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Günter Weinert*

Lasting Recovery in the World Economy

Economic recovery has returned to the industrial countries as a whole. However, expansion is moderate. In continental Europe, utilisation of capacity is still below the long-term average. In Japan, under-utilisation of capacity is even more pronounced. At the same time, unemployment has remained high. Elsewhere, though, and particularly in the USA, resources have been exploited to a high degree. Here too, however, wage and price increases remained moderate. Economic convergence is accompanied by a convergence of economic policy – not just in those countries striving to take part in the European Monetary Union. In view of this, how good are the prospects for economic development and for employment in the coming year?

There was a perceptible upturn in the western industrial economies last year following a distinct cooling down period earlier. Looking at the annual growth rates of the past two years of 2% and 2¼% respectively (see Table 1), it is hard to make out any change in the general economic trend. This change becomes clear only on examination of developments during the course of each of these two years. For example, while real gross domestic product in the fourth quarter of 1995 was only 1½% higher than a year previously, in the corresponding period in 1996 it was 2½% higher. Recovery took place with considerable fluctuations, however, and was marked initially by significant regional differences. For example, while the USA and Japan saw restrained increases in demand and production after a period of strong growth in the first half of 1996, production in Western Europe – following a period of near stagnation in the winter six months – picked up appreciably as the year advanced.

Rapid growth continued in the rest of the world – albeit, as in the past, with considerable regional differences. Despite a certain slowdown, momentum in South East Asia remained particularly pronounced, and expansion in Latin America accelerated. Production also rose markedly in the transition economies of Central Europe, while in Russia on the other hand the long-running decline continued, albeit at a slower rate. All in all, with a growth rate of around 4% in 1996 over the previous year, world production grew faster than in the industrial countries. Global trade expanded at 6½%, slower than a year before.

With fiscal policy primarily geared to consolidation, economic recovery in the industrial countries is in

most cases largely the result of a marked improvement in the monetary environment. Monetary policy, for example, provided considerable impulses almost everywhere. In Japan, short-term interest rates were held at the extremely low level of autumn 1995; in most Western European countries they were lowered considerably further. In the USA, however, following a slight reduction at the start of 1996, they remained unchanged in the face of the high level of resource utilisation; they are considerably higher than in major European countries and Japan. Furthermore, long-term interest rates worldwide – which rose strongly in 1994 – fell again considerably in 1995. This trend continued – after a temporary rise in the first half of the year – in 1996; for some time now, the long-term interest rates in many countries have been as low as they were at the end of 1993. Further stimulus to the sluggish economy in Japan and Western Europe was provided by a departure from the massive shifts in exchange rates of spring 1995 which, in the countries with appreciating currencies, had greatly restricted sales and earnings expectations and thus also the propensity to invest.

High Unemployment

Although there has been a marked alignment in the rate of expansion in the various regions for some time now, there are still striking differences between the individual economies. While production capacity in the USA is being utilised to a high degree as a result of a long period of economic growth, Japan's utilisation of available capacity is well below the long-term average. Utilisation of capacity is also below average in most countries of continental Europe.

Labour market developments reflect the inter-regional differences in capacity utilisation. Employment in the USA, for example, increased noticeably

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faster than the size of the labour force. Between 1992 and the second half of 1996, the unemployment rate thus fell by 2 percentage points to a good 5%. This rate of unemployment, which has since remained almost unchanged, is distinctly lower than levels at which, in previous cycles, wage and price increases began to accelerate.

In contrast, the labour market situation in the other regions has so far shown few signs of improvement. While employment in Japan has increased considerably since last spring, the drop in unemployment has been modest; the country's "hidden reserves" are clearly substantial. In Western Europe, where recovery did not begin to make its presence felt along a wide front until the summer, employment was virtually stagnant throughout the entire year. The unemployment rate remained persistently at 10½%. Given the volume of unutilised production capacity in most countries, this high level of unemployment is also partly a result of the general economic situation, although only in a relatively small measure.

Lower Wage and Price Increases

In view of the unfavourable labour market situation in most countries, wages have risen moderately in almost all the industrial economies. With an average increase of around 3%, they barely outstripped the rate of inflation in many cases, and in some European economies they even fell in real terms. Even in the USA wages hardly rose at all in real terms, despite the low level of unemployment; thanks to the continuing high degree of labour market flexibility and mobility, the much-feared acceleration of wage increases failed to materialise.

With moderate wage increases almost everywhere and with intensive competition continuing unabated, price increases remained modest and often showed signs of further weakening. A number of Western European countries are now either very close to the target of consumer price level stability or have already reached it, as indeed is the case in Japan. Even in the USA, consumer price increases are still restrained despite the high utilisation of production capacity which has been prevailing for some time now.

