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Global Economy Gathering Strength

Encouraged by a highly expansionary economic policy, the global economy is enjoying a rapid upturn. Utilisation of capacity is high in many sectors, particularly in the growth centres of the USA and East Asia, where China leads the field. With inflationary risks on the increase, most countries are now shifting the focus of economic policy. Fiscal policy in particular can be expected to provide little in the way of further stimulus. In addition, there has been a turnaround in interest rates in many countries. Yet how quickly can the monetary reins be tightened without jeopardising growth or endangering price stability?

Stimulated by highly expansionary economic policies, the global economy is enjoying a period of pronounced growth. The recovery that began in the summer of 2003 has continued to gain momentum despite the marked increase in oil prices. Aggregate output expanded at a very strong rate during the first half of this year, just as it had in the previous six months. The utilisation of production capacity is for the most part running at a higher level than a year ago. Both surveys and market developments, particularly on the stock exchanges, indicate a marked increase in investor and consumer confidence in the future of the economy. Recovery is particularly apparent in the development of global trade, which was up by a good 10% in real terms during the first half of this year compared to the same period of 2003.

The pace of expansion, however, varies greatly from region to region. Centres of growth are the USA and the emerging economies of East Asia, particularly China. Strong stimuli emanating from here have also reached Japan, where the long-running economic slump has been overcome. Although external impulses have led to a marked recovery in the euro area, this recovery has been restrained. The ongoing weakness of domestic demand also has the euro area trailing behind the other EU member states. In the United Kingdom, where the impact of the global downturn had been moderate, economic expansion began to accelerate significantly in 2003 and has remained vigorous this year. In the new EU member states, too, economic activity – which in the face of the euro area's economic weakness had proven to be relatively robust despite close trade relationships – has also been gathering strength.

Upturn on Broader Foundation

The global economic upturn has gained strength and breadth since last autumn. Prospects for self-sustaining worldwide growth have improved, especially as private investment is rapidly expanding again in a number of countries. In the USA, where a longer recession was prevented by an increase in private consumption, business investment has been increasing strongly since the spring of 2003 following a previous sharp decline. This development is largely the result of a greatly improved earnings situation. In contrast to the later stages of the downturn, rising profits are no longer primarily due to cost-cutting measures in general and staff reductions in particular, but have for some time now been generated above all by an increase in capacity utilisation triggered by growing demand together with what continues to be a brisk rise in productivity driven by innovation. In Japan, the primarily export-induced upturn has gained in strength as a result of a marked increase in the growth rate of private investment. Investment in China continued to grow very rapidly during the first half of the year, although the rate of increase has slowed to some extent. In the United Kingdom, too, there has again been a marked increase in corporate capital expenditure since the beginning of last year. In the euro area, on the other hand, there has as yet been no significant increase in the propensity to invest in spite of the strong rise in exports; in Germany in particular, weak private consumption and a prevailing atmosphere of uncertainty have helped prevent the foreign trade improvements from making a positive impact on investments.

Another reason for the gain in economic momentum in the industrialised countries is that the upturn in many countries has now spread to the labour market, having appeared initially to be passing it by. Employment has increased in many countries, and the unemployment rate has fallen significantly not only in the USA, but also in Japan and the United Kingdom. This also refutes fears that globalisation would lead to an increase in foreign investments and a displacement of production locations and so induce "jobless growth". Increasing employment is important for the sustainability of eco-

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nomic growth as it enhances income expectations and the consumer environment. This driving force has not yet made itself felt in the euro area, where employment continues to stagnate and where there has even been a further slight increase in unemployment – largely due to cyclical factors – during the first half of this year.

Normalisation of the Economic Context

The strength and breadth of the upturn demonstrate that the impediments that were chiefly responsible for the extended period of economic sluggishness have essentially been overcome. For the most part, the excess capacities created in many areas during the course of the economic boom in the second half of the 1990s have since been dismantled. Many companies experienced financial difficulties as the downturn set in, but in the meantime the consolidation of corporate finances has made substantial progress and the earnings situation has improved again significantly. Furthermore, the trend in some countries towards a liquidity squeeze among the financial institutions that continued into last year has since petered out, so that from this point of view there is little to prevent the transmission of monetary policy stimulus. The economy in the industrialised countries is thus developing more and more within a normal economic context once again.

