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Increased Risks for the World Economy

Last year again saw a rapid increase in global production, with growth of around 4%. However, the deep financial crisis in Southeast Asia led to considerable retarding influences during the second half of the year. In some quarters it is even feared that the crisis could spread to other regions, culminating in worldwide deflation or even depression. Are such fears justified?

Rapid economic growth in the newly industrialised economies of Southeast Asia had for some time been accompanied by increasing macroeconomic imbalances and growing structural problems. Yet despite high current account deficits and foreign liabilities, the influx of – largely short-term – foreign capital initially continued unabated. Together with domestic debtors, foreign investors and creditors were apparently confident that fixed exchange rates would remain in place. In early July, however, Thailand was no longer able to withstand the pressure on its currency. With the baht no longer pegged to the dollar, capital fled the country thus triggering currency depreciation as well as a decline in share prices and property values; the banking and financial system was thrown into increasing turmoil. At the same time, other countries in the region were "revalued" and the financial crisis spread to Malaysia, the Phillipines and Indonesia.

Financial Crisis in Southeast Asia

Having been confined to a few Southeast Asian countries for some time, the financial crisis spread to other regions in October. While share prices fell sharply on almost all the world's stock exchanges, they recovered quickly – particularly in North America and Western Europe – though previous levels were not reached. Currencies also came under pressure in other newly industrialised economies, but swift adjustment measures – often in the form of considerable interest rate increases – prevented a free fall. In the Far East, however, the crisis spread to other countries and to South Korea in particular. The Taiwanese currency, too, was finally forced to devalue. Only Hong Kong was able to withstand the pressure by means of a drastic increase in interest rates. In spite of extensive supportive measures from abroad, the financial crisis in most of the Far Eastern tiger economies continues, not least because some governments are hesitant in introducing necessary adjustments to their economic policy. This gives rise to fears that the crisis could become a global problem.

There is a particular risk of the "Asian flu" being transmitted to other regions via global financial markets and international trade connections. In the financial sector, the high level of foreign debt in the "problem" countries is a particularly significant risk factor given that almost two thirds of all bank loans are short-term. However, with extensive international assistance and debt re-scheduling on the one hand, and with an increasing readiness on the part of most of the countries affected to implement fundamental reforms and to restructure their banking sectors on the other, it should prove possible to master the financial crisis successfully. Moreover, the banking systems of North America and Western Europe are in a healthier state than they were in the early 1980s and can better "cope" with write-offs of uncollectible receivables.

However, the bulk of these receivables is owed by the newly industrialised Asian economies to Japanese banks, whose long-running consolidation efforts will suffer another setback as a result of necessary valuation adjustments. Not least as a result of state support, however, it should prove possible to avoid far-reaching disruption of Japan's financial system.

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Furthermore, those bodies responsible for monetary policy in the larger industrialised countries are aware of the "sensitive" condition of the financial markets and are acting accordingly. This is particularly true of the US Federal Reserve which has announced that a – generally expected – increase in interest rates will not take place in the short term. All in all it is assumed that the current debt crisis in the Far East will be mastered in much the same way as the – probably graver – crisis of the early 1980s.

