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Rapid Expansion of the World Economy

2004 will go down in history as a period of rapid expansion, even though the global economic growth rate slowed markedly during the course of the year. However, it did not come to a complete standstill despite the renewed increase in the price of oil and other energy commodities. Is there a threat of stronger price rises that would "force" the central banks to renounce their expansive course of monetary policy? Will the slowdown in the rate of global output expansion continue? If so, will this be only temporary, or can perhaps a return to a markedly faster rate of expansion be expected?

Since last spring, the global economic upturn has lost momentum as a result of a renewed strong increase in the price of oil and the fading impact of economic policy stimulation (Fig. 1). Even so, output continued to increase perceptibly. This is an indication that the forces of growth have strengthened. During 2004, aggregate production probably reached a growth rate of about 3 ¾ %, its fastest for four years, largely due to its highly dynamic development up to last spring.[1] Global economic vitality is reflected in the development of world trade, which probably increased by a good 10 %.

The nature and strength of economic expansion varied greatly from region to region, however. Economic momentum was particularly strong in China, which has developed into a global economic growth centre and last year has risen to become the sixth largest economy in the world. Vigorous growth in China spread to the other emerging economies of Southeast Asia in particular. In Latin America, too, a marked upward trend has asserted itself. Expansion in the emerging economies was altogether far stronger than it was in the industrialised countries. Among the latter, aggregate output increased most rapidly in the USA. In Japan, a perceptible slowdown took place during the course of last year. However, it is the euro area in particular that continues to lag behind international economic developments.

Differences in the strength of expansion are reflected in the structure of demand growth. While domestic demand in the USA expanded at a particularly strong rate and China enjoyed high levels of both internal and external momentum, development in Japan and the euro area was primarily sustained by exports up to the summer, while domestic demand increased at a restrained rate.

The considerable differences in the expansion of real gross domestic product among the various countries and regions of the world (Table 1) are not least a reflection of differences in the growth of production potential. This is particularly strong in a number of emerging economies in East Asia, above all China. Of the large industrialised countries, it is significantly higher in the USA and the UK than in the euro area and Japan. Furthermore, production potential was utilised to quite different degrees. While the output gap in the USA, the UK and Japan has already been closed to a great extent, in the euro area it remains quite sizeable.

A major contribution to the world economic slowdown was made by the renewed surge in the price of oil that began last spring. Since all the economically weighty countries and regions are net importers of oil, they collectively suffered a loss of income due to their deteriorating terms of trade. However, in the industrialised countries the dampening effects of rising oil prices are not as severe as they were following the two oil price explosions of the mid-1970s and early 1980s. Not only has the level of oil intensity decreased, but the rise in oil prices of 80 % (in US dollar terms) since 2002 represents a considerably weaker increase than that experienced in the 1970s and 80s. Also, rather than being the result of a supply shock, as was the

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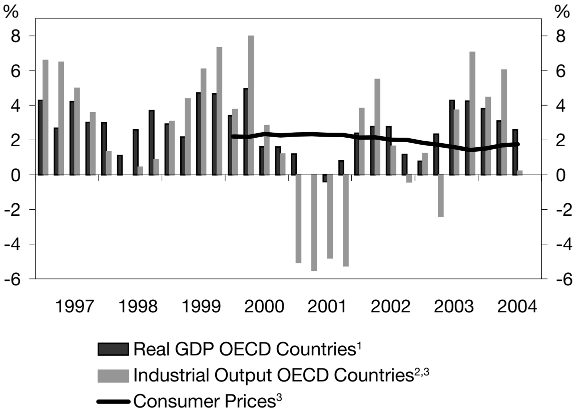
[1] Based on the US dollar-weighted gross domestic product of 2003. In the year 2000, the corresponding growth rate was 4 %. Based on the purchasing power parities used by the IMF, however, world output increased by around 5 %. According to this calculation, it was the highest increase for more than three decades. Cf. IWF: World Economic Outlook, September 2004, p. 1.

Figure 1
World Economic Indicators



[1] Seasonally adjusted, changes over preceding quarter converted into annual rates. [2] Excluding food and energy. [3] Year-on-year change.

Sources: OECD, calculations by HWWA.

case three decades ago, last year's price increase was in fact primarily caused by endogenous factors. Supply was not able to keep pace with the sharp rise in oil demand that followed the upturn in the energy hungry growth centres of the USA and China in particular, but also in the other emerging economies of East Asia and in India. The situation was exacerbated by production interruptions caused by strikes and domestic political crises as well as the forces of nature.

