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World Economic Situation Remains Precarious

Global production increased at a rate of just 2% in 1998, half the previous year's growth. The USA and the EMU member countries in particular were spared a recession thanks to robust domestic demand. With continuing volatility on the financial markets, the world economic situation remains precarious.[1] How can we expect the world economy to develop in the next two years?

Renewed turbulence on the international financial markets in the second half of last year further darkened prospects for the development of the world economy. Although the financial market situation in the emerging economies of Southeast Asia which suffered a severe financial and currency crisis in the second half of 1997 has now been improving for some time, new crises erupted in Russia and Latin America. The decision taken by the Russian government in August to suspend foreign debt service sent shock waves around the globe. A worldwide re-assessment of liquidity risks ensued, with overriding priority being given to investment security. Capital flowed out of the emerging economies once more, this time including Latin America. But in the industrialised countries, too, share prices tumbled by up to 30% in the space of just a few weeks.

Marked Global Downswing

With the adverse developments on the financial markets, the economic situation in the USA and Western Europe deteriorated considerably. Fast-growing pessimism among enterprises and private households with regard to economic prospects – which had been improving up to the summer – was fuelled by a growing anxiety that with ever more regions of the world sliding into recession, the economies of Western Europe and the USA would come under increasing strain, as well as by fears that in the industrialised countries, too, the financial crisis could spread to the real economy.

Not only Russia – where national production had appeared to be on the verge of stabilising after its steep decline during the earlier years of the decade – stood on the brink of further economic collapse following the outbreak of the rouble crisis. In Latin America, too, a marked slowdown in production growth began to become apparent, primarily as a result of – in part substantial – interest rate increases aimed at preventing a decline in exchange rates. Furthermore, production in the Southeast Asian newly industrialised economies continued to fall. The fact that the economic crisis in Southeast Asia turned out to be longer and more profound than initially expected is partially due to the surprisingly severe and drawn out recession in Japan where, in spite of massive attempts to kick-start the economy, real gross domestic product has now been in strong decline for more than a year. In China and Taiwan, meanwhile, gross domestic product continued to increase markedly in real terms. Altogether, the countries currently beset by recession account for approximately two fifths of the world economy.

The collapse of these countries' imports also had a dampening effect on the western industrialised economies. In the USA and Western Europe, however, domestic demand proved relatively robust, at least until last autumn. In the meantime, early indicators and developments in the economic climate have begun to point to a marked slowdown in economic expansion in these regions too.

Employment Situation

The global employment situation has worsened considerably as a result of the poor state of the world economy. The number of jobs fell markedly in the crisis economies and there was a strong increase in unemployment. Some Southeast Asian countries experienced growing social and political tension; the blow of losing employment – which in these countries

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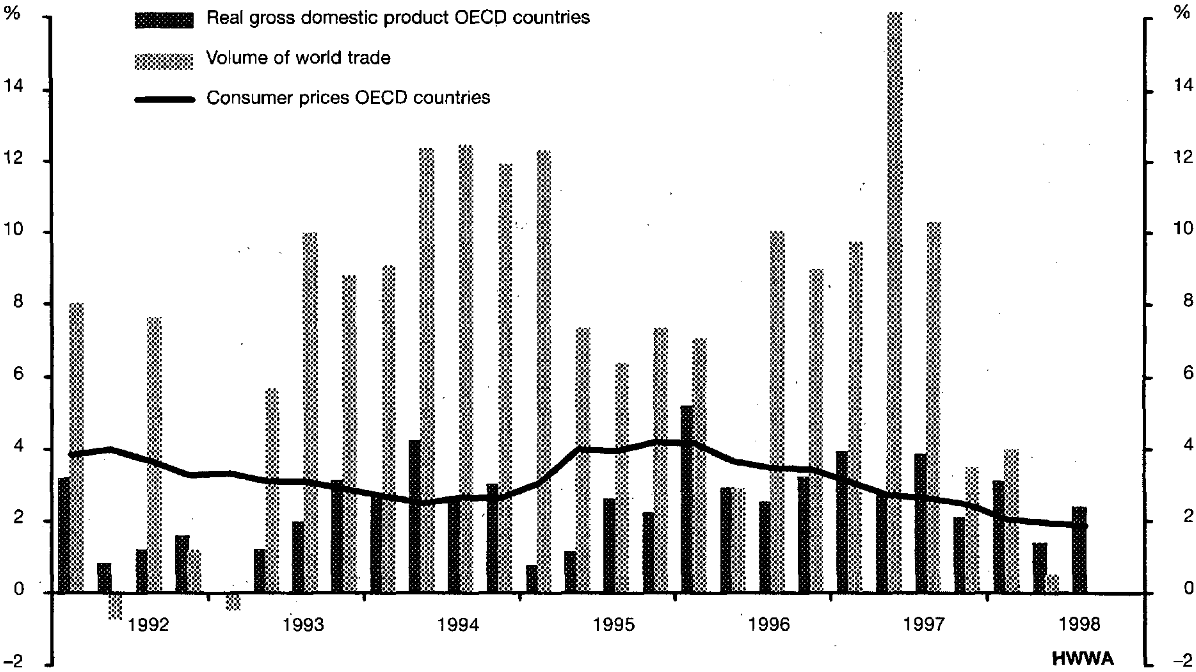
[1] For an in-depth analysis of economic developments see G. Weinert, E. Wohlers et al.: HWWA Report No. 188, 1999.