Forecast Assumptions

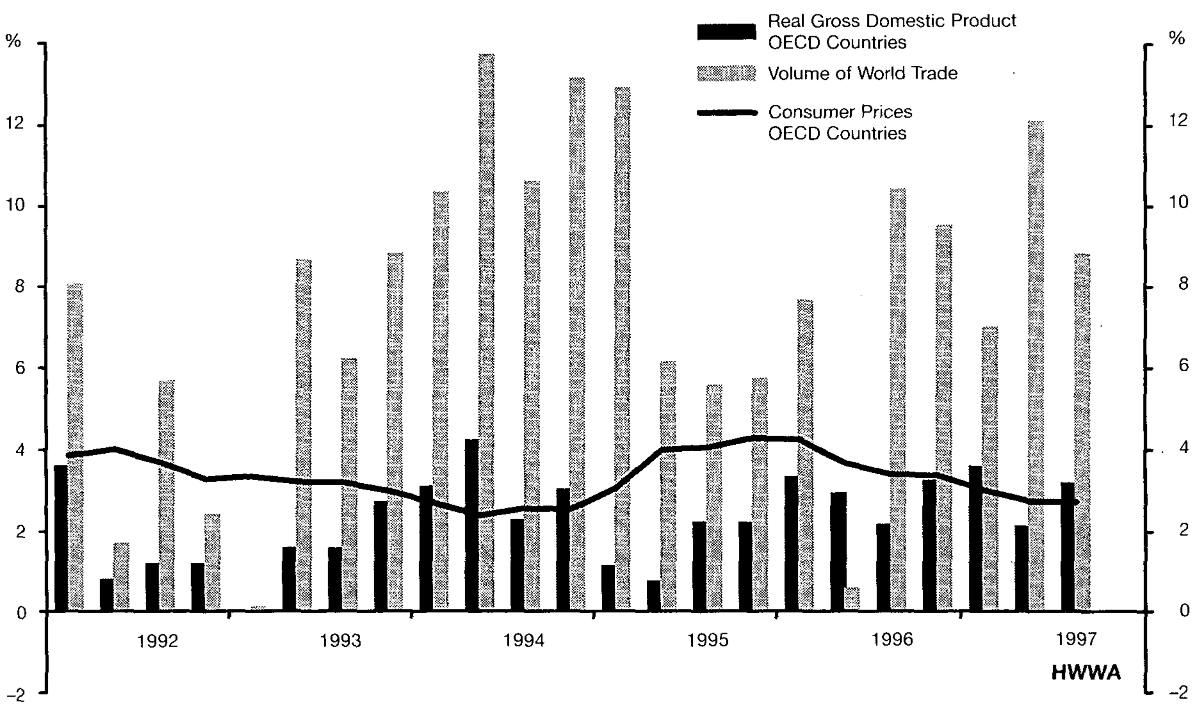
The forecast thus assumes that, as far as the debt aspect of the Far Eastern crisis is concerned, there will be no massive disruption of economic developments in the rest of the world. However, there has been a general increase in "risk premiums" for the "emerging markets". Growth prospects will suffer as a result of higher interest rates, not least in Eastern Europe and Latin America.

Once a credible concept for solving the debt crisis is found, the exodus of capital from Eastern Asia will also come to a halt. Moreover, in view of the excessive devaluation of the "crisis currencies", a subsequent influx of capital would probably ensue such that a trend towards revaluation could prevail. For this reason, the forecast is based on average US dollar exchange rates for 1998 which correspond to those valid at the end of 1997. The exchange rates of the industrialised countries' currencies are assumed to remain at these levels.

The fall in share prices in the East Asian NIEs will come to an end when a solution to the debt crisis is found and exchange rates are stabilised. For this reason another stock exchange crash in the industrialised countries – which would have marked dampening effects on the economy – is ruled out.

These assumptions may appear optimistic given the ongoing crisis. Less favourable developments would have to be expected if tensions in the financial markets were to come to a head, particularly if this were the case in Japan – the world's largest lending nation and its second largest economy. However, supportive government action for the Japanese banking system should prevent this from happening.

Figure 1
Economic Indicators[1]



[1] Current annual rates; consumer prices (excl. Turkey): change over the previous year in %; partially estimated.

Sources: OECD; IMF; HWWA calculations.

Dampening Effects

Nonetheless lasting effects can be expected to ensue as a result of international flows of goods and services. These effects arise from a severe weakening of economic expansion in the "problem" countries and, above all, as a result of drastic shifts in exchange rate relationships. Initially, growth in the "problem" countries will slow down markedly. Political reforms, which ultimately imply the liberalisation of a number of sectors and thus stronger competition, will be introduced alongside macroeconomic restrictions in order to dismantle structural imbalances. Domestic demand will level off strongly at first, and in some countries it will even fall for the first time in years.