The indirect dampening effects of rising oil prices have been relatively slight this time, because they affected the oil importing countries during a phase of inflationary calm. While prices in these countries have increased, thanks not least to the price of oil, this effect should prove to be temporary, particularly as – in contrast to the previous price shocks – there are currently no signs of any significant acceleration in wage increases.

This is also the reason why the central banks did not have to react to oil price-related inflation by raising interest rates. Nevertheless, the reins of monetary policy were tightened in those countries where the upturn was strong. The central banks in the USA and the UK in particular lifted interest rates appreciably during the course of last year. The Chinese government introduced loan restrictions. However, in the USA as well as in Japan and the euro area – where interest rates remain unchanged at a low level – monetary policy continues to be charting an expansive course. Long-term interest rates, moreover, are still low in both nominal and real terms. A far more pronounced effect is being felt in some countries by the shift towards a

Table 1
Real GDP, Consumer Prices and Unemployment Rate in the World

	Gross Domestic Product				Consumer Prices				Unemployment Rate			
	Changes over the preceding year in %								in %			
	2002	2003	2004	2005	2002	2003	2004	2005	2002	2003	2004	2005
Industrialised countries												
EU 25	1.2	1.0	2.3	1.9	2.1	2.0	2.0	2.1	8.8	9.1	9.0	8.8
Norway	1.4	0.4	3.0	2.8	1.3	2.5	0.5	2.8	3.9	4.5	4.4	3.8
Switzerland	0.3	-0.4	1.7	1.5	0.6	0.7	0.8	1.5	3.2	4.1	4.2	4.1
Western and Central Europe[1]	1.1	1.0	2.3	1.9	-2.4	-2.5	-2.5	-2.3	8.7	8.9	8.8	8.6
Japan	-0.3	1.3	2.9	1.2	-0.9	-0.3	-0.1	0.0	5.4	5.3	4.8	4.6
Canada	3.4	2.0	2.9	2.8	2.2	2.8	1.9	2.3	7.7	7.6	7.2	7.0
USA	1.9	3.0	4.4	3.2	1.6	2.3	2.6	3.0	5.8	6.0	5.5	5.3
Industrialised countries, total[1]	1.3	1.9	3.2	2.3	1.4	1.8	2.0	2.2	7.2	7.4	7.1	6.9
Emerging economies												
Russia	4.7	7.3	6.5	6.0								
East Asia[1,2]	5.2	3.7	5.4	4.9								
China	8.0	9.3	9.3	8.0								
Latin America[3]	-0.3	1.0	4.7	3.7								
Emerging economies, total[1]	4.4	5.0	6.5	5.6								
Total[1]	1.8	2.3	3.7	2.8								
Memo item:												
Export weighted[4]	1.6	1.7	3.0	2.5								
World trade, real	3.5	5.5	10.0	7.5								

[1] Weighted with GDP of 2003 in US dollar. [2] Weighted average of: South Korea, Taiwan, Indonesia, Thailand, Malaysia, Singapore, Philippines. [3] Weighted average of: Brazil, Mexico, Argentina, Columbia, Venezuela, Chile. [4] Total of listed country groups. Weighted with shares of German exports in 2003.

Sources: Eurostat, ILO, IMF, OECD; calculations by HWWA; 2004 partly estimated, 2005: HWWA forecast.

less expansive fiscal policy. Fiscal stimulus weakened in the USA and the UK in particular.

Global Economic Imbalances

The world economic upturn was notably encouraged by generally very low interest rates on the money and capital markets. These low rates are also to be seen in connection with global economic imbalances, which became even more pronounced last year. Of particular concern is the large US current account deficit, which, despite the considerable depreciation of the dollar against the euro and the yen of more than 30 % and 20 % respectively since the start of 2002, has again increased – not least because of international differences in the dynamics of domestic demand. Last year it probably amounted to slightly more than 5 ½ % of gross domestic product.

The pull of import demand from the USA, which is reflected in the continuing rise in the country's current account deficit, provided strong demand stimulus for the rest of the world. Furthermore, interest rates in the USA – and thus, given their leading role in the global markets, worldwide – stayed at a relatively low level. In spite of a closing output gap they were even negative in real terms until most recently. This is partly due to the form of deficit financing: the high US financing requirements are covered to a considerable extent by Asian governments intervening massively in favour of the dollar to prevent an appreciation of their own currencies in order to maintain their competitive position.