Figure 1
Economic Indicators[1]



[1] Changes over previous quarter, projected to annual rates; world trade seasonally adjusted according to ASA II (HWWA version); consumer prices (excluding Trukey): year-on-year comparison in %; partially estimated.

Sources: OECD; IMF; own calculations.

is seldom softened by the provision of social welfare – plunges many people into poverty. In Japan, too, the labour market situation has deteriorated considerably. Jobs were lost not least in the course of corporate collapses. However, large companies which had never previously experienced redundancies also reduced staff levels.

The unemployment rate in Japan has now risen to 4.4% of the labour force, the highest level for decades. For the first time since the second world war it is no longer lower than in the USA,[2] where it is tantamount to full employment. Only in the course of last year did employment growth in the USA begin to slow down markedly. While employment in Western Europe has been on the increase again for some time now, growth rates remain subdued. Unemployment here is far higher than in the USA.

Price Stability in Industrial Countries

As the world economy cooled down, prices for individual categories of goods developed in quite disparate ways. Commodity prices, for example, fell again markedly last year. The decline was strongest in the case of crude oil, where prices fell by a good 40% to their lowest level since mid-1986. Deflated using prices for industrial products, oil prices have even approached the levels seen before the first oil crisis. Following the further intensification of competition, prices for internationally traded industrial goods have been virtually constant for some time now. The marked decline in capacity utilisation in Japan and in the other countries of Southeast Asia – but also, albeit on a much higher level, in the USA – has been a contributing factor here.

All in all, price levels for private consumption in the USA and Western Europe have remained practically unchanged for some time now, thanks in part to the marked decline in import prices. Only in Japan, where the official increase is zero, is it likely that prices have actually tended to fall slightly. In contrast, price levels have increased markedly in a number of newly industrialised economies where there has been a stronger fall in the external value of local currencies. While devaluation was the cause of strong price rises in some regions such as Southeast Asia, in others it "compensated" for faster internal price increases, as was the case in central eastern Europe.

[2] Unemployment rates for individual countries are comparable to a limited extent only because of differences in the statistical methods applied. This is particularly true of Japan where the level of unemployment is clearly understated.

Particularly as a result of the crisis in East Asia there have been marked shifts in foreign trade balances. For example, since exports have been falling for some time and there has been a sustained increase in imports, the USA's trade deficit has again seen a marked increase, and trade surpluses in Western Europe have dwindled. These developments stand in particularly stark contrast to those in the crisis economies of East Asia which have seen a dramatic turnaround from the relatively large trade deficits which helped contribute to the outbreak of the crisis in 1997, to large surpluses. However, since these surpluses are primarily the result of lower import levels, related demand impulses have been slight and in Japan the "structural" surplus position has increased still further.

Falling Interest Rates

However, the financial and economic crisis in a number of newly industrialised economies also gave rise to factors which bolster domestic demand in the industrialised countries. For example, further falls in commodity prices have lowered companies' production costs as well as strengthening real incomes and thus also private consumption. In addition, capital market interest rates fell markedly as capital was redirected towards safe investments – especially US and Western European government bonds – and inflation expectations fell further, but also as a result of weakening global capital demand.

