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Günter Weinert*

Expansion of the World Economy Continues Apace

There has been further strong growth in global demand and production so far this year. While this is particularly true of the emerging economies and the developing countries, the industrialised countries are also showing marked expansion. Since the rate of expansion is generally little higher than the tempo of the growth of capacity, however, price rises have remained small. Employment on the other hand has increased noticeably. Unemployment has nonetheless remained high – albeit with pronounced regional differences. In continental Europe in particular, unemployment will remain a weak spot despite a further foreseeable upward trend in the economy.

The world economy is currently in a favourable situation. In the first half of 1997, demand and production expanded at an even faster rate than last year when real gross domestic product increased by 4%, faster than the long-term average. At the same time, there was a pronounced increase in employment. However, high unemployment remains a weak point, and this is certainly an important reason why wage and price increases remained low. The price climate continues to be placid in the industrialised countries in particular, and prices on the international commodity markets actually fell in spite of strong demand growth. In general, given the large degree of price stability, monetary policy stuck to its course of modest expansion. The commitment to budgetary consolidation seen in fiscal policy almost everywhere helped lower interest rates still further to a very low level.

Economic expansion in the developing countries and the emerging economies remained well above average. While it is true that growth in South East Asia has slowed down, it was still stronger than in most of the other regions of the world. In China, economic activity continues to be particularly dynamic. Production growth in Latin America accelerated markedly,

and the strong upward trend in Africa continued. Expansion in the reform economies of central Europe slackened considerably, however, while the decline in production in the countries of the former Soviet Union slowed down; in Russia, the downward trend now seems to have bottomed out.

In the industrialised countries, too, expansion has continued apace (cf. Figure 1). In the first half of this year, the underlying growth of real gross domestic product was about the same as the year's average in 1996 (2.5%). In the winter six months, however, what had previously been a uniform upward development was marked by distinct temporary regional differences which were accentuated by the impact of exceptional factors. While national production in North America, Japan and the United Kingdom increased considerably faster than before, there was a marked temporary slowdown in continental Europe. Since then, however, production has generally been expanding again at a rate similar to the increase in productive capacity.

Under these circumstances, there are still large differences between the position of individual countries in the economic cycle. In the USA and the United Kingdom in particular, where expansion is characterised by strong internal forces, productive capacity is being utilised to a high degree. In most of the other countries, meanwhile – and in continental Europe in particular, where the economy is being "led"

* Hamburg Institute for Economic Research (HWWA), Hamburg, Germany. For a more detailed analysis of economic development cf. Christiane Brück, Wolfgang Crinius, Klaus Matthies, Günther Weinert: Anhaltend zügige Expansion der Weltwirtschaft, in: Festigung der Konjunktur, HWWA-Report No. 167, Hamburg 1997.

above all by export trade – capacity utilisation is below the long-term average. Here, the rate of growth of capacity has slowed down, probably due not least to a long-running weakness in investment to which strong currency appreciation in the first half of the 1990s made a considerable contribution in several countries. In Japan, the prolonged crisis – which has still not been overcome – in the financial sector as a result of the speculative excesses of the late 1980s also played an important role.

With the exchange rate “correction” which began in the summer of 1995, and following a long period of highly expansive monetary and fiscal policy, prospects for sales and earnings finally improved there, and the propensity to invest increased once more. In continental Europe, however, the propensity to invest continues to be relatively weak. As a result, the largely export-led expansion has not yet spread to domestic demand, so that a lasting, self-supporting upturn has not yet materialised.