However, a large or even rising government financed current account deficit is not sustainable in the longer term. What is by no means certain, however, is when the tide will turn towards a process of lasting adjustment and how rapid the adjustment will be. An abrupt end to intervention and so to this form of financing would lead to substantial exchange rate turbulences. From today's point of view, however, this is not probable.

For the forecast it is assumed that there will be no major exchange rate or interest rate shocks. Accordingly, a rate of 1.30 dollars for the euro is assumed for the year 2005. For the yen, which is currently trading at a level of a little over 102 per dollar, an exchange rate of 100 is assumed, while most other currencies remain largely unchanged in their relationship to the US dollar. As far as the price of oil is concerned, scarcely any reduction is assumed during the course of the year. As an annual average it will be similar to last year (38.5 dollars per barrel for Brent crude), and will remain subject to a high level of volatility. Since external inflationary impulses will fade under these circumstances, not least for the USA, the monetary policy reins there will continue to be tightened albeit only cautiously. In general, monetary policy continues to chart an expansive course. Fiscal policy in most of the larger countries and in the euro area is focussing on consolidation.

Rapid Expansion in the USA Continues

Although the pace of economic expansion in the USA has slowed slightly, self-supporting forces have now become well established. With corporate profits recovering strongly, growth in commercial capital expenditure was particularly dynamic. Private consumption continued its robust expansion and showed little sign of flagging regardless of the loss of purchasing power caused by the high price of oil and despite the fading stimulus from previous tax relief measures. This was primarily due to a further decline in the already low savings rate, which among private households fell to just 0.2 % last autumn.

Given the strength of economic growth and in view of the narrowing output gap, a change in US interest rate policy was implemented in order to preclude the risk of inflation. The target for the federal funds rate – which most recently stood at 2 ¼ % – has been increased by a total of 1 ¼ percentage points since last summer, weakening monetary stimulus as a result. Expansion in the house building industry has already slowed as a consequence, and as the incentives to refinance mortgages fade, one source of consumption is running dry. With the upturn well established, and in view of the resulting increase in the danger of inflation, further interest rate steps are to be expected. However, considering that fiscal policy is currently charting a more or less neutral course, and given what are still considerable uncertainties regarding the stability of the recovery, such steps will probably be taken cautiously and less rapidly than before – provided that the economy does not gather speed again, which is relatively improbable.

Uncertainty exists not least with regard to the future course of private consumption. In 2005, following the disappearance of what have up to now been its driving forces, private consumption will be determined by income developments, which will no longer be supported by tax relief measures; assuming that wage rises remain moderate, employment growth will tend to accelerate somewhat, particularly as productivity is increasing at a considerably slower rate than during the early phase of the upturn. This, together with a return to more optimistic expectations on the part of private households, points to a further marked increase