Since last autumn in particular, the fall in interest rates has been assisted by reductions in key lending rates in the USA and also – in a coordinated action – in the EMU member countries. The speed of monetary expansion – which was in line with potential in the EMU countries last year and which in the USA, if anything, even tended to overshoot this mark – did not call for interest rate steps of this nature. The decisive factors behind the interest rate reductions were the unfavourable economic outlook in conjunction with sustained price stability. Particular cause for alarm was given by clear indications in the USA that companies' scope for financing business undertakings was deteriorating fast. It is probably fair to assume that last autumn's massive collapse of share prices – and the attendant danger of a significant weakening of private consumption – was also partly responsible.

With a discount rate of 0.5% in place since autumn 1995, Japan has largely exhausted its potential for using interest rate policy to stimulate the economy. Key rates in the East Asian crisis economies, which were subject to a substantial increase when the financial crisis erupted, have now been lowered again significantly. In real terms, however, they remain relatively high. This is also true of Latin America; in Brazil in particular they remain at a level which is unsustainable for the real economy over any period of time.

Relaxation of Monetary Policy

On the whole, and taking into consideration the particular weight of the industrialised countries, monetary policy across the world has been relaxed markedly in recent months. The spread between long-term and short-term interest rates in the industrialised countries, which had become very small in the course of last year, has increased only slightly since key interest rates were reduced. This is one major reason why calls for further interest rate reductions can be heard from a variety of quarters. On the whole, however, monetary indicators give little ground for further interest rate moves. Developments on the financial markets also indicate a sufficient provision of liquidity in the industrialised countries. With long-term interest rates established at a low level, share prices have risen again to the levels seen before the crash of late summer last year, such that any demand-dampening effects resulting from a related loss of wealth should remain slight.

EMU Fiscal Policy Charts Neutral Course

Under these circumstances, the central banks can be expected to stick to their present course of slightly stimulatory monetary policy, for any further interest rate reductions would engender a considerable risk of an unwanted strong price increase in the medium term – similar to the one experienced following the marked relaxation of monetary policy in 1987. However, should there be any signs of an enduring economic downturn, or should greater risks to the economy emerge – as a result of renewed turbulence on the international financial and foreign exchange markets, for example – then a marked reduction of key interest rates in the industrialised countries would be probable.

The general relaxation of monetary policy was complemented last year in the EMU countries by a new fiscal policy course which at least no longer had any dampening effects on the economy. Following their drastic reduction under the pressure of Maastricht in the previous two years, overall government deficits fell only slightly last year, if at all, and this was solely due to the economic cycle. This year and next should see fiscal policy in the EMU on a neutral course. The same is true of the USA where the long-running upturn has helped produce a state budget surplus again for the first time in decades. In November, in contrast, the Japanese government massively strengthened its expansive fiscal course – which, however, had only replaced the previous, distinctly restrictive, regime early last year – after the extensive stimulatory programme which was introduced last April largely failed to put a brake on the recession. The two programmes, which above all allow for additional expenditure, but also a – now permanent – reduction of income and corporation taxes, have a combined volume amounting to a good 8% of GDP. However, only part of this – albeit a considerable part – directly affects demand.

In most of the crisis economies, fiscal policy is of a restrictive nature. In view of the high levels of public deficit in Latin America in particular, and especially in Brazil and Mexico, the need for consolidation is great. In the East Asian crisis economies, where there is increasing evidence that confidence in the economy is returning, a further relaxation of fiscal policy can probably be expected.

Forecast Assumptions

Within the framework of global economic developments there are a number of endogenous variables which, from the point of view of individual economies, appear exogenous. Commodity prices are one example. Nonetheless, a number of assumptions have to made for the global economic forecast, too. This is particularly true in a period as precarious as the present, in which the propensity towards major state intervention in the international economic order is strong. Attempts could thus be made to apply intervention and regulation in order to "rectify" the results of market interactions which are to be expected from the further development of the world economy.

