	1.5	6.7	7.3	8.0	8.1
Finland	0.6	1.2	1.5	2.8	2.6	2.0	1.5	1.4	9.1	9.1	9.3	9.1
France	2.1	1.2	0.9	1.8	1.8	1.9	2.0	1.2	8.5	8.7	9.3	9.4
Germany	0.6	0.2	0.0	1.5	1.9	1.4	0.8	1.0	7.8	8.6	9.4	9.6
Greece	4.1	3.9	4.0	3.9	3.6	3.9	3.7	3.0	10.4	9.9	9.4	9.4
Ireland	5.7	6.0	3.7	4.5	4.0	4.7	4.0	3.5	3.9	4.4	4.7	4.7
Italy	1.8	0.4	0.5	1.5	2.3	2.6	2.9	2.0	9.4	9.0	8.8	8.8
Luxembourg	1.2	1.1	1.5	2.0	2.4	2.0	2.4	1.6	2.1	2.8	3.6	3.6
Netherlands	1.3	0.3	-0.1	1.3	5.1	3.9	2.5	1.5	2.4	2.8	4.0	4.5
Portugal	1.6	0.5	-0.5	1.5	4.4	3.7	3.4	2.1	4.1	5.1	7.2	7.8
Spain	2.7	2.0	2.0	2.7	2.8	3.6	2.9	1.9	10.6	11.3	11.4	11.3
EMU[3]	1.5	0.9	0.7	1.7	2.3	2.3	1.9	1.4	8.0	8.4	8.9	9.0
Denmark	1.4	1.6	1.4	2.1	2.3	2.4	2.3	1.8	4.3	4.5	5.1	5.0
Sweden	1.1	1.9	2.0	2.5	2.7	2.0	2.2	1.6	4.9	4.9	5.4	5.3
United Kingdom	2.1	1.8	1.9	2.6	1.2	1.3	1.3	1.3	5.0	5.1	5.1	5.0
EU[3]	1.6	1.1	1.0	2.0	2.0	2.0	1.8	1.4	7.4	7.7	8.1	8.2
Western Europe[3]	1.6	1.0	0.9	2.0	2.0	2.0	1.8	1.4	7.2	7.5	8.0	8.0
Canada	1.9	3.3	2.5	2.6	2.6	2.2	2.8	2.1	7.2	7.7	7.6	7.5
Japan	0.4	0.2	1.8	1.8	-0.7	-0.9	-0.4	-0.4	5.0	5.4	5.4	5.4
USA	0.3	2.4	2.2	3.0	2.8	1.6	2.1	2.1	4.7	5.8	6.1	6.0
Industrial countries[3]	0.8	1.6	1.7	2.4	2.2	1.9	1.9	1.6	6.0	6.6	6.9	6.9

[1] European Union: harmonised consumer price indices. [2] Standardised; in % of labour force. [3] Total of listed countries; weighted by gross domestic product, private consumption and size of the labour force, respectively, for 2002.

Sources: Eurostat; OECD; national statistics; 2003 and 2004: HWWA forecasts.

monetary policy will remain restrained, particularly as any expansive effects are neutralised to a considerable extent by the appreciation of the euro.

Aggregate demand will be slow to recover this year. However, it will gain momentum next year, supported by a return to stronger foreign demand growth. Expansion of the - negative - output gap will not stop until the second half of 2004. Around this time there should also be a gradual improvement in the labour market situation, especially as labour market reforms aimed at increasing flexibility can, in a number of countries, be expected to lower the barriers to employment. In view of what continues to be a low level of capacity utilisation, competition will remain intense. As a result, and in contrast to previous years, consumer prices are likely to increase at a rate which, at just under 2 %, is below the stability mark; this is partly because the appreciation of the euro continues to have a stabilising effect.

Altogether, economic prospects also improve in the other EU countries. In the United Kingdom in particular, aggregate production - following a weak period at the start of the year - will expand strongly once more. This is also the result of rising budget deficits caused by discretionary policies; the structural state deficit quickly increases to a level that cannot be sustained in the long term.

Economic development will gain momentum in those eastern European countries due to join the EU next May, their economies having remained relatively robust during the global downturn. At the same time, there is a change in the pattern of demand growth. While domestic demand continues to expand at a relatively brisk rate, despite the fact that some governments are shifting to a consolidation course in view of last year's substantial budget deficits, the EU 15 provides increasing impetus as the economy picks up. Accession to the EU, on the other hand, is unlikely to result in any significant additional stimulus; indeed, the stimulating effects have been spread over recent years as preparations for accession took place.