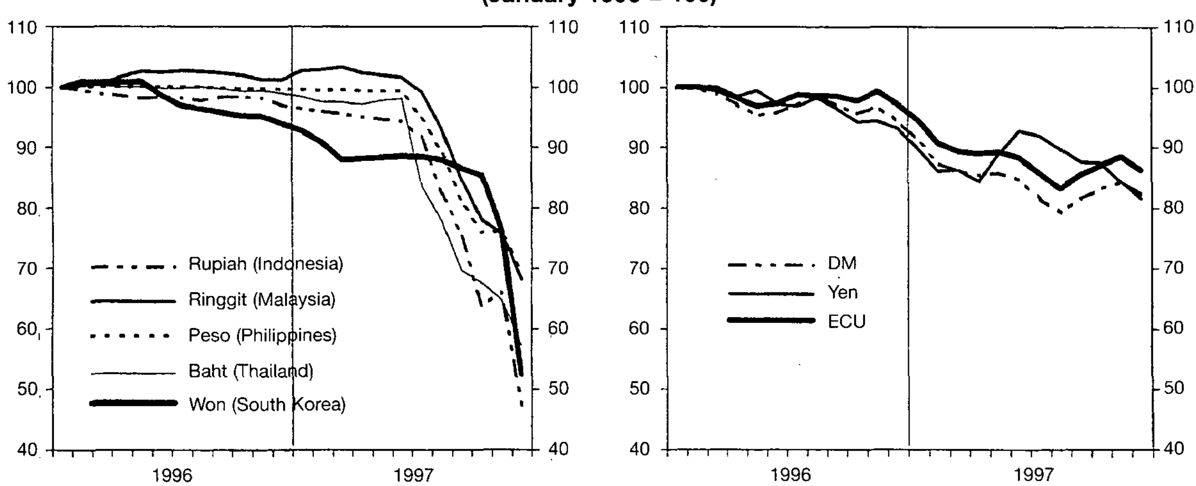
In contrast, foreign trade will provide a strong economic stimulus, particularly as a result of drastic improvements in international competitiveness brought about by devaluation; in the second half of 1997, the value of most currencies against the dollar fell by almost fifty per cent (see Fig. 2). Given the weakness of domestic demand, the Far Eastern NIEs will use this competitive advantage to mount an export offensive. Since there is hardly any scope for increasing the exchange of goods between the relatively close-knit countries of Southeast Asia, we can expect significant growth in exports to other regions, particularly to North America and Western Europe. Under these circumstances there should be a drastic improvement in the contribution made by foreign trade to the economy. Thus real gross domestic product for the year is likely to be slightly higher in 1998 than it was in 1997.

This will have a dampening influence on the rest of the world. The consequences will vary depending on the intensity of each country's trade relations with the Far East. Japan is comparatively badly affected due to its close foreign trade connections in the region: around one fifth of Japanese exports are sent to its Asian neighbours and one sixth of its imports come from there. In the USA and Western Europe, Southeast Asia accounts for a far smaller proportion of foreign trade.

In addition to the direct effects which result from bilateral trade relationships, improvements in the international competitiveness of Far Eastern companies in other markets will have a further dampening influence. At the cost of the industrialised countries, Southeast Asia's newly industrialised economies will thus increase exports to North America and Western Europe in particular. Altogether, the degree to which the industrialised economies are affected by direct and indirect trade will vary from country to country. The effects will be far more pronounced in Japan than in the USA or Western Europe.

As a result there will be changes in the balances on current account, some of them drastic. Initially, shifts in the terms of trade will simply conceal these changes. In the newly industrialised economies of Southeast Asia the existing high deficits will probably

Figure 2
Exchange Rates of Selected Currencies to the US Dollar
(January 1996 = 100)



Sources: Deutsche Bundesbank; IMF; PACIFIC Exchange Rate Service.

be eliminated to a great extent, and in Japan the surplus will surely increase further. On the other hand, the surplus in Western Europe will diminish and the already high deficit in the USA will increase once again. This could lead to new trade conflicts. For this forecast, however, it is assumed that no significant protectionist tendencies will arise; such developments would make it more difficult to overcome international financial problems and would thus increase the dangers for the development of the world economy.