Global economic recovery is leading to mounting price pressure once again. This development has dispersed the concerns of deflationary dangers expressed in various quarters in the summer of last year. At that time such concerns had caused the American central bank to further intensify its expansionary monetary policy. Prices have risen again significantly since then. Most recently, the inflation rate in the USA stood at 3.0% and in China at 5.3%, and was thus higher than a year ago. At the same time, there has been a marked decline in the rate of deflation in Japan. In the euro area, where inflation proved obstinate during the downturn and exceeded the stability level of just under 2% established by the European Central Bank, there has been little change in the inflation rate – which recently stood at 2.3% – despite the fact that the euro has since gained in value against the dollar.

In addition to fundamental developments, however, prices are being forced upwards by adverse external factors. To a great extent this acceleration reflects both the renewed substantial increase in oil prices, which only temporarily fell to 23 dollars a barrel following the end of the Iraq war, and the strong increase – up to last spring – in other commodity prices. Their rise of 30% in US dollar terms within a year was, however, only partly a reaction to the substantial increase in commodity consumption spawned by economic growth. It was exaggerated to a large extent by speculation, a typical development in early phases of a cyclical upturn. Not surprisingly, prices for non-energy commodities have since stabilised, albeit at a high level. In the case of crude oil, on the other hand, price rises have not least resulted from supply-side disturbances. While consumer prices excluding energy have also been rising at an accelerated rate in the industrialised countries, the upward trend has remained moderate. Moreover, the danger that commodity prices could trigger off an inflationary development is slight, since high levels of unemployment in most countries make compensatory wage rises relatively improbable.

For the forecast it is assumed that the price of crude oil will remain at the current level for the time being, but will fall again during the course of next year to 35 dollars a barrel. With regard to the other commodities, constant prices are assumed for the most part. At the same time it is assumed that the euro will stay close to 1.25 dollars and the dollar to 110 yen. For the euro area and for certain other European countries whose currencies have appreciated strongly against the dollar in recent years, as well as for Japan, this means that exchange rate developments will no longer have a dampening effect on prices, nor will they be the cause of any more price increases for the USA.

Economic Policy Stimulus on the Wane

The strong expansion of the global economy is not least the result of a highly expansionary economic policy, which, after the end of the Iraq war, and with a number of structural imbalances overcome, has achieved a considerable effect. This is particularly true of monetary policy with very low interest rates in the USA and Japan and vigorous loan expansion in China. In the euro area, too, monetary policy has been charting an expansive course for some time. Here and there this was supplemented by strong fiscal stimuli: in the USA such impetus was largely due to a further extensive reduction in income tax, in the UK it was primarily achieved by means of a sharp increase in public spending.

When a strongly expansionary economic policy is maintained over a long period of time, it gradually loses effectiveness and its stimulus becomes weaker. In many countries macro policy is approaching the limits of its economically justifiable potential to stimulate growth. Public debt in all the large industrialised countries has increased considerably in recent years, raising doubts as to the soundness of fiscal policy. Given the strong increase in the aggregate state deficit that has taken place in recent years, the US government in particular is shifting towards a neutral course. The central government in China is making efforts to curb the increase in public spending by sharply reducing the expansion of loans for regional authorities. In view of a deficit-to-GDP ratio of just under 7%, and given the strengthening of the economy this year, Japanese fiscal policy is also geared to consolidation. In the euro area, the governments of the large member countries in particular are striving to reduce their deficit-to-GDP ratios – in part also to better fulfil the requirements of the Stability and Growth Pact. In the United Kingdom, public expenditure is now expanding at a much slower rate, and several of the new EU member countries are also making efforts to reduce their considerable budget deficits.

