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## Outlook for the world economy 1996/97

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## Outlook for the World Economy 1996/97

**A**s a whole, the world economy is still on a clear growth path. Above all in the developing countries, particularly East Asia, the momentum remains strong and in the Central European reform countries the pace of expansion is meanwhile considerable. After the distinct slowdown last year the forces for growth have revived in the industrial countries. In Japan in particular – after three years of virtual stagnation – a definite upward trend has developed since last summer as a result of a strongly expansive monetary and financial policy and a correction of the steep yen appreciation of spring 1995. In the USA, too, production – which had shown only a minimal rise in the first half of 1995 largely due to adverse foreign trade factors – again rose rapidly; the expansion showed a basic trend equivalent to a current annual rate of a good 2%, which is roughly in step with the growth of production capacity. In Western Europe, however, the winter six months saw stagnation but there is much to indicate that a recovery is imminent here, too. Real aggregate gross domestic product in the industrial countries in the first half of this year ought to be almost 2% higher than in the same period last year, following a growth rate of 1.9% for 1995 as a whole over 1994.

The generally more favourable trend in production in the industrial countries is largely attributable to the fact that stimuli began to be emitted from factors that had previously acted as a major brake. In particular, long-term interest rates declined steeply in the course of last year, following the sharp worldwide rise in 1994. Monetary policy too has for the most part been expansive, particularly so in Japan with its extremely low interest rates. In the USA, where the Federal Reserve had tightened the monetary reins considerably in 1994 to forestall cyclical overheating, interest rates have been carefully lowered since spring 1995, when a soft landing appeared threatened. In Western Europe, short-term interest rates in many countries were cut distinctly; following the renewed

sharp exchange-rate fluctuations in the first months of last year, however, they were raised by a considerable margin in the weak currency countries to avert an inflationary spiral induced by depreciation. At the same time, financial policy in general kept to a consolidation course. Despite all this, due to the usual time lags, there was a marked dampening effect on the economy of Western Europe as a whole, exacerbated by stock shedding and the unusually harsh winter, but it is picking up again due to the widespread “normalization” of exchange rates since last summer and the attendant drop in interest rates in the weak currency countries and ongoing slight relaxation in the hard currency countries. Also, the retarding effects of the low dollar on developments in Western Europe and in Japan have abated considerably with the appreciation of the US currency. The weighted external value of the dollar in spring of this year was about 10% higher than a year previously, thus again approaching the level of 1992 to 1994.

The increasing divergencies among the business cycles of the industrial countries in the first third of this decade have again been diminishing clearly for some time (see box). There continue, however, to be considerable cyclical differences between regions. While capacity utilization in the USA is still above the long-term average, in most other countries it is below average, in some cases well below. This holds also for Japan, despite a surge in production in the last winter six months. Aggregate employment has hardly increased in the industrial countries since early 1995. While the number of employed in the USA this year rose markedly, the trend in Western Europe has kept downward. At 11%, unemployment here is about twice that in the USA. In Japan, the 3½% figure is also very high by national standards. Due to differing classification criteria, a comparison with unemployment in other regions reveals little. There, as in Western Europe, high unemployment has been a

major contributory factor to moderate pay rises, although these have remained relatively restrained in the USA as well, in spite of the continuing high level of employment. The sharp rise in raw materials prices which began in 1994 came to a halt in response to the marked cooling-down of the economic climate last year. Since summer in fact prices for industrial raw

materials have taken a marked downward turn. Measured against the HWWA index of world market prices on a dollar basis, they were about 15% lower in June than a year previously. With costs rising little overall, prices remained comparatively stable in the industrial countries. Consumer prices in spring in the industrial countries as a whole were a good 2% up on

### Economies Almost in Step Again

Economic trends in the USA, Japan and Western Europe were more disparate in the first third of this decade than in previous cycles. Since then, though, the basic tendency has been reconvergence. This also holds for the economies in Western European countries, although there is still a pronounced divergence in capacity utilization. Another wide gap is in the employment trend, particularly between the USA and Western Europe. While the number of employed in the USA at the end of 1995 topped the level at the start of the decade by nearly 8% in Western Europe it was a good 2% below the equivalent figure (see Figure). This discrepancy is only in part the result of differing points on the economic cycle. Considering the almost equal production growth of nearly 2% per annum on average over the whole period in both regions, the relatively high rise in the number of jobs in the USA reveals a far higher employment intensity of growth.