Renewed Economic Weakness in Japan

The influence of external shocks on the short-term economic development of a particular country does not only depend on their "numerical" significance for its foreign trade movements, however, but also on the current economic "status" of that country. From this point of view, Japan appears to be particularly badly affected. The dampening influence on Japanese exports, which is relatively strong compared to other industrialised countries, comes during an ongoing phase of economic weakness and sluggish growth. A recovery seemed to take hold during the winter six months last year: export growth accelerated fast, due not least to the marked fall in the external value of the yen which began in spring 1995, and there was also a strong rise in domestic demand. The upturn did not continue, however, primarily as a result of fiscal restrictions which were dampening private consumption severely. Indeed, as a result of a marked reduction in public expenditure (including investments in new equipment by public enterprises) and a drop in private housing construction investments, domestic demand last year was slightly lower than in 1996. Since the summer, export growth has also slowed markedly, not least as a result of the economic crisis in neighbouring countries. Thus, for the year as a

Table 1
Economic Indicators

	Real Gross Domestic Product (Year-on-year change in %)					Consumer Prices[1] (Year-on-year change in %)					Unemployment Rates[2] (Annual average)				
	1987 to 1995[a]	1996	1997[b]	1998[b]	1999[b]	1987 to 1995[a]	1996	1997[b]	1998[b]	1999[b]	1986 to 1995[a]	1996	1997[b]	1998[b]	1999[b]
USA	2.3	2.8	3.75	2.25	2.0	3.7	2.9	2.25	2.0	2.5	6.3	5.4	5.0	5.0	5.0
Canada	2.1	1.5	3,75	3.0	2.5	3.3	1.6	1.5	1.5	1.5	9.5	9.7	9.25	9.0	8.75
Japan	3.0	3.9	0,75	0.75	2.0	1.4	0.1	1.7	0.75	0.5	2.5	3.4	3.25	3.5	3.5
Austria[2]	2.6	1.3	2,0	2.25	2.5	2.8	1.9	1.25	1.25	1.5	5.2	4.4	4.5	4.25	4.0
Belgium	2.3	1.5	2.25	2.75	2.5	2.4	2.1	1.6	1.5	1.75	8.6	9.8	9.5	9.5	9.25
Denmark	1.5	2.7	3,0	2.5	2.8	2.9	2.1	2.0	2.5	2.5	10.0	6.9	6.5	6.0	5.75
Finland	1.3	3.3	5.0	4.0	3.0	3.7	0.6	1.25	1.5	2.0	9.6	15.3	14.5	13.5	12.5
France	2.1	1.5	2.25	2.75	2.75	2.7	2.0	1.25	1.5	1.75	10.4	12.4	12.5	12.25	12.0
Germany[3]	2.3	1.4	2.3	2.6	2.6	2.7	1.5	1.75	2.0	2.0	6.2	8.9	9.75	9,5	9.75
Greece	1.8	2.6	2.25	3.0	3.0	14.7	8.2	6.0	4.5	3.5	8.3	10.3	10.5	10.25	10.0
Ireland	5.9	7.9	7.0	6.5	6.0	2.7	1.6	1.5	1.5	1.5	15.0	11.6	10.25	9.25	8.5
Italy	2.0	0.7	1.25	2.0	2.75	5.3	3.9	1.8	2.5	2.5	10.0	12.0	12.0	12.0	11.75
Luxembourg	5.7	3.0	3.5	3.5	3.0	2.8	1.4	1.5	1.75	1.75	2.3	3.3	3.25	3.75	4.0
Netherlands	2,6	3.3	3.0	3.0	2.75	1.9	2.1	2.25	2.25	2.25	6.9	6.3	5.5	5.0	4.75
Norway	2.4	5.3	4.0	3.5	3.5	4.0	1.3	2.5	2.5	3.0	4.6	4.9	4.25	4.0	4.0
Portugal	3.1	3.0	3,0	3.0	3.0	9.3	3.2	2.0	1.75	2.0	5.9	7.3	6.5	5.75	5.0
Spain	2.9	2.3	3,25	3.5	3.5	5.5	3.6	2.0	2.0	2.5	20.0	22.1	20.25	18.5	17.0
Sweden	1.2	1.3	2,0	2.5	2.25	5.3	0.5	0.5	1.5	2.0	4.8	10.0	10.25	10.5	10.25
Switzerland	1.3	-0.2	0,5	2.0	2.0	3.1	0.8	0.5	0.5	1.0	2.0	4.7	4.0	3,75	3.5
United Kingdom	2.1	2.3	3,5	2.25	2.0	4.8	2.4	3.1	3.3	2.8	9.3	8.2	7.25	6.75	6.5
Industrial countries (total)[5]	2.4	2.6	2.6	2.2	2.3	3.3	2.1	2.0	1.8	1.9	7.1	7.6	7.3	7.1	7.0
Western Europe[5]	2.2	1.7	2.5	2.6	2.7	3.9	2.3	1.9	2.1	2.1	9.2	10.7	10.9	10.4	10,0
European Union[5]	2.2	1.7	2.5	2.6	2.7	3.9	2.4	1.9	2.1	2.1	9.5	10.9	11.1	10.6	10.2
EMU[4,5]	2.3	1.6	2.4	2.7	2.8	3.5	2.3	1.7	1.9	2.0	9.7	11.6	12.1	11.6	11.2

