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Marked Recovery in the World Economy

With expansion accelerating strongly since last summer, the world economy has overcome an extended period of weakness. The USA, driven by highly expansive fiscal policies, is once again proving to be an important locomotive for global economic development. The strong fiscal stimulus will diminish sharply this year, however. Can the recovery continue nonetheless? This is of importance for the euro area in particular, where exports have so far been the primary foundation of economic resurgence. Is the substantial appreciation of the euro jeopardising prospects of catching up with the rest of the world?

The world economy is currently in a phase of rapid recovery. Following an unusually long period of frailty, output in the OECD countries has been expanding at a distinctly accelerated rate since last spring, and production capacities, which have hitherto been significantly under-utilised, are even being put to greater use again in many cases. This increasing economic momentum is also reflected in distinctly accelerated growth of the international trade volume. The clear improvement in the economic climate and developments on the financial markets are not least a reflection of widespread expectations that the global economic situation will continue to grow in strength.

In contrast to the previous downturn, world economic recovery is developing in an asynchronous manner. While aggregate output in Japan already increased strongly during the course of 2002, economic momentum in the USA has been intensifying since the spring of 2003. In the emerging economies of Southeast Asia and in China, real gross domestic product expanded at a very strong rate subsequent to the SARS-related setback during the spring. Following a year of stagnation in the euro area, an – albeit restrained – upward trend did not become established until after the middle of the year. Output growth in the transformation economies of Central and Eastern Europe, which had in the past proven to be relatively robust, is increasing again. Bolstered by a marked rise in commodity prices, there has also been a resurgence in economic activity in Latin America, although this upward trend still appears to be very fragile.

Reasons for Recovery

There are several reasons behind the pronounced recovery of the global economy. For example, a number of factors that had for a long time impeded the stimuli generated by economic policy have ceased to be of significance. The uncertainty spawned by the Iraq conflict, which had led to perceptible purchasing restraint and had thus for a long time frustrated the impetus that should have been generated by economic policy, has faded more and more since the end of the war.

Also, factors that had contributed decisively to the downturn in the year 2000 and to the unusually long slump thereafter gradually ceased to have a dampening effect on the economy. During the past three years, over-capacity in one of the key sectors responsible for strong growth in the second half of the 1990s, the IT industry, has been dismantled in the course of an extensive adjustment process. Beyond this, there are increasing indications that demand for IT products is rising again perceptibly. In addition, companies have reduced what in some cases were very high levels of indebtedness. More favourably structured balance sheets and – following far-reaching restructuring measures – an improving earnings situation, have helped enhance corporate financing opportunities not only via the capital markets. Bank loan conditions, too, have become more favourable again, particularly as the pronounced earnings crisis in the financial sector in a number of countries also appears to have been

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largely overcome. The marked share price recovery that has taken place since last spring is both a response to and a fortification of this development.

Although there has been an increase in the price of oil following a temporary decline last spring, it has remained at a level similar to that of before the Iraq war. However, any relief for the world economy emanating from oil price developments turned out to be less substantial than had been expected, so that there was little improvement in the terms of trade of the oil importing nations from this point of view. In addition, there was a considerable rise in prices for industrial raw materials.

As the effect of retarding influences has diminished or ceased to exist, expansive economic policies are unfolding a discernible effect, and endogenous growth factors are gaining force. The current economic recovery has already proved to be relatively robust, given that neither recent financial scandals nor the terrorist attacks in Turkey and the Middle East managed to impair the positive inclination in the economic climate, the stock markets or demand. These are all indications that the recovery will continue at a brisk pace during this year. The danger of a short-lived recovery as seen in 2002 is slight as long as the world economy is not shaken by any serious new shocks.

Fiscal Policy on Consolidation Course

It is unclear, however, how strong the endogenous forces are. A considerable portion of the uncertainty regarding the intensity and sustainability of the economic upturn is due to the difficulty in estimating the influence of fiscal policy. In the USA in particular, which has once again assumed the role of global economic powerhouse, the accelerated increase in demand is principally a response to income tax relief. In view of the consolidation constraints arising from the strong increase in the country's budget deficit in the past three years fiscal stimulus is now running out. The national budget deficit in the USA will show only a slight increase this year. While public expenditure is increasing at a markedly slower rate, the revenue situation is improving in the wake of the economic upturn. Although the structural deficit is still widening perceptibly, fiscal policy is charting a far less expansive course than in recent years.

As the tax cuts run out, real disposable incomes and private consumption in the USA will increase at a slower rate during the rest of this year. At the moment it is very difficult to estimate how strong this effect will be, in part also because the savings rate among private households is low and there is no longer much scope for additional relief by means of restructuring mortgage debt.