The "drifting apart" of the economic cycles had begun at the beginning of this decade after the long upswing in the 1980s. Whereas in the USA the downswing dates back to as early as 1990, it did not begin in Western Europe until 1991 and in Japan until 1992. This staggering was the main reason for the difference in the downswing pattern for the industrial countries as a whole from that of the mid-1970s and early 1980s: the downswing this time was not as strong but far more protracted.

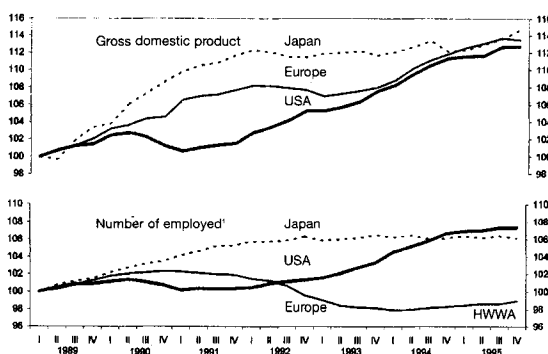
Crucial to the marked deviation from the previous, more or less concurrent, economic trends were the differences in the kind, "range" and timing of the shocks. The two previous downswings were caused substantially by global shocks, namely the oil price hikes and the largely parallel responses of economic policy to them. This decade, in contrast, has been dominated by regional and national shocks.

Major determinants for the onset and duration of the downswing in several countries were sizable asset losses in the private sector. Particularly in the USA, Japan, Great Britain and some Scandinavian countries, real estate and share prices plummeted after the excesses of the 1980s. As the assets were heavily encumbered with loans, debt had to be cut back by a huge amount. All this placed a heavy constraint on private demand and the need to restore balanced finances long overshadowed the impacts of easing monetary and fiscal policy.

In Western Europe the upswing at the start of the 90s lasted longer than in the USA, due among other things to German reunification. The attendant demand boom in Germany at first spread via higher imports to the European trading partners. In many countries, a brake was placed on the economy earlier than in Germany by monetary policy's raising interest rates in response to exchange rate turbulence. Altogether, this resulted in a period of considerable economic divergence within Western Europe as well.

### Real Gross Domestic Product and Employment

(Index, 1st Quarter 1989 = 100)



<sup>1</sup> Seasonally adjusted according to ASA II (HWWA version).

Sources: OECD; own calculations.

Currency shocks have in recent years affected the economies of different countries in different ways. The steep rise in the external value of the yen, but also of some European currencies in 1992 and 1993 as well as early 1995 inhibited development in the corresponding countries.

The after-effects of the regional and national shocks that had made a major contribution to the downswing have been largely overcome in recent years, first in the USA, in 1994 in Western Europe and last year also in Japan. The renewed pronounced exchange-rate shifts in the first months of 1995 have largely been corrected. All this will help bring developments in the USA, Western Europe and Japan back onto a relatively convergent track for the time being.

the previous year. Only in a few countries did price rises exceed this to any marked degree; in some, prices have remained stable, especially Japan.

With inflation being contained persistently, monetary policy will remain expansive overall. The faster rise in industrial output and the rapid expansion of employment in the USA this year has again fuelled inflation fears, which have been a major contributor to the rise in capital market interest rates in recent months. Since, though, bottlenecks are unlikely in the near future given the basic economic trend and the continuing flexibility on the goods and factor markets, and since monetary expansion as a whole is in step with that of production capacity, monetary policy in the USA is unlikely to be tightened much in the near future. In view of the distinct economic recovery since last summer in Japan and the very large expansion in M1 money supply – though with the expansion of M2 still on target – interest rates can be expected to go up, but the rise will probably be small at first; monetary policy will thus continue to provide stimuli. There will be some interest rate cuts in Western Europe, particularly in those continental European countries whose currencies have meanwhile recovered markedly following their previous considerable depreciation.