Table 2
Real GDP, Consumer Prices and Unemployment Rate in the EU

	Gross Domestic Product				Consumer Prices[1]				Unemployment Rate[2]			
	Changes over the preceding year in %								in %			
	2002	2003	2004	2005	2002	2003	2004	2005	2002	2003	2004	2005
Austria	1.3	0.7	1.6	2.0	1.7	1.3	1.8	1.7	4.2	4.3	4.5	4.4
Belgium	0.9	1.3	2.7	2.4	1.5	1.4	1.8	1.9	7.3	8.0	7.7	7.8
Finland	2.3	2.1	3.1	2.8	2.0	1.3	0.2	1.5	9.1	9.0	8.9	8.5
France	1.1	0.5	2.1	1.7	1.9	2.2	2.3	1.8	8.9	9.5	9.6	9.5
Germany	0.1	-0.1	1.7	0.9	1.4	1.1	1.8	1.6	8.7	9.6	9.8	9.8
Greece	3.6	4.5	4.0	3.0	3.9	3.4	3.0	3.5	10.0	9.7	9.3	9.5
Ireland	6.1	3.6	4.7	4.2	4.7	4.0	2.4	3.5	4.3	4.6	4.5	4.1
Italy	0.4	0.4	1.2	1.5	2.6	2.8	2.3	2.3	9.0	8.6	8.1	8.0
Luxembourg	1.1	2.1	2.2	2.0	2.0	2.6	3.1	2.5	2.8	3.7	4.2	4.3
Netherlands	0.6	-0.9	1.4	1.2	3.9	2.2	1.4	1.4	2.7	3.8	4.6	5.2
Portugal	0.4	-1.2	1.8	2.3	3.7	3.3	2.5	2.7	5.0	6.3	6.6	6.5
Spain	2.2	2.5	2.5	2.3	3.5	3.2	3.0	3.0	11.3	11.3	10.9	10.4
Euro Area[3]	0.8	0.5	1.8	1.6	2.3	2.1	2.1	2.0	8.4	8.9	8.8	8.7
Denmark	1.0	0.5	2.1	2.0	2.4	1.9	0.9	1.7	4.6	5.6	5.4	5.3
Sweden	2.0	1.7	3.0	2.8	2.0	2.3	1.1	1.8	4.9	5.6	6.3	6.2
UK	1.8	2.3	3.2	2.6	1.3	1.4	1.3	2.0	5.1	4.9	4.7	4.6
EU 15[3]	1.1	0.9	2.1	1.8	2.1	2.0	1.9	2.0	7.7	8.1	8.0	7.8
Czech Rep.	2.0	3.1	3.8	3.7	1.4	-0.1	2.4	2.5	7.3	7.8	8.4	8.2
Cyprus	2.2	2.0	3.3	3.3	2.8	4.0	1.8	2.3	3.9	4.5	5.0	5.4
Estonia	6.0	5.1	6.2	6.0	3.6	1.4	2.8	3.0	9.5	10.2	9.4	8.2
Hungary	3.5	2.9	3.7	3.5	5.2	4.7	6.8	5.5	5.6	5.8	5.8	6.1
Latvia	6.1	7.5	8.0	7.0	1.9	2.9	5.9	5.8	12.6	10.4	9.8	9.5
Lithuania	6.8	9.0	7.0	6.5	0.4	-2.1	1.2	2.5	13.5	12.7	11.0	9.5
Malta	1.5	-0.1	1.5	2	2.7	1.9	2.8	3	7.7	8.0	7.4	6.9
Poland	1.4	3.8	6.2	5.0	1.9	0.7	3.4	3.1	19.8	19.2	18.9	18.5
Slovakia	4.4	4.2	5.0	4.5	3.5	8.4	7.6	7.0	18.7	17.5	18.2	17.4
Slovenia	2.9	2.3	3.7	3.4	7.4	5.7	3.8	3.5	6.1	6.5	6.0	5.7
New Member States[3]	2.5	3.7	5.1	4.4	2.7	2.0	4.0	3.7	14.7	14.3	14.2	13.8
EU 25[3]	1.2	1.0	2.3	1.9	2.1	2.0	2.0	2.1	8.8	9.1	9.0	8.8
Memo item:												
Export weighted[4]	1.5	1.4	2.5	2.3	2.4	2.1	2.2	2.3				

[1] Harmonised Index of Consumer Prices. [2] Standardised. [3] Total of listed countries. GDP and consumer prices weighted with GDP of 2003 in US dollar; unemployment rate weighted with civilian labour force in 2003. [4] Total of listed countries. Weighted with shares of German exports in 2003.

Sources: OECD, Eurostat; calculations by HWWA; 2004 and 2005: HWWA forecast.

in private consumption. However, such increase will be substantially weaker than it has been during the upturn so far. A considerable risk with regard to the forecast is that of a marked rise in the currently low savings rate: a further increase in interest rates could reduce people's willingness or ability to enter into debt and lead to a greater inclination to save.

Commercial capital expenditure continues to expand strongly as sales and earnings prospects remain favourable, especially as the competitive position of American companies has improved considerably with the decline in the external value of the dollar against the euro and the yen. For this reason, exports will also probably continue to increase strongly in spite of slower economic growth in the rest of the world, while imports will tend to increase at a somewhat slower pace. Any decline in the negative trade balance will be slight, however. Altogether, aggregate production will continue to increase considerably. The current account deficit, of which more than two fifths relate to the economies of East Asia (2003), will continue to widen for the time being at least. Thus one grave global economic imbalance will continue to exist.

Upturn Also Slows in East Asia

In China – as in other emerging economies of East Asia – the pace of economic expansion has also slowed. This is mainly due to a combination of higher oil prices and restrictive economic policy measures, although bottlenecks in the energy and transport sectors also added to the situation. The exceedingly rapid increase in investments in plant and equipment is to be curbed – chiefly by means of administrative loan restrictions – particularly as there has been a partial misallocation of capital in the past.