In the past, the economic effects of expansive fiscal policies were contradictory. Deficit spending, for example, has only occasionally been followed by an upturn. Besides the fact that high budget deficits tend to lead to an increase in interest rates, waning confidence in the solidity of fiscal policy can weaken the potency of any multiplier effects. The monetary political (re-)actions of the American central bank depend decisively on an assessment of the role of fiscal policy in the current recovery process.

In view of high budget deficits and consequent levels of government debt, which has increased sharply in some cases, fiscal policy in other countries, in contrast to the USA, is more geared towards consolidation. In Japan, however, the national deficit has increased again not least as a result of a number of exceptional factors last year; the country's fiscal policy is charting a restrictive course this year. In the euro area, fiscal policy will remain virtually neutral in its effects on economic growth, as it was last year, despite tax cuts in individual countries; while the deficit in Germany and France will fall, it remains significantly above the ceiling established in the Stability and Growth Pact.

Labour Market Situation Slowly Improving

Whether or not private consumption, which in previous years had been the mainstay of economic growth in the USA, continues its rapid expansion in an environment of waning fiscal impulses, depends not least upon recovery spreading to the labour market. There have been considerable doubts about this in recent months. While it is true that the labour market always lags behind developments in the economic cycle, the delay is usually relatively short in the USA due to a high level of flexibility and mobility among the work force. This time, however, accelerated expansion of production has been accompanied by an increase in productivity that is unusually strong even for early phases of a cyclical recovery. On the other hand, the recent appreciable fall in unemployment together with a return to increasing employment indicate that the economic recovery has gradually found its way to the labour market too. At 5.7 %, the unemployment rate in December was around two percentage points higher than at the start of the downturn in the year 2000.

In Japan, where the economic recovery began as much as two years ago, employment is currently stagnating. The cyclical factors promoting employment are pitted against ongoing structural adjustments in the business sector. In the euro area, employment even increased up until the summer at least in spite of stagnating aggregate output. This is not least a reflection of measures on the part of a number of countries to make the labour market more flexible and to transfer activities from the shadow economy into legitimate employment. The unemployment rate remained unchanged. At the end of last year, it was ¾ of a percentage point higher than at the start of the downturn.

Conflicting Price Effects Due to Exchange Rates

Price developments were for the most part unspectacular last year. Consumer prices in the USA increased by 2.3 % compared to 2002, and at 2.1 % the inflation rate in the euro area remained above the ECB target of 2 % despite a slight decline during the course of the year. In Japan on the other hand, prices continued to fall, if only moderately, and consumer prices dropped by 0.2 % on average over the year.

The widespread concerns about deflation that still existed last summer have been rendered obsolete by the economic recovery in the USA. On the other hand, however, there is little danger of inflation the world over for the time being. One indication of this is not least the continuing intensity of competition. Capacities are under-utilised almost everywhere, in some cases considerably. The aggregate output gap is closing only gradually in most cases, and in the euro area it will even continue to widen for the time being.[1] In the USA it will probably close this year, but in the euro area and Japan this will not even happen next year. In view of the high level of unemployment, wage increases will remain restrained.

Exchange rate developments have different effects on price levels in individual countries. In the past two years, the yen and the euro have both appreciated substantially against the US dollar. This gives rise to stabilising influences in Japan and the euro area. In the USA on the other hand, devaluation facilitates a more rapid rise in prices. Any inflationary impulses resulting from the devaluation of the dollar appear limited, however. Foreign suppliers will refrain from raising their dollar prices to any substantial degree in order to maintain their market shares. The pressure to do so is all the greater given that the competitive position of important competitors from the emerging economies of East Asia, not least from China, has improved considerably as a result of the close binding of their domestic currencies to the US dollar. In addition, low levels of capacity utilisation will encourage American companies to pursue a cautious price policy for the time being.

Monetary Policy Remains Expansive

Monetary policy is charting an expansive course. This is particularly true of the USA, where the short-term interest rate is lower than the Taylor rate. The monetary conditions are favourable, even though money supply expansion is relatively restrained. Monetary policy in other countries is also following an expansive course. During the course of last year, the monetary policy reins were slackened still further. The ECB, for example, again lowered its interest rates in June; the short-term real interest rate is now zero. In Japan, the country's zero-interest policy was reinforced by a strong expansion of the monetary base, particularly via the purchase of government bonds and intervention on the foreign exchange markets.