Table 1
Economic Indicators

	Real Gross Domestic Product (Year-on-year change in %)				Consumer Prices (Year-on-year change in %)				Unemployment ¹ (Annual average)	
	1987 to 1994 ^a	1995	1996 ^b	1997 ^c	1987 to 1994 ^a	1995	1996 ^b	1997 ^b	1995	1996 ^b
USA	2.4	2.0	2.5	2.25	3.8	2.8	3.0	3.0	5.6	5.4
Canada	2.1	2.3	1.5	3.0	3.4	2.2	1.6	2.0	9.5	9.6
Japan	3.2	1.3	3.5	2.0	1.6	-0.1	0.1	1.5	3.1	3.4
Austria	2.7	1.8	1.0	1.5	2.9	2.2	1.9	2.0	3.8	4.1
Belgium	2.3	1.9	1.5	2.5	2.5	1.5	2.1	2.0	9.9	9.9
Denmark	1.4	2.8	1.0	2.5	3.0	2.1	2.5	2.5	7.1	6.3
Finland	0.8	4.2	2.5	3.5	4.0	1.0	0.7	1.5	16.6	16.1
France	2.1	2.2	1.25	2.5	2.7	1.7	2.0	1.5	11.6	12.2
Germany ²	2.9	1.9	1.4	2.5	2.9	1.8	1.5	1.5	8.2	9.0
Greece	1.5	2.0	2.0	1.5	15.6	9.3	8.0	7.0	10.0	10.2
Ireland	4.8	10.3	6.0	5.0	2.8	2.5	1.7	2.0	12.4	12.4
Italy	1.8	3.0	0.75	1.0	5.3	5.2	3.8	3.0	11.9	12.0
Luxembourg	6.0	3.7	2.0	2.5	2.6	1.9	2.0	2.0	2.9	3.1
Netherlands	2.7	2.1	2.5	3.0	1.9	1.9	2.1	2.0	7.0	6.7
Norway	2.1	3.3	4.0	2.5	4.2	2.5	1.3	2.5	5.0	5.0
Portugal	3.0	2.4	2.0	2.0	9.6	4.1	3.0	3.0	7.3	7.3
Spain	2.9	2.8	2.25	3.0	5.6	4.7	3.5	3.0	22.9	21.9
Sweden	1.0	3.0	1.0	2.0	5.8	2.5	0.5	1.5	9.2	9.9
Switzerland	1.4	0.1	-0.5	1.0	3.2	1.8	0.8	1.0	4.2	4.6
United Kingdom	1.9	2.4	2.25	3.0	5.0	3.4	2.4	3.0	8.8	8.4
Industrial countries (total) ³	2.5	2.0	2.3	2.3	3.4	2.1	2.0	2.3	7.5	7.6
Western Europe ³	2.3	2.3	1.5	2.3	4.0	2.8	2.3	2.2	10.6	10.7
European Union ³	2.3	2.4	1.5	2.4	4.0	2.9	2.4	2.2	10.8	10.9

¹ In % of the labour force, in most cases OECD standardised figures. – ² Gross domestic product and consumer prices up to 1991: West Germany. – ³ Weighted as appropriate by gross domestic product, private consumption, labour force 1994; total of the countries listed. – ^a Average year-on-year change. – ^b Partly estimated. – ^c Forecast; country figures rounded.

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

Producer prices have barely risen at all in most countries; in fact, they have actually fallen – albeit marginally in most cases – in Canada and Japan, in Sweden and Finland, in Switzerland and even in Germany.

This has led some observers to warn of the possible danger of a deflationary development. This, however, is improbable for a number of reasons. Firstly, returns – especially in the industrial sectors – are relatively good in most of these countries. Furthermore, the producer prices registered in some countries' statistics represent only a fraction of all industrial goods. In France, in particular, this index includes only primary products and hardly any goods from "higher" processing stages. This means that the producer prices published here, and in some other countries, are strongly influenced by price developments in the international commodity markets. With the exception of crude oil, these prices fell considerably last year. Measured using the HWWA Index in dollar terms, raw materials prices excluding energy were 8½% lower than in 1995, not least as a result of a fall in prices for some non-ferrous metals which was caused by speculation; including energy commodities, on the other hand, there was an increase of 6½%.