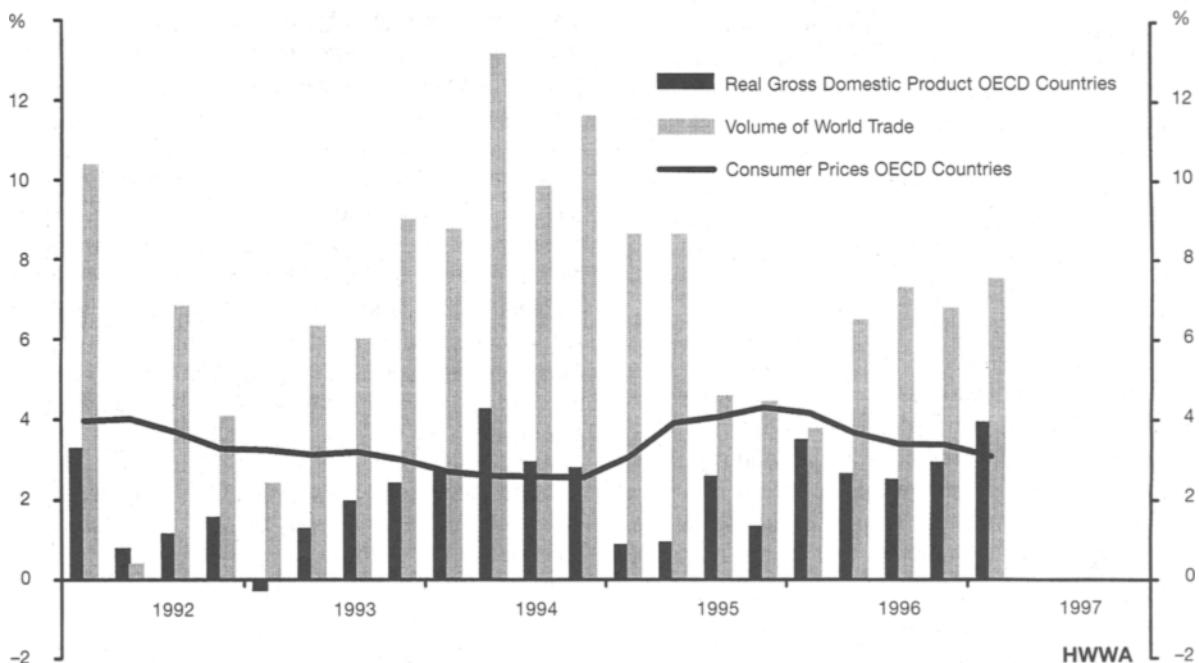
High Unemployment

The labour market situation in continental Europe remained unfavourable given the muted economic upturn. Employment at best stagnated in the larger continental countries – only in a few smaller

economies was there any considerable expansion – and unemployment on the whole persisted at a high level (cf. Figure 2). However, mass unemployment is by no means a “secular” problem, as labour market developments in the USA in particular, but also in the United Kingdom and the Netherlands have shown. Employment developments are above all favourable and unemployment relatively low in countries where employment conditions – flanked by a variety of restrictions on the welfare state – have been deregulated for some time and where there is a high degree of labour market flexibility.

Flexibility and worker mobility not only help meet the challenges of increasing globalisation, but also make it easier to achieve lasting expansion of the national economy. There is, for example, less danger of a pronounced increase in production and employment leading at an early stage to wage rises which go well beyond the kind of level which is compatible with economic stability. This has been demonstrated in the USA in particular, where the unemployment rate has fallen to an extremely low level by local standards in spite of sharp increases in the size of the labour force over a number of years and where wage rises have remained similarly modest to those industrialised countries with high levels of unemployment. In

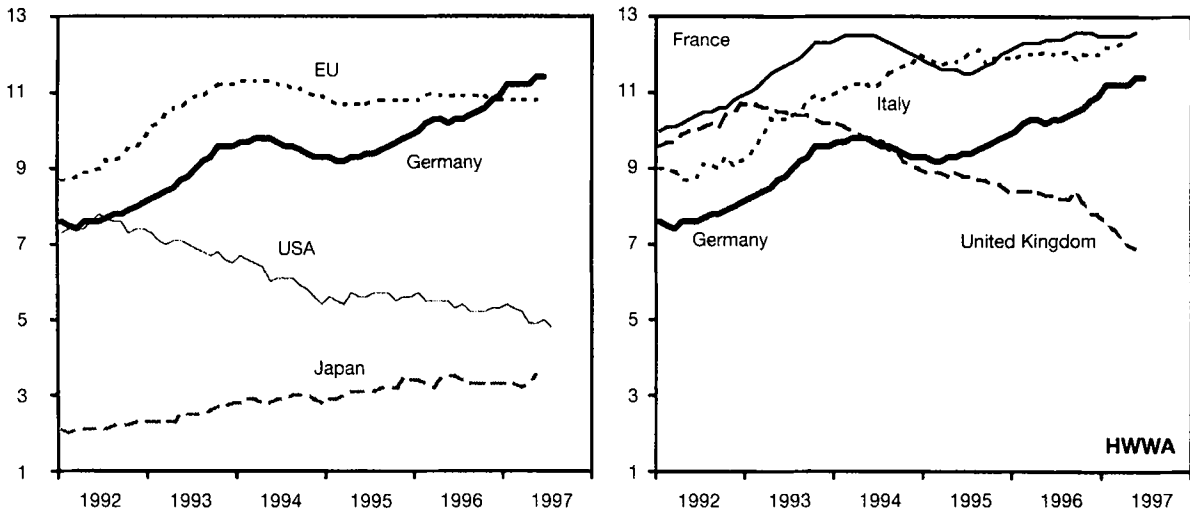
Figure 1
Economic Indicators¹



¹ Current annual rates; consumer prices: change over the previous year in %.

Sources: OECD; IMF; HWWA calculations.

Figure 2
Unemployment Rates¹



¹ Unemployed as a percentage of the labour force.
Sources: OECD; Deutsche Bundesbank.

addition, restrained wage increases everywhere – real wage levels have remained unchanged in many countries – are not only influenced by widespread price stability, but at the same time have also contributed to it.