In view of the marked economic recovery and price impulses caused by the depreciation of the dollar, monetary policy in the USA can be expected to tighten again during the course of this year. The American central bank, which has the responsibility to ensure both price stability and growth, and is not bound to any particular rule of monetary policy, will approach the change in interest rate policy with care. So as not to jeopardise the upturn at hand, it is currently more likely to accept the risk of inflation. For the forecast it is assumed that key interest rates will be raised by a total of one percentage point during the spring and again by half a percentage point at the end of the year. Monetary policy would then still be charting an expansive course. In Japan and the euro area, key interest rates will probably remain unchanged this year, if only because the monetary environment has deteriorated as a result of the appreciation of the yen and the euro.

In contrast to short-term interest rates, long-term rates picked up again as early as last summer. In early January, interest rates for ten-year government bonds in the USA and the euro area were 1 and ¾ of a percentage point higher than in the middle of last year respectively; this level is still low from a historical point of view, however. The increase partly reflects higher real yields spawned by the improved economic situation as well as significantly higher budget deficits, particularly in the USA. At the same time there was an increase in inflation premiums, evidence of which

[1] The output gap defines the degree, in per cent, to which a country's actual output deviates from its potential output. However, this reference value can only be estimated. Different results may be reached depending on the method used. This is particularly true with regard to the size of the gap, less so for its development over time.

is provided by the results of surveys among financial market players as well as by increasing yield spreads between nominal and indexed bonds.

Long-term interest rates will continue to rise as the economy improves. For the forecast it is assumed that long-term interest rates for government bonds in the USA and the euro area will slightly exceed 5 % by the end of this year, and so be around ¾ of a percentage point higher than last December. Interest rates for corporate bonds will probably rise less sharply, since risk premiums are likely to decline further as a result of the advanced stage of financial consolidation in the corporate sector.

Further assumptions for the forecast include an oil price of 28 dollars per barrel and a further marked increase in the price of industrial raw materials. Furthermore, an exchange rate in the region of 1.25 dollars per euro is assumed.

Recovery in the USA Continues

Under these conditions regarding economic policy and the general international environment the world economy can be expected to continue its recovery. While aggregate economic expansion in the USA will slow down significantly as fiscal stimuli cease to apply, the underlying trend will still be one of significant growth. The propensity to invest will continue to increase significantly, especially as companies' earnings will continue to improve as interest rates stay low and the international competitiveness of US firms improves with the depreciation of the dollar.

The deceleration in the rate of economic expansion is largely due to private consumption. Despite gradually increasing employment, private consumption will expand at a distinctly slower pace than in the second half of 2003, primarily because the stimulating effects of tax cuts are wearing off. Furthermore, a return to higher long-term interest rates will deprive private households of the opportunity – much exploited in recent years – of refinancing their mortgages in order to either reduce their loan costs or expand their credit volume on a cost-neutral basis. This will also mean that the sharp rise in housing prices that continued into last year will flatten out still further. As this wealth effect recedes private consumption will become more restrained, and it is improbable that any increases in stock prices will be able to offset this development. Under these circumstances the savings rate among private households is also unlikely to decline significantly.

The strong depreciation of the dollar together with economic recovery in the rest of the world will cause exports to increase at an accelerated rate. On the other hand, import growth will weaken, so that the external "withdrawal effects" diminish. While real gross domestic product is expected to expand more slowly during the course of this year, it will still grow at a faster rate than potential output. The output gap is likely to close in the course of this year. In spite of a decline in real net imports of goods and services, the current account deficit will remain at a little over 5 % because the terms of trade will continue to deteriorate for the time being due to the depreciation of the dollar. There will be little change in the size of the government deficit, which increased dramatically in recent years.

More Restrained Expansion in Japan

In Japan, aggregate output has been increasing for almost two years already despite the country's persistent deflation. While the strong increase in demand from the USA and from neighbouring countries is contributing decisively to economic recovery, domestic demand is also improving and there has been a marked increase in investments in particular. Japanese companies have apparently taken considerable steps in their far-reaching restructuring and cost-cutting programmes, and progress in the consolidation of the financial sector as well as a massive expansion of the monetary base have improved financing conditions. Earnings prospects, however, are clouded by the sharp appreciation of the yen against the dollar that has taken place since last autumn despite massive intervention on the part of the central bank. Despite further rapid export growth, there will be little increase in the propensity to invest.

The labour market situation will improve only gradually. With just a small increase in real disposable incomes and – after years of decline – a low savings rate, any expansion of private consumption will remain slight. Furthermore, fiscal policy is charting a restrictive course. This year, Japan's real gross domestic product will grow at a slower rate than in 2003. Not least the lower import prices resulting from the appreciation of the yen will at first contribute to a further decline in price levels.

The emerging economies of Southeast Asia and China in particular are benefiting from the weakness of the dollar, because their international competitiveness has strongly improved as a result of their currencies being practically pegged to the dollar. This promotes the dynamic development of the entire region. In contrast to the USA, however, this growth centre also depends to a considerable degree on external stimuli.