Monetary policy will also be tightened in order to counter the risk of inflation in an overheating economy. However, given the uncertainty concerning the extent to which transmission has normalised again, and in view of the higher interest rate reagibility that may be presumed on the part of the private households, it is difficult for the central banks to determine a policy course which on the one hand assures price stability and on the other hand does not jeopardise economic growth. The effects connected with a shift towards consolidating public finances can normally be measured relatively accurately for individual countries. However, this task is far more complex within a framework of economic development that is increasingly determined by international interdependencies. The mutual amplification effects associated with parallel policies are frequently underestimated. It is particularly difficult in this regard to estimate the development of the national economy in the growth centre of China, where estimating the intensity of demand-dampening effects is fraught with uncertainties. Firstly, it is questionable as to how effectively the drastic curbs on credit expansion – not only for regional authorities – desired by the government can be achieved, and then it is also difficult to quantify the short-term economic consequences of the credit policies that are actually implemented.

Moreover, assessing the consequences that the unusually long period of economic support – afforded by what has been a staunchly expansionary monetary policy in addition to the highly expansive fiscal policy – may have on the structure and stability of demand is loaded with considerable uncertainty. For example, the low interest rates of recent years in the USA (where short-term rates have even been negative in real terms for some time now), in the United Kingdom, but also in France and Spain, have largely helped stimulate demand for housing and durable consumer goods through a sharp increase in private debt. This development was additionally facilitated by a marked rise in house prices. In the USA in particular, private households also augmented their purchasing power to a considerable degree by restructuring their mortgage loans, which in itself results in a lower interest burden.

All this is likely to have raised the interest rate elasticity of private consumption considerably. Consequently, the American central bank will only gradually tighten its monetary policy. Following last June's first increase in interest rates for more than four years by a quarter of a percentage point, and further increases of the same magnitude in August and September, further cautious steps can be expected during the forecast period. The Fed funds rate is likely to be raised to 2½% by the end of 2005. In the United Kingdom, the monetary reins have already been tightened to a far greater extent; here, given the high level of capacity utilisation that has been increasing rapidly until most recently, and in view of a significant increase in the rate of inflation, further interest rate steps are to be expected. In China, the hitherto generous expansion of loans – at the beginning of the year the credit volume was almost 50% higher than a year previously – is to be curbed substantially. The reins of monetary policy are also being tightening in most of the other regions of the globe. Contrary to fiscal policy, however, monetary policy almost the world over still continues to chart an expansive course. Meanwhile, the Japanese central bank has announced that it will maintain its zero-interest policy until deflation has been completely banished. As long as there is no marked acceleration in the expansion of money supply and loans, the key interest rate in the euro area is likely to remain unchanged at 2% until around the middle of next year.

Expansion Progresses Slowly

Under these general conditions, output in the industrialised countries will continue to develop along a distinctly upward path. With economic policy stimulus on the wane, economic expansion will slow down despite its greater intrinsic impetus. This is particularly true for the USA. Now that the government programme of income tax cuts is completed, disposable income will grow at a slower rate in spite of rising employment. Moreover, with wealth effects diminishing as a result of slower rises in house prices, private consumption expands at a distinctly slower rate than it has been doing up to now. On the other hand, corporate investments will continue to expand rapidly in view of favourable earnings prospects; the fact that special depreciation on IT investments expires at the end of this year will probably lead to no more than a temporary slowdown in investment growth. This assumption is also supported by the great improvement in corporate America's international competitiveness brought about by the depreciation of the dollar, which is contributing to strongly rising exports and a somewhat slower increase in imports. Real gross domestic product expands by 3¼% next year – barely more than potential output – following an increase of just under 4½% this year. With production capacity at roughly normal levels of utilisation the American economy will for the most part enjoy a period of relaxed expansion.