For the forecast it is assumed here that

☐ renewed efforts on the part of important oil exporting countries to significantly raise oil prices will again be unsuccessful in this forecast period;

☐ no new currency and financial crises will flare up;

☐ increasing current account deficits will be accepted by the western industrialised countries and the degree of international trade and services liberalisa-

Table 1
Economic Indicators

	Real Gross Domestic Product (Year-on-year change in %)				Consumer Prices (Year-on-year change in %)				Unemployment Rates[1] (Annual Average)			
	1997	1998[a]	1999[b]	2000[b]	1997	1998[a]	1999[b]	2000[b]	1997	1998[a]	1999[b]	2000[b]
USA	3.9	3.8	1.8	2.2	2.3	1.6	1.8	2.2	4.9	4.5	4.7	4.8
Canada	3.8	2.9	2.0	2.3	1.6	1.0	1.5	2.0	9.2	8.4	8.5	8.5
Japan	1.4	-3.0	-0.3	1.5	1.8	0.7	0.0	0.5	3.4	4.1	4.8	4.8
Austria	2.5	3.3	2.2	2.8	1.3	1.0	1.3	1.5	4.4	4.4	4.4	4.2
Belgium	2.9	3.0	2.0	2.3	1.6	1.0	1.3	1.5	9.2	8.8	8.5	8.3
Denmark	3.7	2.3	1.9	2.0	2.1	1.8	2.0	2.3	5.5	4.7	4.4	4.3
Finland	5.9	4.8	2.7	3.5	1.2	1.5	1.8	2.0	13.1	11.8	11.0	10.4
France	2.3	3.0	2.1	2.5	1.2	0.7	1.0	1.2	12.4	11.9	11.7	11.4
Germany	2.2	2.8	2.0	2.7	1.8	1.0	1.1	1.5	10.0	9.8	9.5	9.2
Greece	3.2	3.0	3.0	3.0	5.6	4.5	3.5	3.0	10.0	9.6	9.4	9.2
Ireland	10.6	9.0	6.0	8.0	1.4	2.5	2.2	2.4	10.1	9.0	8.3	7.8
Italiy	1.5	1.5	2.0	3.0	1.8	1.8	2.0	2.0	12.1	12.3	12.1	11.5
Luxembourg	4.8	4.2	3.3	3.8	1.4	1.0	1.3	1.5	3.2	3.0	2.8	2.8
Netherlands	3.3	3.7	2.2	2.7	2.1	1.7	2.0	2.2	5.2	4.0	3.6	3.5
Norway	3.4	2.7	1.8	2.0	2.5	2.5	3.0	2.8	4.1	3.3	3.2	3.2
Portugal	3.7	3.9	2.7	3.0	2.3	2.5	2.5	2.5	6.8	4.9	4.3	4.0
Spain	3.5	3.8	3.0	3.5	2.0	2.0	2.2	2.3	20.8	18.8	17.2	16.0
Sweden	1.8	2.8	2.0	2.5	0.9	0.5	1.0	1.3	9.9	8.2	7.5	7.2
Switzerland	1.8	2.2	1.5	2.0	0.6	0.0	0.5	0.8	4.4	4.0	3.8	3.5
United Kingdom	3.5	2.7	0.7	1.5	3.1	3.3	2.7	2.5	7.0	6.3	6.5	6.5
Industrial countries (total)[2]	2.9	2.1	1.5	2.2	2.0	1.4	1.4	1.7	7.3	7.0	7.0	6.9
Western Europe[2]	2.7	2.8	1.9	2.6	1.9	1.6	1.7	1.8	10.5	9.9	9.5	9.2
European Union[2]	2.7	2.9	2.0	2.6	1.9	1.6	1.7	1.8	10.7	10.1	9.8	9.4
EWU[2,3]	2.5	2.9	2.2	2.7	1.7	1.3	1.5	1.7	11.7	11.2	10.7	10.3

[1] Standardised in % of labour force. [2] Weighted by gross domestic product, unemployment rates by the 1997 labour forces. [3] Member countries of the European Monetary Union. [a] Partially estimated. [b] Forcecast; country figures rounded.

Sources: OECD; European Commission; national statistics; 1998: estimates; 1999 and 2000: HWWA forecasts.

tion so far achieved will not be cut back by protectionist measures;

☐ the *reforms of international financial structures* which have become necessary following the crises of recent years will adhere to the principles of free capital flows and liberal financial market constitutions;

☐ no significant disturbances will result from the so-called millennium bug.