There is no danger of deflation in the sense of a general fall in the level of prices, however, particularly since monetary policy, which is decidedly expansive, is providing considerable stimulus to the economy. In Japan and in most of the Western European countries, M1 money supply was higher in the autumn than a year previously by double-figure rates; the most significant exception is Italy, where the central bank – particularly in view of the imminent wage round – continued to keep key interest rates high. Although the wider money supply definition is largely expanding more slowly than M1, its rate of expansion – with the exception of France – is at least in line with potential. The interest rate structure – in general, despite the pronounced fall in capital market interest rates since spring, the difference between long and short-term interest rates has remained clearly positive – also provides an indication of the expansive stance of monetary policy.

In contrast, US monetary policy appears to be neutral. Following the slight reduction in interest rates last February, key rates remained unchanged. In the USA, money supply is growing – in the M2 definition at least; again with considerably different rates of change between the various individual monetary

aggregates – at a rate which is roughly in line with potential, and the difference between long and short-term interest rates is relatively small. Despite the high level of capacity utilisation, the much-expected increase in US central bank interest rates did not occur because the strong acceleration of expansion in the spring proved to be temporary. Since the summer, production has been increasing at roughly the rate of growth potential; several indicators, however, suggest that there has again been some acceleration recently.

Monetary Policy Mostly Remains Expansive

In most countries, monetary policy can be expected to continue its recent course for the time being. In the USA it will remain more or less neutral given the high level of capacity utilisation and low unemployment. This allows a further increase in production in line with the increase in capacity. For this reason there are no real grounds to expect an increase in wage and price inflation. However, last year's further strong increase in bond prices has even caused the American central bank to worry about excessive speculation in the financial markets. The danger here is not so much that private consumption could grow too quickly as a result of increased wealth. Much weightier is the risk of plummeting prices – as in 1987 – and the subsequent loss of wealth and the need for extensive value adjustments. In order to prevent this situation from developing into a process of economic contraction, an initial step would probably involve lowering interest rates and expanding the money supply considerably. In the longer term, however, this could result – as in the late 1980s – in a marked increase in prices.

Further strong price rises in the financial markets would lead the central bank to raise interest rates – in the same way as economic expansion over and above the pace of production potential would do. However, a slight increase in interest rates ought to be enough to achieve the desired effect in the financial markets. At the same time, budding doubts regarding the orientation of monetary policy towards stability would be quashed.

The extent to which massive disturbances in the financial sphere can dampen economic activity even for a relatively long period was experienced by Japan at the start of the decade when real estate prices fell dramatically and there was a sustained slump in share prices. The resulting strain on the economy was a major reason for the obstinate stagnation – despite repeated efforts to boost the economy – in the first half of the decade. The process of adjustment has not

yet been completed. In view of these retarding effects which still persist, Japan's main focus of attention is currently to ensure economic recovery. Given the change of fiscal policy direction towards consolidation, the central bank will probably refrain from raising interest rates until later in the year when the upward trend has been consolidated.

On the whole there is little indication of monetary policy relaxation in Western Europe. Against a background of somewhat more favourable economic prospects, the central banks are unlikely to lower interest rates any further. A marked reduction can be expected only in countries such as Italy whose key interest rates are still high. In the United Kingdom, on the other hand, where expansion has increased once more, a further rise in interest rates is to be expected; however, the danger of an overheating economy is now much smaller as a result of the appreciation of the British pound.

Further recovery in the industrial countries will also be helped by the significantly lower level of long-term interest rates. In view of the persistently moderate level of price increases and the considerable progress still being made in many countries towards the consolidation of their public finances, these rates will probably remain low in most countries. Some observers fear the emergence of significant inflationary dangers in the USA, increases in key interest rates by the central bank as well as a rise in long-term interest rates inducing a corresponding increase in Europe's capital market interest rates. This is not very probable, however, given that the outlook for economic stability remains favourable and in view of the continuing policy of consolidation.

Fiscal Policy Remains on Consolidation Course

In the past year, most governments were concerned with reducing their general financial deficit. In continental Europe this often necessitated radical measures, since recovery from the economic slump was very slow. Member countries of the European Monetary System in particular – not least in order to qualify for participation in the European Monetary Union which is planned for 1999 – stepped up efforts to reduce their deficits towards the reference value of 3% of gross domestic product, partly by throttling public expenditure growth, but often also by increasing taxes. In the USA, where great progress has been made in consolidating the state budget, a renewed slight fall in the aggregate state deficit was largely the result of the sound condition of the economy. In Japan, the regional administrative bodies' expenditures and deficits increased slowly following the strong expansion at the start of the year.