[1] Greece, Ireland, Luxembourg, Portugal: private consumption deflator. [2] In % of the labour force, in most cases OECD standardised figures; Austria to 1995: unemployment rates as a % of employees; Austria, Denmark, Greece and Switzerland: national figures. [3] Gross domestic product and consumer prices up to 1991, unemployment rate up to 1992: West Germany. [4] Weighted as appropriate by gross domestic product, private consumption, size of the labour force 1996; total of the countries listed. [5] European Monetary Union: countries wishing to join. [a] Average year-on-year change. [b] Forecast; country data rounded to quarter percentage points.

Sources: OECD; national statistics; 1997: partly estimated; 1998 and 1999: HWWA forecasts.

whole, 1997 saw little increase in real gross domestic product.

With Japan's unfavourable export prospects raising the spectre of renewed recession, the government again announced a fiscal support programme in December, amounting to 1% of gross domestic product. Moreover, additional funds are being made available to the banks in order to counteract risks in the financial sector. Furthermore, with central bank interest rates staying persistently low, monetary policy continues to be strongly expansive and long-term interest rates remain at a very low level.

Under these conditions, domestic demand will recover again, following stagnation during the winter six months. While there will be a marked increase in public expenditure, tax reductions will strengthen disposable real income and thus stimulate private consumption. However, investment activity will remain restrained due to unfavourable sales and earnings prospects, not least as a result of a marked reduction in export stimuli due to the crisis in Southeast Asia. For the year as a whole, production should be only slightly higher than in 1997; in 1999 it will increase by 2%. Prices levels will remain almost unchanged.

Robust Economy in the USA

For the USA, the effects on international trade arising from the financial and economic crisis in the Far Eastern NIEs are much less severe than for Japan. Moreover, the US economy is in a robust state, even in its seventh year of expansion. Indeed, with 3% growth in 1997 – expansion trailed off in the second half of the year – real gross domestic product increased at a faster rate than in any of the previous years of the present upswing. Price increases have nonetheless tended to slow down.

In view of the surprisingly strong increase in production together with high levels of employment, a further slight increase in interest rates was generally expected for the winter. Given the Asian turmoil, however, the Federal Reserve has decided not to take this step for the time being, especially as the danger of accelerating price increases has diminished, not least as a result of tougher foreign competition largely brought about by the strength of the dollar. This is also a reason for a renewed fall in long-term interest rates to a very low level, and they are expected to remain low for the rest of this year. Financial policy will continue to pursue a largely neutral course. While a moderate increase in government expenditure is expected given the healthy state of the economy, there will be a steep rise in income. In 1998, the government budget will even post a slight surplus.