In Japan the country's export-induced economic recovery has strengthened on a sustainable basis due to the fact that extensive reforms to the political and legal framework in recent years as well as measures on the part of companies to consolidate their finances have evidently made substantial progress. The large corporations in particular have experienced a fundamental improvement in their earnings situation. Under these conditions the impact of the country's expansionary monetary policy can be expected to intensify. The propensity to invest in particular will probably continue to improve, especially as private consumption continues to expand this year, buoyed up by rising employment. This development is reinforced by the gradual petering out of deflation. On the one hand there is no longer any incentive to delay purchases, and on the other hand real interest rates are falling. Even so, aggregate economic activity will expand more slowly towards the end of the forecast period, primarily as a result of the weaker impetus of foreign trade; aggregate output, which this year will be 4½% higher than in 2003, increases in 2005 by 2½%. Impulses from China in particular will decline. The loan restrictions introduced there to combat the threat of an overheating economy can be expected to lead to a perceptible slowdown in aggregate production; however, with a growth rate of 7 to 8% real gross domestic product will still increase much faster than in all the industrialised countries.

The euro area will continue to lag behind international economic developments, particularly as foreign demand stimuli will weaken in the wake of slower global economic expansion. Nonetheless, expansion in the euro area will actually tend to gain in strength. The dampening effects caused by the revaluation of the euro will diminish and monetary policy remains expansive. Recovery is still restrained, however, because overcoming the impediments of existing rigidities, widespread insecurity concerning further reforms to the political and legal framework, and considerable pressure on incomes can only take place very gradually. Even so, the euro area will be the only region in which aggregate output increases at an – albeit only slightly – faster rate in 2005 than this year. External price impulses once again delay a return to price stability; not until next spring will the inflation rate fall to the stability mark of just under 2%. Expansion in the rest of the EU will be considerably stronger than in the euro area, particularly in the countries which acceded in the spring of this year.

With expansion slowing in the growth centres on the one hand, and with the euro area economy tending to strengthen on the other, the divergences in output growth between the large regions will diminish. Even so, differences in the cyclical position of these economies remain. While output in the industrialised countries at least increases at roughly the same pace as growth potential during the forecast period, a considerable output gap continues to exist – in contrast to the USA – in the euro area in particular.

Real gross domestic product in the industrialised countries as a whole will increase at 3½% this year and at a little more than 2½% next year. Expansion in the rest of the world will be much stronger despite a pronounced slowdown. Inflation in the industrialised countries will remain calm if only because of international competition, which, if anything, will become even more intense. With growth rates of over 10% this year and at just under 9% next year, global trade will expand faster than in the past three years.

Forecast Risks

Faster expansion of the global economy during the rest of this year and in the course of next year compared to that forecast here cannot be ruled out. For example, the dynamism of the economy and the mutual amplification of economic growth under ongoing expansionary monetary policy conditions could prove stronger than forecast. However, the risk of a more pronounced slowdown in the global economy than assumed here appears greater. One uncertainty factor is the price of oil. Persistently high oil prices or still further rises would place an additional burden on global recovery. In view of the fact that oil production is largely operating at full capacity, even small output disruptions or restrictions lead to uncertainty and the fear of price increases – as can be witnessed in connection with the turbulences at Yukos. A further sustained increase in oil prices as a result of intensifying geopolitical tensions could prove to be more serious.

Over and above the loss of income this would entail, investor and consumer confidence could also decline again.

A further risk is that of renewed strong exchange rate movements. These could be triggered by the substantial US current account deficit, which is still increasing despite the depreciation of the dollar. Various studies show that a significant reduction of the deficit via the exchange rate alone would require a considerable additional depreciation of the dollar against the euro and the yen. The necessary depreciation could be considerably less if countries with high export surpluses with the USA would allow their currencies to appreciate against the dollar. However, China in particular will be keen to keep the exchange rate against the dollar unchanged, if only because of the country's substantial dollar denominated currency reserves. Conversely, other fundamental factors such as shifts in interest rate relationships could also lead to a marked revaluation of the dollar. However, this can only occur if the strong economic expansion in the USA continues. There is a further risk that the strong increase in house prices that has taken place up to now could prove to be a bubble that bursts during the forecast period. There is a not inconsiderable risk of falling house prices, particularly in those countries where prices have been rising in recent years; should this happen, global economic development could suffer a substantial setback.