This year, fiscal policy will again focus largely on consolidation. This will now be the case in Japan, too, where fiscal policy will be less concerned with supporting economic recovery than previously, particularly in view of the strong increase in the deficit and in state debt which equalled almost 7% and around 90% of gross domestic product last year respectively for government authorities at the central, regional and local levels. With plans for an increase in consumption tax by two percentage points to 5% at the start of the financial year in April, for the ending of the temporary income tax cut, for increases in social security contributions, and for reductions in public investments, the budget plans revealed so far indicate that fiscal policy will have a dampening effect on the

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economy; however, should economic recovery falter, it is likely that fiscal support measures will be re-introduced.

In Western Europe, efforts to reduce budget deficits are being stepped up in many countries, not least under the pressure of the Maastricht treaty. State expenditures should increase only slightly in the majority of cases. Above all, however, countries which still have particularly large deficits, i.e. Italy and Spain, are also increasing taxes considerably. Even so, most countries' deficits are likely to exceed the reference value of 3% of gross domestic product agreed on for the European Monetary Union, if only by a relatively narrow margin in many cases. Fiscal policy will have a further dampening effect on the economy, particularly in those countries which are prepared to enter the European Monetary Union, but also in most of the other Western European countries. According to some observers, adherence to a policy of consolidation could jeopardise economic recovery. This risk is exaggerated, however, not least because deficit reductions do not always affect demand. They are often achieved to a not inconsiderable degree by means of "creative" bookkeeping. In some countries they are also partly due to a substantially reduced interest burden resulting from lower interest rates. In many cases, structural deficit reductions which affect demand are not likely to be much stronger than they were in 1996.

The deficit in the USA – following the considerable consolidation achieved in the past few years – will not be further reduced this year. Indeed, the deficit quota will rise slightly to almost 2% of gross domestic product. In all probability, this will merely represent a temporary interruption of the consolidation process, as the deficit is to be dismantled completely by the year 2002.

Favourable Conditions for Foreign Trade

The correction of exchange-rate relations which came about in 1996, not least as a result of the convergence in the global economy and in important areas of economic policy, will continue to have a considerable effect on world economic development this year. With the higher external value of certain currencies restored – in particular the US dollar and some European currencies such as the lira, the peseta, the pound sterling, and the Swedish krona – the exchange rates are now more in harmony with fundamental factors such as balances of payments and their development, and purchasing power parities.

As decisions on the European Monetary Union draw nearer, it is particularly uncertain how exchange

rates will develop this year. It is still unclear, for instance, which countries will participate in the Monetary Union. A resolution not to admit some members of the European Union, for example, would probably lead to considerable changes in the exchange rates between "ins" and "outs". On the other hand, participation of all the EU member countries which are prepared to join the Monetary Union would probably be interpreted as a softening of the entry criteria and would considerably weaken the currencies merging into the euro. It is impossible to assess these risks, particularly as they are dependent upon political actions and the way in which these actions are "interpreted" in the currency markets. For this reason, it is assumed in the forecasts that the current exchange rates remain largely unaltered. It is additionally assumed that oil prices will gradually fall again while other commodity prices will slowly rise.

The industrial countries will continue to receive impulses from the rest of the world where, overall, demand and production will expand at largely the same rate as last year. While the momentum in the newly industrialised economies of South East Asia will further slacken slightly, growth in Latin America will increase once more. Real gross domestic product will also expand rapidly in the transition economies of Central Europe, not least as a result of the economic recovery in Western Europe. In Russia, the decline in production will come to a halt.

Recovery at a Moderate Pace

Under these general conditions, economic recovery in the industrial countries will continue, with relatively small differences in the speed of expansion. In the USA, given the high level of utilisation of the factors of production, economic policy is keen to limit expansion to the increase in production potential which is growing at a good 2%. The more or less neutral course adopted in monetary and fiscal policy appears appropriate to this end. Investment in new equipment will continue to expand at above-average rates, albeit more slowly than in the last few years.

Aggregate economic production in the other regions is unlikely to see stronger growth than in the USA. In Japan, financial sector adjustments continue to have a retarding effect, albeit to a lesser degree than has been seen in the past. In addition, fiscal policy will exercise a dampening influence on the economy. The continuation of an expansive monetary policy is likely to contribute to a gradual consolidation of private demand recovery. This process will be greatly helped by the international competitiveness of

Japanese companies which has improved again as a result of the devaluation of the yen. All in all, real gross domestic product will be 2% higher in 1997 than a year previously. While the increase in production thus remains well below that of last year, the latter was "exaggerated" by the surge of public demand at the start of 1996.