Under these general conditions, domestic demand will continue to increase at a fast rate, if somewhat slower than last year. Foreign trade, in contrast, will have a marked dampening effect on the economy. This year, real gross domestic product is expected to be around 2% higher than last. It will thus grow at approximately the same rate as production potential, such that expansion, supported by tougher competition resulting from exchange rate adjustments and by cheaper imports from Southeast Asia in particular, will continue without undue strains. Consumer prices are expected to rise at a little over 2% – a rate which is even slightly lower than last year's average.

Increasing Recovery in Western Europe

Given its relatively low exposure to Southeast Asia, the foreign trade effects of the Far Eastern turmoil are much less severe for Western Europe than they are for the USA. Consolidation of economic recovery in continental Europe has reduced its "susceptibility" to external disturbances, while in the United Kingdom, where the economic upturn is in its sixth year, such susceptibility is already limited. Although economic recovery in continental Europe is largely export-based, there has been a return to significant increases in domestic demand since last spring.

As European Monetary Union draws closer, additional uncertainties arise regarding the further economic development of Western Europe. Early May will see a number of important decisions being taken, including the naming of the participant countries and the establishment of a procedure for calculating conversion rates. For our forecasts, we assume – as was the case last summer – that an 11-member European Monetary Union will begin on schedule at the start of 1999, and that currencies will be converted at central EMS rates. Under these circumstances short-term interest rates in the participating countries will soon come into alignment once the fundamental decision has been taken. In view of the global economic risks resulting from the financial crisis in the Far East, and given the moderate wage increases and favourable prospects for stability – which are also the result of tougher competition from the East Asian countries (including Japan) – we are unlikely to see any signifcant increase in interest rates in the traditional hard currency countries, at least for some time to come. Indeed, interest rates may converge – and this continues to hold true for Italy in particular, even after the most recent marked reduction – as a result of rate reductions in countries where interest rate levels are relatively high. As a result, monetary policy will continue to have a marked expansionary effect this year.

At the same time, the dampening effects of fiscal policy are slackening off. While most governments pursued a strict consolidation course last year – particularly in those countries aiming for direct entry to the European Monetary Union – this year will see structural budget deficits being reduced to a much smaller degree. Given the strength of the economy, however, they will continue to fall perceptibly. On the whole we expect economic policy to provide a significant stimulus in 1998.

Given these general conditions, there should be a tangible increase in industry's propensity to invest as prospects for sales and earnings continue to improve, and public investment will probably increase in most Western European countries following a marked decline in many cases during the last few years. Private consumption is also likely to increase more rapidly, due not least to a marked rise in disposable real income supported by the expected increase in employment. In contrast, stimuli from trade with non-European countries will weaken significantly, if only because of the retarding effects of the Southeast Asian crisis; moreover, impulses which resulted from the depreciation of European currencies, especially against the dollar, will become weaker. This year, real gross domestic product in Western Europe should be around 2% higher than in 1997, whereby growth will continue to be less dynamic in the larger countries than in most of the other European economies. Price increases will remain moderate, not least as a result of tougher international competition. European Monetary Union will thus begin life as a community of "stability", albeit with a high level of unemployment.