As already the case in some countries for a number of years, fiscal policy is almost everywhere pursuing a

distinct course of consolidation. Only in Japan has public spending and hence the budget deficit been enlarged by a sizable amount as part of a programme to reignite the economy. In view of the strengthening recovery, however, the Japanese government will gradually adopt a policy of consolidation following the high rise in public debt in recent years; one indication of this is the planned two per cent rise in consumer tax to five per cent next spring. In the USA, the overall government deficit has dropped again to 1½% of gross domestic product; despite a planned medium-term deficit cut there are, however, plans for a „consolidation break“ next year. In Western Europe, the deficit ratio is much higher even after considerable progress in curbing government spending. In nearly all countries it exceeds to a lesser or greater extent the ceiling of three per cent laid down in the Treaty of Maastricht for membership of the monetary union. The current cyclical weakness will make it even more difficult to meet this requirement. Nevertheless, countries with basically bright prospects of membership are keen to meet this criterion next year and here real increases in public spending are being kept to a minimum. Fiscal policy in Western Europe will therefore put heavier constraints on demand than before; these will, however, be offset by positive effects such as the easing of the capital market and the improvement of investor and consumer expectations. The cyclical rise in demand for capital will,

### Real Gross Domestic Product and Consumer Prices

(Year-on-year changes in %)

	Real Gross Domestic Product					Consumer Prices				
	1986 to 1993 <sup>a</sup>	1994	1995	1996 <sup>b</sup>	1997 <sup>b</sup>	1986 to 1993	1994	1995	1996 <sup>b</sup>	1997 <sup>b</sup>
USA	2.3	3.5	2.0	2.0	2.0	3.8	2.6	2.8	3.0	3.0
Canada	1.9	4.1	2.3	1.5	2.5	3.9	0.2	2.2	1.5	2.0
Japan	3.5	0.5	0.9	3.0	2.5	1.6	0.7	-0.1	0.5	1.5
Western Europe <sup>1</sup>	2.3	2.9	2.4	1.3	2.3	3.7	2.7	2.7	2.4	2.4
Austria	2.5	3.0	1.8	1.0	1.5	2.7	3.0	2.3	1.5	2.0
Belgium	2.2	2.2	1.9	1.0	2.5	2.4	2.4	1.5	2.0	2.0
Denmark	1.4	4.4	2.6	1.0	2.5	3.2	2.0	2.1	2.5	2.5
Finland	0.5	4.4	4.2	2.0	3.5	4.3	1.1	1.0	1.0	2.0
France	2.0	2.8	2.2	1.5	2.5	2.9	1.7	1.7	2.0	2.0
Germany <sup>2</sup>	2.9	2.9	1.9	1.0	2.0	2.2	2.7	1.8	1.5	1.5
Ireland	4.5	6.4	7.7	6.0	5.0	3.0	2.3	2.5	3.0	3.0
Italy	2.0	2.1	3.0	1.5	2.0	5.5	4.0	5.2	4.5	4.0
Netherlands	2.4	2.7	2.4	2.0	2.5	1.6	2.8	1.9	2.0	2.0
Norway	2.0	5.7	3.7	4.0	2.5	4.9	1.4	2.5	1.0	2.5
Spain	3.0	2.1	3.0	2.0	2.5	6.1	4.7	4.7	4.0	3.5
Sweden	0.8	2.6	3.0	1.0	2.0	5.9	2.2	2.5	2.0	3.0
Switzerland	1.6	1.2	0.7	0.5	1.5	3.2	0.9	1.8	1.0	1.5
United Kingdom	2.0	3.8	2.4	2.0	3.0	5.1	2.5	3.4	2.5	3.0
OECD Countries Total <sup>1</sup>	2.4	2.9	2.0	1.9	2.4	3.3	2.1	2.1	2.2	2.4

<sup>1</sup> Total of listed countries weighted by real gross domestic product or private consumption in 1994. <sup>2</sup> Gross domestic product until 1990, consumer prices throughout: West Germany. <sup>a</sup> Average year-on-year change. <sup>b</sup> Forecast; country data rounded to nearest half percentage point.