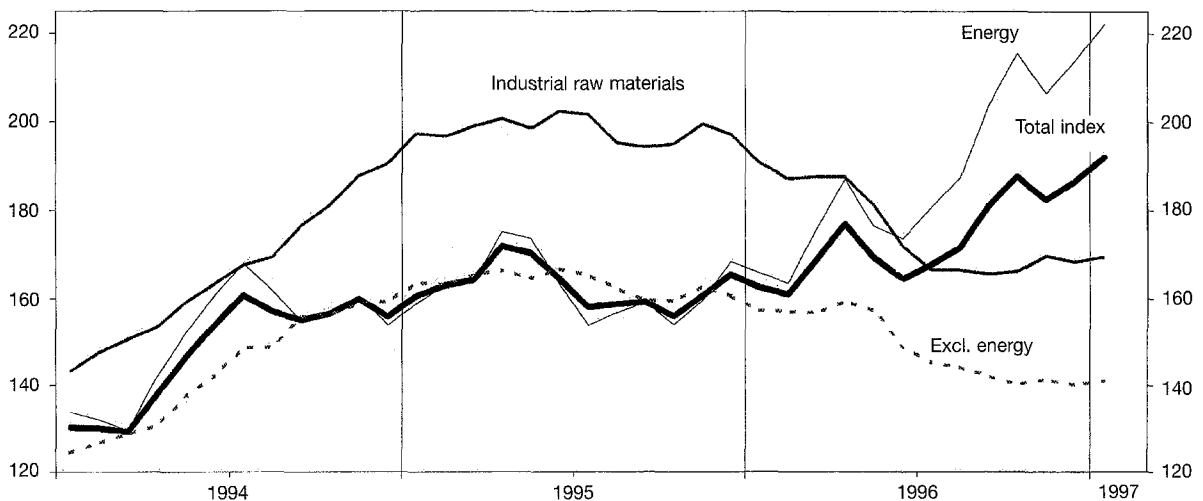
In Western Europe, exports will continue to stimulate the economy. This is particularly true for countries whose currencies have lost a significant amount of external value in the past year. However, the substantial increase in exports has as yet had little impact on domestic demand, i.e. on investment. Important conditions for investment are relatively favourable, though, and industrial investment will thus recover noticeably this year. In 1997, Western Europe's real gross domestic product will increase by

2¼% over the previous year, after a rise of 1½% last year.

Given the favourable monetary conditions in most of the major industrial countries, a marked continuation of the upturn in the world economy can be expected. However, the recovery is as yet not very robust. The pace of expansion this year will pick up only slightly compared to the second half of 1996. At 2½%, the increase in real gross domestic product in the industrial countries will thus be similarly modest to that of 1996. Most countries will see little increase in the utilisation of production capacity, and there will be no significant improvement in the labour markets of Japan and Western Europe. Under these circumstances price increases will remain low. Nevertheless, world trade will increase by a good 7% in real terms this year.

HWHA Index of World Market Prices of Raw Materials¹

(1975 = 100)



Raw Materials and Groups of Materials ²	1996	Jul 96	Aug 96	Sep 96	Oct 96	Nov 96	Dec 96	Jan 97 ³
Total index	173.3 (6.5)	167.6 (6.0)	171.4 (8.0)	181.0 (13.7)	187.7 (20.3)	182.4 (13.5)	186.5 (12.8)	192.2
Total, excl. energy raw materials	149.2 (-8.6)	145.4 (-12.0)	144.3 (-11.1)	142.1 (-10.9)	140.1 (-12.1)	141.3 (-13.1)	140.0 (-12.9)	141.0
Food, tropical beverages	114.3 (-2.7)	117.8 (0.2)	115.3 (-3.1)	111.3 (-2.1)	105.9 (-5.9)	104.3 (-8.8)	102.9 (-8.6)	103.6
Industrial raw materials	175.7 (-11.3)	166.5 (-17.4)	166.4 (-14.8)	165.5 (-14.8)	166.1 (-14.9)	169.6 (-15.1)	168.2 (-14.7)	169.4
Agricultural raw materials	187.5 (-12.3)	176.0 (-18.4)	175.2 (-14.2)	177.2 (-14.3)	180.2 (-15.90)	179.3 (-17.3)	176.7 (-17.8)	176.7
Non-ferrous metals	176.8 (-15.6)	162.3 (-25.3)	163.0 (-25.0)	159.2 (-23.5)	157.2 (-21.9)	170.8 (-19.0)	172.2 (-17.1)	175.7
Energy raw materials	187.4 (15.4)	180.5 (17.4)	187.3 (19.5)	203.7 (28.1)	215.5 (39.9)	206.4 (29.4)	213.7 (27.1)	222.1

¹ On a dollar basis. — ² Averages for the period; figures in brackets: percentage year-on-year change. — ³ Up to and incl. 10th January.