Stimuli for Demand and Production

Under these circumstances, the macropolitical environment – which has on the whole become considerably more favourable – and the further reductions in capital market interest rates – especially in the industrialised countries – point to significant stimuli for demand and production during the rest of this year. Furthermore, the dampening influences from the rest of the world will begin to subside.

Although the rapid decline of demand and production in Russia will continue as the country's reform deficits remain as huge as ever, and there will be a further significant slowdown of economic activity in Latin America, there are signs that production could be stabilising in the crisis economies of East Asia. The noticeable relaxation of monetary and fiscal policy which, accompanied by what have become large current account surpluses, has also taken place in these countries, along with the fact that the pronounced liquidity fix experienced during large parts of last year has been overcome and the massive depletion of stockpiles and the contractive effects this entailed have come to an end, all give good reason to expect an upward trend, albeit of modest proportions, during the rest of the year. This trend will be favoured by the expected stabilisation of demand and production in Japan, not least as a result of the massive fiscal stimulation measures there.

Thus the dampening effects felt in the USA and Western Europe which were caused by the collapse of production in the crisis economies will weaken. However, the after-effects of the exchange rate induced deterioration of US and Western European competitiveness compared to the crisis economies will continue to be felt for some time to come. Furthermore, there will be little respite from the pressure on profits induced by foreign trade, since any imported cost relief will peter out with the expected stabilisation of prices for oil and other commodities.

In the USA, moreover, the fact that private consumption will expand at a considerably slower rate will have a dampening effect on investments, if only because the savings rate – in the third quarter the country's entire disposable income was used for consumptive purposes – should increase again. Under these circumstances, US real gross domestic product will expand at a noticeably slower rate this year and next than in 1998. While in the EMU the propensity to invest will be dampened by the markedly weaker development of foreign demand seen over recent months, the favourable monetary environment in particular should limit the detrimental effects, especially as the proportion of trade with the rest of the world is relatively small.

Global Production Weak This Year

In addition, private consumption is more likely to increase at a faster pace than last year thanks to a noticeable rise in real income, due not least to stability and employment. In contrast, virtual stagnation can be expected in the United Kingdom in particular this year, induced by policy measures geared to stabilising the economy. It should be overcome next year, thanks in particular to a further marked relaxation of monetary policy. Altogether, world production this year will be about as weak as last; slightly higher growth rates are not expected until next year.

Prices in the western industrialised countries will probably tend to rise again in the further course of the year – albeit slowly, if only because on the whole any increases in wage settlements will be little higher than in the recent past. As the world economy recovers during the course of the rest of the year the decline in global commodity prices can also be expected to come to a halt; however, in view of the fact that improvements in the world economy will be only very gradual, the price rise expected in the latter part of the year will remain moderate. At the same time, the price rises induced by local currency devaluation will subside in most of the newly industrialised economies. These trends will continue next year.

There will be further shifts in current account balances, if only because of the continuing differences between the economic cycles in the various countries and regions. The trend towards surpluses in those countries with a high production gap is an important prerequisite for economic recovery there. As the situation gradually stabilises, however, these surpluses – in contrast to last year – will be increasingly sustained by exports and so will contribute to the recovery of the world economy as a whole. The USA and Western Europe will have to accept the current account deficits which nonetheless continue, especially as converse tendencies – induced not least by exchange rate adjustments and increasing stability in the crisis economies – will assert themselves in the longer term. Protectionist measures on the other hand would be an impediment to world economic recovery.