Sources: OECD; national statistics; own estimates and forecasts.

however, work towards higher interest rates. Given the continued, relatively smooth expansion in the USA as well, though, the increase will not be very great at first.

The forecast is based on the assumption that capital market interest rates will rise little if at all at first, that exchange rates against the dollar will remain more or less unchanged and that no major shifts will occur in European currency relations. Further, there will be an initially moderate rise again in prices for industrial raw materials with aggregate production also showing modest growth. Oil prices will tend to fall when supply expands due to the planned easing of the export ban on Iraq.

Within these overall parameters the economic recovery in the Western industrial countries will soon broaden out. In Western Europe, partly due to stimuli from monetary policy, a distinct upward trend will emerge in the further course of this year which ought to strengthen next year. In countries whose currencies have reappreciated since the middle of last year, recovery will, however, be modest at first, despite falling interest rates. Thanks to brighter sales and earnings prospects, also supported by stimuli from abroad, the propensity to invest in many Western European countries will improve substantially and stockbuilding will probably again have an expansive effect. With real disposable income expanding only little, however, the increase in private consumption will remain subdued. Government demand in real terms will hardly expand at all in the course of consolidation efforts. At 1¼%, gross domestic product will rise by much less this year than in 1995 (+2.4%). Next year, growth ought to come to 2¼%. In the USA, the forces for growth will remain robust; investment in machinery and equipment in particular is likely to increase strongly with continued favourable

sales and earnings expectations. Aggregate output there will rise by a comfortable 2% both this year and next. In Japan, after the powerful speed-up in the first months of this year caused by fiscal policy, growth will slow down noticeably again. Above all, stimuli from fiscal policy will recede; in the course of next year, it can even be expected to have a retarding effect due to the consolidation drive. Monetary policy will also adopt a less expansive course as demand in the private sector strengthens further. A contributory factor here too will be the faster growth in exports due to the much lower external value of the yen. Improved competitiveness due to exchange rates, the brighter sales and earnings outlook and low interest rates will give a tangible boost to the propensity of businesses to invest. Under these conditions, the basic trend in demand and output should remain upward. Considering the high figure at the outset, compared with last year the increase in real gross domestic product – at 3% – will be somewhat higher this year than next, when it can be expected to record 2½%. In 1995, the figure was a mere 0.9%. In the Western industrial countries as a whole aggregate output this year will rise by a similar amount to last year: nearly 2%; in 1997 it is likely to rise by 2½%. Overall utilization of capacity will only pick up slightly at first. Unemployment will only decline a little and will remain the most urgent economic policy problem in Western Europe. Price rises will remain restrained in all; averaging a good 2% overall in the industrial countries, consumer prices will go up as moderately as in the two previous years, and in 1997 inflation will only exceed this figure by a small margin. For all this, real world trade will rise by 6% this year and by about 8% in the next.

*Compiled by the Department of World Business Cycles of the Hamburg Institute for Economic Research (HWWA).*

**HWWA Index of World Market Prices of Raw Materials'**  
(1975=100)

Raw Materials and Groups of Materials	1995		1996					
	AA <sup>2</sup>	June	March	April	May	June	5. 7.	19. 7.
Total index	162.7	164.4	168.6	176.8	169.2	164.4	169.3	166.3
Total, excl. energy raw materials	163.3	166.7	156.7	159.4	157.1	149.2	147.2	144.3
Food, tropical beverages	117.4	119.7	116.1	122.4	125.4	119.7	119.0	116.3
Industrial raw materials	198.2	202.4	187.7	187.6	181.3	171.8	168.8	165.6
Agricultural raw materials	213.9	222.4	202.1	201.8	187.2	181.2	181.2	174.4
Non-ferrous metals	209.4	210.4	192.1	193.5	195.9	172.2	162.4	161.6
Energy raw materials	162.3	163.2	175.5	187.0	176.2	173.3	182.2	179.1

<sup>1</sup> On dollar basis. <sup>2</sup> Annual Average.