The chances of a soft landing are by no means bad. Slower expansion of loans since last summer is one indication that the economic policy measures are taking effect. On the other hand, the accelerated expansion of energy generation suggests that this particular bottleneck is losing importance more rapidly than previously expected. Real gross domestic product will probably be just under 8 % higher than last year, when the growth rate probably reached a good 9 ¼ %. This being said, the rate of inflation will probably slow down once more after consumer prices recently were more than 5 % higher than the previous year's level.

In the other emerging economies of East Asia, any loss of momentum will be slight. In Indonesia in particular, the tsunami disaster will lead to markedly less growth than previously expected, whereas the influence on Thailand's real gross domestic product will probably be small.

In Japan, aggregate demand virtually stagnated during the course of the second and third quarters of last year. Export growth was considerably slower than before, while domestic demand even dropped slightly. Thus, the country's zero-interest-rate policy continues unchanged. Monetary policy is becoming more effective now that deflationary tendencies are on the wane. This supports the propensity to invest, particularly as foreign demand will increase appreciably as economic expansion in important export markets continues. On the other hand, however, exports and the propensity to invest are being inhibited by the country's loss of international competitiveness owing to the appreciation of the yen against the dollar.

Despite a return to a recovery in the course of this year, real gross domestic product will only be 1 ¼ % higher than last year, when it probably grew by just under 3 %.[2] This pace of expansion is similar to the slow rates seen during the period of cyclical weakness and poor growth up to 2002 that followed the bursting of the price bubble on the asset markets in the early 1990s; even so, a renewed relapse into a prolonged period of economic frailty is fairly improbable. One reason for this optimism is the progress that has since been made by Japanese businesses in overcoming the most important structural problems in the corporate and financial sector.

Euro Area Continues to Trail the Field

Economic development in the euro area was relatively constrained (see Table 2). Aggregate output in the first half of 2004 only expanded at approximately the same rate as growth potential, and after that was even considerably slower again. Development was shaped by foreign demand. After the middle of the year, however, exports again expanded at a slower pace as the global economy quietened down. The simultaneous acceleration of import growth reflects a somewhat faster increase in domestic demand, the expansion of which after the middle of the year was however largely due to the replenishment of inventories. One positive aspect at least is that investment in plant and equipment also increased somewhat faster despite the ongoing weak constitution of the construction sector. Consumption on the other hand remained weak. Domestic demand was appreciably dampened by the high price of oil. Above all, however, the sluggishness of the domestic economy may be attributed to fundamental structural problems in the goods and factor markets, particularly in the large member countries.

It is up to the national governments to solve the numerous structural problems hindering aggregate production growth. Various steps in the form of labour market and social reforms have been undertaken in this respect. However, these are probably not yet sufficient to trigger off any noteworthy increase in economic vitality in the short term, let alone to meet the demographic challenges ahead. The common currency area has made little progress towards the target – established in Lisbon in the year 2000 – of becoming the world's "most competitive and dynamic" region.

With regard to this objective, however, monetary policy can at best play a supporting role, as it has been doing for some considerable time now. The ECB has held its key interest rate at 2 % since the middle of 2003. The short-term real interest rate is thus about zero. Short-term interest rates are also considerably lower than the Taylor rate.[3] With the appreciation of the euro, however, the monetary conditions have developed less favourably. Last year, its external value against the dollar was a good 30 % higher than in 2002. The effective exchange rate of the euro rose by

[2] Following the recent methodological change from constant yen prices to chained-yen measures in the national accounts, the aggregate output curve was flatter than had been the case under the previous constant price method. The same is true for the forecast of last summer.

[3] On the calculation of the Taylor rate, cf. E.-U. Feldkord: Konjunkturschlaglicht: Output-Gap und Taylor-Zins, in: Wirtschaftsdienst, Vol. 84, No. 12, 2004, pp. 795 f.

more than 16 % during the same period, the increase in the effective exchange rate in real terms was even greater.[4] Bearing in mind the recent further rapid appreciation of the euro against the dollar and the related import of stability, it is unlikely that the ECB will change its key interest rate significantly this year, even though the M3 money supply is expanding faster than considered reasonable by the ECB in terms of its reference value and despite the fact that since last summer this has been due above all to a stronger increase in loans to the non-financial sector. However, inflation expectations have not increased despite higher oil prices, particularly as the threat of second round effects is small. In addition the rate of inflation, which owing to the high price of oil was 2.4 % in December on a year-on-year basis, will fall below this level again in the spring.