Considerable Risks Remain for World Economic Recovery

All in all, the world economy will gradually recover during the rest of this year. This development will be borne above all by the USA and the emerging economies of East Asia. Next year, the global economy will expand at an accelerated rate, since the recovery will then also encompass regions such as the euro area where the economy has been relatively slow to take off. Real gross domestic product in the industrialised countries will increase by 2½ % for the year as a whole. While this is the highest increase since the year 2000, a long-term comparison shows this growth rate to be decidedly restrained. World trade, which has picked up again perceptibly following virtual stagnation in the final quarter of 2002 and the first quarter of 2003, sees accelerated growth during the rest of this year and continues its brisk expansion next year. With an expected growth rate of 3¼ % for the year 2003 as a whole, however, its development is little stronger than last year. For 2004, the increase can be expected to amount to 7 %.

All the same, this forecast incorporates a number of considerable risks. On the other hand, however, an even stronger expansion than that considered probable here cannot be ruled out for next year. The propensity to invest could prove stronger than forecast: for instance if replacement and modernisation requirements are greater than expected or companies' financial scope improves more appreciably due to the progress made in balance sheet consolidation. This could lead to fast-growing confidence in further economic development and a diminishing fear of job losses, which in turn could break through the private households' various forms of spending restraint sooner than expected.

Such a development could be forced by a more substantial fall in oil prices than that assumed here. A rapid increase in Iraqi production could make it difficult for the OPEC cartel to maintain oil prices in the region of 25 US dollars.

Should the economy develop as forecast, moreover, there will be less risk of Japanese-style deflation, a risk that exists in extended periods of economic weakness in particular. For a number of individual countries, this risk was judged to be relatively high. The American central bank's policy of aggressive interest rate cuts, for example, was for some time predominantly driven by the aim of avoiding a deflationary scenario. Early this summer the risk of deflation was still considered relatively high for Germany too, in contrast to the rest of the euro area.[3]

Nonetheless, the downside risks outweigh the chances of a more favourable development than that forecast. This year, the recovery still lacks the robustness needed to cope with any further large-scale negative shocks - e.g. of a geopolitical nature - that could potentially occur, especially as the world economy continues to be US-oriented. Indeed, recovery in the USA appears to be a necessary pre-requisite for a marked global upswing.

Yet even with a US-led recovery of the global economy, the latter stages of the forecast period are fraught with considerable risks. In particular, there is an increased danger of exchange rate shocks, since a sustained expansion gap to the advantage of the USA accentuates existing imbalances within the world economy. This problem is reflected in particular in a further increase in the current account deficit. It is already running at around 5 % of GDP today, and a further rise seems probable. Whether the net capital influx into the USA continues to increase in the same measure in the longer term depends on the continuing attractiveness of financial investments. This would be the case above all should corporate earnings and investments in the USA undergo sustained recovery. Initially, however, private consumption in the USA remains the decisive mainstay of the economy. A further aspect is the recent sharp increase in the federal budget deficit. Rapidly increasing public debt could shake confidence in the credibility of budget policy and in the sustainability of economic recovery.

The structure of capital flows into the USA has shifted considerably from long-term investments to short-term money and this, coinciding with a loss of attractiveness, was accompanied by a strong devaluation of the dollar. Moreover, rapid expansion in the economies of East Asia and also Latin America has for some time now resulted in an increased willingness to invest in the emerging markets again. All this points to a risk of a further marked devaluation of the dollar.

Sharp shifts in exchange rates are not necessarily a zero-sum game, and massive adjustment problems in those countries with appreciating currencies can ultimately place a considerable burden on the global economy. A further severe devaluation of the dol-

[3] On the discussion of the risk of deflation for Germany, cf. J. Hinze, E. Wohlers: Konjunktur ohne Schwung, in: Wirtschaftsdienst, Vol. 83 (2003), No. 7, p. 474 f.

lar would hit individual regions to a greater or lesser extent not only because international financial flows would be redirected, but also as a result of differences in exchange rate regimes and policies. In times of economic weakness, an increasing number of regions have an interest, for reasons of international competitiveness, in keeping the external value of their own currencies low. The Japanese government, for instance, has repeatedly intervened in the foreign exchange market since last autumn in order to prevent the yen appreciating against the dollar over and above a particular level. The aim is to prevent a deterioration in the competitiveness of Japanese companies not only compared to American firms, but also in relation to producers in neighbouring countries where the dollar rates are stabilised by substantial interventions in favour of the American currency.

For some time now there have been increased demands to allow an appreciation of the renminbi in particular, which is pegged to the dollar and is of only limited convertibility. These demands are primarily based on China's increasing foreign exchange reserves, but above all on its substantial foreign trade surpluses; these are not least the result of growing competitive strength due, in combination with falling domestic prices, to a long-running devaluation of the Chinese currency in real and, together with the weakness of the US dollar, in effective terms.

Under these circumstances, there is also a growing risk of international conflicts over exchange rate relationships. The more intense these conflicts are, the greater the negative effects on the world economic climate could be.