Euro Area: The Straggler is Slowly Catching Up

The euro area is lagging behind economic developments in the rest of the world. The fact that domestic demand has been fundamentally stagnating for more than two years is not least a reflection of the weak growth momentum in the larger member countries. The revival of aggregate production after mid-2003 is primarily due to a marked increase in foreign demand. At the same time, however, the distinct increase in confidence in both the industrial and service sectors indicates that the revival is gradually spreading to domestic demand. In the euro area, too, considerable progress has been made with regard to structural adjustments, not least in the IT sector.

With the continuing consolidation of corporate finances and considerable restructuring in the financial sector, the propensity and ability to invest can be expected to increase again following an extended period of weakness. The euro area's persistently expansive monetary policy is auspicious in this respect. However, monetary conditions have deteriorated as a result of the rapid appreciation of the euro against the dollar – by more than 10 % between September, following the G7 meeting in Dubai, and the start of January alone. Although foreign demand will continue to expand as the world economy recovers, profit margins in the tradables sectors will decline considerably under these circumstances. This development will only be partially offset by a significant improvement in terms of trade, particularly as imports will grow at an accelerated rate due to the depreciation of the dollar.

Fiscal policy, particularly in the large member countries, is under pressure to consolidate, even though the Stability and Growth Pact is not being applied as stringently as originally agreed. At the same time, modifications to labour market policy and other social reforms that are connected with consolidation efforts are strengthening supply-side conditions. Experience shows, however, that such changes will encourage growth and employment only in the longer term. Altogether, the euro area will remain a straggler in the global economy for the time being. While, at 1.8 %, real gross domestic product will this year increase at a significantly faster rate than in 2003, this will be partially due to the greater number of working days this year. All the same, there will probably be no further expansion of the output gap in the second half of this year. A marginal improvement in the labour market situation can be expected in the latter part of the year. Inflation will slow slightly as a result of faster improvements in productivity due to the economic recovery and the stabilising impulses generated by foreign trade.

The accession of ten eastern and southern European countries to the EU in May this year will be accompanied by positive integration effects and numerous structural adjustments in both groups of countries. On the other hand, these processes have been ongoing for some considerable time now, so that no perceptible additional impulses can really be expected this year either for the economy in the euro area and the other current member states or in the acceding countries. The continuing rapid expansion in the acceding countries also reflects a higher potential growth rate that is typical for economies during the catching-up process.

Risks

Altogether, the global economic upturn will continue. The upward trend will further establish itself not only in the industrialised countries, but also in the rest of the world. Economic momentum will remain high in the emerging economies of East Asia, with China leading the field. In Latin America the restrained upward trend can be expected to continue. Global production will increase at 3½% for the year, global trade at more than 8%.

The global economy could even expand faster than forecast here. In view of the advanced stage of consolidation and restructuring in the corporate and banking sectors it cannot be ruled out that the impetus emanating from a monetary policy that continues to chart an expansive course could unfurl a greater effect than assumed here. Moreover, the strengthening economy could develop into a stronger self-sustaining upward spiral.

On the other hand there is a pronounced risk that developments could be less favourable. This is due to the fact that global economic imbalances will tend to intensify as the world economy recovers. The substantial US American current account deficit in particular represents a considerable risk factor. Financing this deficit is made still more difficult by the sharp increase in the government budget deficit. Dampening demand in the USA would reduce the foreign trade deficit there, but this "option" is unrealistic as it would clearly run counter to US economic policy targets. A weaker economy in the USA would, moreover, rebound unfavourably on economic developments in other regions of the world.

The depreciation of the dollar thus remains the most important potential adjustment mechanism. However, a further rapid depreciation against the euro and the yen would place excessive strain on the adjustment capabilities of the euro area and Japan and so at least endanger the economic recovery in these countries. This would be the case even more if the emerging economies of East Asia continued to prevent a revaluation of their currencies. Since an adjustment of the US current account is hampered by the fact that a number of East Asian currencies are linked to the dollar, there is a greater risk that industrialised countries could react to intervention in the foreign exchange markets by introducing trade protection measures. The global economic climate could quickly deteriorate as a result.

An interest rate risk is also linked to the risk of stronger shifts in exchange rates. An ebbing capital inflow into the USA or less investment of the still increasing East Asian foreign exchange reserves in long-term US bonds could lead to a rapid increase in long-term interest rates in the USA. This increase would probably spread to other countries as a result of the close interconnection of international interest rates and high budget deficits in most industrialised countries. In view of the high level of indebtedness among private households – in Europe too – this would lead to a considerable loss of wealth and a necessity to save.