Fiscal policy, which if anything had an expansive effect last year, will probably be more or less neutral in 2005. According to current plans it is geared to a slightly restrictive course, with the aggregate deficit of the member countries projected to fall by 0.2 percentage points compared to last year. However, this is due in part to the – cyclically neutral – sale of assets. In order to avoid a further infringement of the 3 % limit this year, Germany, France, Greece, the Netherlands and Portugal will need to implement additional savings measures. Italy will also have to implement further measures to limit its deficit. For the forecast, however, no further savings measures beyond those so far announced are assumed. It is possible that even these will not be implemented. With all the signs pointing to an extension of the catalogue of exceptions that allow a higher deficit than 3 % in relation to gross domestic product without constituting a breach of the Stability and Growth Pact – as is currently under discussion within the framework of a reform of the Pact that is to be passed by the summer – the deficit in these countries could even turn out to be greater than so far planned.

For the forecast period, it emerges that economic vitality will be little stronger than last year. According to the expected development, the dampening effect of what continues to be a high price of oil – despite a marked fall from its record high in October – gradually diminishes, and there is also a considerable increase in deliveries to the rest of the world. One reason for this is the continuing economic expansion in the purchasing countries, including not least the new member states of the EU. However, the rate of growth will be considerably slower than in 2004; the somewhat slower expansion of the world economy is compounded by dampening effects arising from the appreciation of the euro.

Domestic demand on the other hand will probably grow at a somewhat faster rate. As sales prospects abroad begin to brighten once more, and with an investment backlog to be tackled, commercial capital expenditure will gradually recover despite the fact that the appreciation of the euro has not favoured the region's international competitiveness. Corporate earnings, moreover, have improved substantially, helped in part by ongoing wage restraint and a cyclical increase in labour productivity. Furthermore, companies have made significant progress in their efforts to improve balance sheet structures.

With little change in employment and a moderate increase in disposable incomes, private consumption improves only slightly. As wage increases remain modest, employment will pick up slowly, so that disposable income continues to increase moderately. However, purchasing power will be strengthened by a somewhat lower rate of inflation than last year. The slower rise in consumer prices compared to last year is due not least to lower oil prices and the import of stability resulting from the euro's high rate of exchange. In addition, the inclination to consume could improve somewhat, due in part to the fact that the uncertainty that arose in the wake of labour market and social reforms in a number of countries should recede.

For the year as a whole, real gross domestic product in 2005 will grow at roughly the same rate as in 2004. Under these circumstances there will be no far-reaching improvement in the labour market situation. Employment will increase by varying degrees, however, as a result of labour policy measures, but not always in the form of regular private-sector jobs. Any appreciable fall in unemployment will probably not take place until the latter part of the year.

Risks for the Global Economy

Altogether, the global economy remains on a distinctly expansive path. Nonetheless, growth for the year as a whole will be lower than during the upturn so far. This is reflected in the development of world trade, which will probably grow by 7 % in 2005, following a good 10 % in 2004.

This forecast is subject to considerable uncertainties, however. On the one hand there is a chance that

[4] These figures refer to exchange rate developments vis-á-vis 23 countries. The real effective exchange rate is calculated on the basis of consumer prices developments. The use of other deflators leads to similar results. Cf. ECB, Monthly Bulletin, December 2004, p. 67.

the economic development will be stronger than predicted. China's dynamism, for example, could prove to be more robust in the face of the government's containment measures than forecast. Similarly, it cannot be ruled out that the price of oil may fall further than assumed here, thus providing a positive stimulus for the oil importing countries.

On the other hand, however, the downside risks appear greater. For instance, given the high level of production capacity utilisation and a further, if – due to the more restrained nature of global economic development – slower, rise in oil demand, the price of oil could turn out to be higher than assumed here, particularly as the elasticity of supply can be expected to remain low. A further considerable risk for the global economy lies in the possibility that the sharp increase in the US current account deficit together with the large budget deficit could further shake the currency markets' confidence in the dollar and so trigger off substantial exchange rate changes. In view of the fact that most Asian currencies are either pegged to the dollar or operate a managed floating regime, the euro in particular could remain under substantial upward pressure. However, the gradually increasing interest rate spread – assumed here – that favours dollar assets over euro investments, as well as the greater momentum of US expansion both work to relieve this pressure.