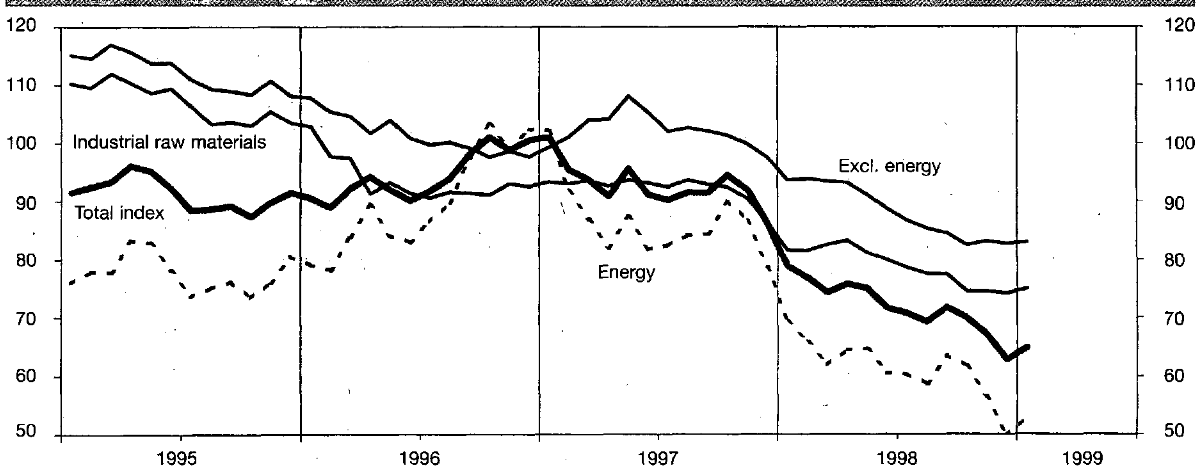
Uncertainties

This forecast is subject to a high degree of uncertainty which goes far beyond the "normal" difficulties of determining turning points and subsequent rates of development. In Latin America, the developments assumed here depend not least on the implementation of budgetary consolidation, particularly in Brazil, in line with IMF agreements. In a number of other countries there are far-reaching fundamental structural and institutional weaknesses to be surmounted. This is true not least for the financial sectors which, as a result of unrealistic valuation of receivables, excessive debts and under-capitalisation, tend to be unstable – not only in developing countries and newly industrialised economies but also in Japan. Although the reconstruction measures implemented so far have in most cases stabilised the financial sector, there nonetheless remains a large risk of further bank collapses with destabilising tendencies for the national and international financial markets. Such developments defy forecasting.

After the repeated and sometimes drastic downward revision of world economic forecasts made over the past two years, there is also a chance that recovery could be faster than is considered probable here. In the East Asian crisis economies in particular, the upturn which follows stabilisation could prove more forceful than expected. In Japan, too, a stronger recovery following the deep recession cannot be ruled out, although this would probably not become apparent until the year 2000. All in all, the danger of a less favourable development than forecast is considerably greater.

HWWA Index of World Market Prices of Raw Materials[1]

(1990 = 100)



Raw Materials and Groups of Materials[1]	1998	July 98	Aug. 98	Sep. 98	Oct. 98	Nov. 98	Dec. 98	Jan. 99[2]
Total Index	72.0 (–22.4)	70.7 (–21.6)	69.2 (–24.3)	71.8 (–21.5)	69.9 (–26.0)	67.0 (–27.0)	62.8 (–27.1)	64.8 (–17.9)
Total, excl. energy	88.2 (–13.7)	86.7 (–15.1)	85.3 (–16.8)	84.6 (–17.2)	82.5 (–18.5)	83.2 (–16.6)	82.8 (–15.1)	83.0 (–11.3)
Food, tropical beverages	115.8 (–12.2)	110.6 (–15.2)	108.5 (–16.0)	105.6 (–18.3)	106.3 (–16.8)	109.0 (–14.7)	108.2 (–17.3)	106.6 (–17.4)
Industrial raw materials	78.9 (–14.5)	78.6 (–15.0)	77.6 (–17.2)	77.5 (–16.6)	74.5 (–19.4)	74.5 (–17.5)	74.2 (–13.9)	75.0 (–8.1)
Agricultural raw materials	79.3 (–14.4)	79.0 (–13.6)	78.1 (–15.9)	77.9 (–17.3)	74.4 (–21.3)	74.6 (–19.2)	75.8 (–13.6)	77.7 (–4.0)
Non-ferrous metals	71.1 (–20.8)	69.7 (–24.8)	69.0 (–26.4)	69.8 (–21.5)	67.5 (–21.8)	67.6 (–19.1)	64.6 (–18.1)	63.6 (–16.8)
Energy	61.4 (–29.0)	60.3 (–26.9)	58.7 (–30.3)	63.4 (–24.9)	61.7 (–31.4)	56.5 (–34.8)	49.7 (–36.8)	52.9 (–23.7)

[1] On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.
[2] Up to and incl. 22nd January.