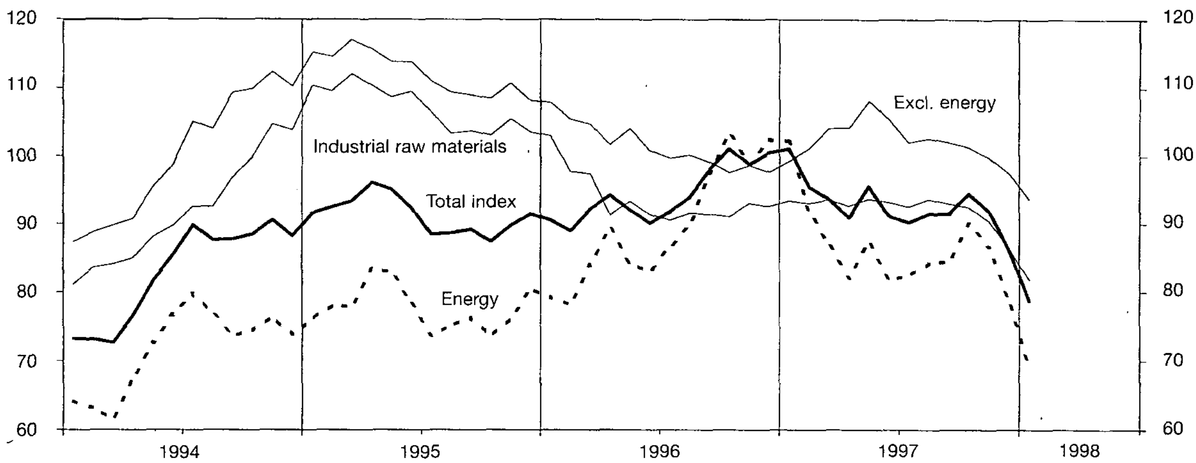
Expansion to Accelerate Soon

With growth of over 2%, overall production in the industrialised countries as a whole will expand at almost half a percentage point less than was forecast last summer. This is largely due to the expected unfavourable developments in Japan. Consumer prices will also increase at a slower rate. Total world production will probably increase at no more than a little over 3% compared with 1997, largely as a result of weak growth in Eastern Asia. Corresponding adjustments must be made to forecasts for world trade which is expected to increase by 6% in 1998, almost two percentage points less than was assumed in mid-1997. Given this situation there will be a renewed decline in commodity prices, albeit less marked than that of 1997.

Assuming that the financial crisis in Southeast Asia can be successfully contained, 1999 should see a return of expansive strength to the global economy. The dampening influence of extensive adjustment processes in the "problem" economies of Southeast Asia will have slackened off by then. However, given the grave problems which result from high levels of debt in the private sector, a strong decline in assets and a fragile financial system – a situation similar to that already seen in Japan –, recovery in domestic demand will probably be very slow. This will continue to place a burden on Japanese economic recovery, which is expected to be very moderate in 1999. In the USA and Western Europe, where economic policy is expected to pursue a neutral course by then, economic expansion will continue at about the same rate as this year. All in all, real gross domestic product in the industrialised countries will probably grow by 2% again in 1999, and there will be a more marked increase in prices than this year. In the world as a whole, the rate of increase will probably be around 3%.

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

(1990 = 100)



Raw Materials and Groups of Materials[1]	1997	July 97	Aug. 97	Sept. 97	Oct. 97	Nov. 97	Dec. 97	Jan. 98[2]
Total Index	92.7 (–1.7)	90.2 (–1.7)	91.4 (–2.6)	91.4 (–6.9)	94.5 (–6.5)	91.8 (–7.1)	86.1 (–14.3)	78.7 (–22.1)
Total, excl. energy	102.3 (0.8)	102.0 (2.3)	102.6 (2.4)	102.1 (3.0)	101.3 (3.8)	99.8 (1.2)	97.5 (–0.2)	93.6 (–5.7)
Food, tropical beverages	132.0 (12.5)	130.4 (2.7)	129.2 (2.8)	129.3 (5.9)	127.7 (9.1)	127.9 (10.8)	130.9 (15.8)	128.4 (9.8)
Industrial raw materials	92.3 (–1.5)	92.5 (2.1)	93.6 (2.2)	92.9 (1.7)	92.4 (1.5)	90.3 (–2.8)	86.2 (–6.8)	81.8 (–12.3)
Agricultural raw materials	92.6 (–3.5)	91.5 (–2.1)	92.8 (–2.3)	94.1 (–1.9)	94.6 (–2.1)	92.4 (–4.6)	87.7 (–8.2)	81.5 (–13.9)
Non-ferrous metals	89.8 (2.0)	92.6 (12.5)	93.7 (13.4)	88.8 (10.5)	86.3 (10.0)	83.5 (–1.8)	78.9 (–8.4)	76.1 (–15.7)
Energy	86.5 (–3.5)	82.5 (–4.7)	84.2 (–6.2)	84.4 (–13.4)	90.0 (–12.9)	86.6 (–12.4)	78.7 (–23.2)	69.1 (–32.4)

[1] On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.
[2] Up to and incl. 23rd January.