Stimulative Monetary Policy

All in all, the roughly constant level of prices is the result of years of determined policy-making aimed at achieving economic stability; this determination, and the implementation of a variety of monetary policy concepts, has helped the central banks to build up a high degree of credibility. Given that there is still hardly a single country where the placid price climate appears to be at risk, bank rates will probably be raised by no more than small increments in the near future. This is even true of the USA where economic expansion is unlikely to exceed the growth of productive capacity by any great amount; only in the United Kingdom will there be a further marked increase in interest rates, not least to counteract the emergence of strong inflationary expectations.

In Japan, the discount rate will probably remain for the time being at the extremely low level of 0.5% to which it was reduced in the autumn of 1995. While there has been a marked increase in consumer prices as a result of a rise in value added tax in April, this is true of just one level of prices. A continuation of the low interest rate policy also seems likely in view of the ongoing need for structural adjustments in the bank-

ing and insurance sectors, and the continuing weakness of domestic demand.

In continental Europe on the other hand, bank rates will probably remain at current levels in countries with already low interest rates and be lowered again markedly in countries with relatively high interest rates. This is assuming that a decision will be made in May next year to establish a European Monetary Union (EMU) as of 1st January 1999 which includes all the countries wishing to participate (with the exception of Greece)¹; the United Kingdom, Sweden and Denmark have so far rejected membership.

The financial markets seem to share this expectation. At least this appears to be the message of the considerable reduction in differences between the long-term interest rates in individual countries which has been going on for some time now. Thus the interest rate difference between the southern European countries' long-term state bonds and similar DM bonds has been reduced to one percentage point, having been three percentage points in the middle of last year. At the same time as reaching a decision on the EMU, the method for determining the conversion rates for national currencies to the euro will also be established; thus the exchange rates will effectively

¹ On the prospects of individual countries achieving the reference values of the Maastricht treaty, see the Joint Report of the Association of German Economic Research Institutes, spring 1997, p. 4.

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be fixed as of May. With irrevocably fixed exchange rates there will be an almost complete alignment of interest rates, whereby bank rates in hitherto hard currency countries will probably be raised a little, especially as there will have been a noticeable consolidation of the economic upturn in these countries by then. However, in countries which still have interest rates which are well above average, they will be further reduced by a considerable amount. Monetary policy in the countries of the future EMU will thus remain slightly expansive.

A slight increase in bank rates in major countries underlines the continued commitment to stability policies. This counteracts the emergence of any inflationary expectations, such that a significant increase in long-term interest rates as feared in various quarters is unlikely. Given the continuation of lasting expansion in line with the speed of the growth of capacity expected here, long-term interest rates are also unlikely to increase in real terms. Thus from this perspective, too, the general monetary conditions will remain altogether favourable.

Realignments

Differences in interest rate perspectives and in the cyclical position of the various countries have led to widespread exchange-rate realignments. The weighted external value of those currencies which experienced a marked devaluation during the course of the 1990s has increased again noticeably; that of the US dollar has recently been as high as its 1989 average, sterling has once again reached the level it had before the de facto collapse of the European Monetary System in the autumn of 1992. In contrast, the external values of the deutschmark and the yen have fallen to levels seen at the end of 1992 and the beginning of 1993. The current exchange rates probably reflect the fundamental equilibrium rates much better than they did last year. For this reason, too, a high degree of constancy of the current relationships between the currencies of the industrialised countries is assumed for the forecast period.

The method of calculating the exchange rate at which national currencies are converted to the euro is

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)			
	1988 to 1995 ^a		1996		1988 to 1995 ^a		1996		1988 to 1995 ^{a,c}		1996	
	1995 ^a	1996	1997 ^b	1998 ^b	1995 ^a	1996	1997 ^b	1998 ^b	1995 ^{a,c}	1996	1997 ^b	1998 ^b
USA	2.3	2.8	3.5	2.3	3.7	2.9	2.8	3.0	6.1	5.4	5.0	5.0
Canada	1.8	1.5	2.8	2.8	3.1	1.6	2.0	2.3	9.5	9.7	9.3	9.0
Japan	2.8	3.5	0.8	2.0	1.6	0.1	1.5	1.0	2.5	3.4	3.3	3.1
Austria ²	2.8	1.0	1.8	2.5	3.0	1.9	1.5	1.8	5.3	4.4	4.4	4.2
Belgium	2.3	1.4	2.5	2.5	2.5	2.1	2.0	2.3	8.4	9.8	9.6	9.4
Denmark	1.7	2.5	2.5	3.0	2.7	2.1	2.5	2.8	10.5	6.9	6.5	6.0
Finland	0.8	3.3	4.0	3.5	3.7	0.6	1.0	1.8	10.6	15.7	14.5	14.0
France	2.0	1.5	2.0	2.8	2.6	2.0	1.3	1.5	10.5	12.4	12.7	12.3
Germany ³	2.4	1.4	2.3	2.8	2.8	1.5	1.5	1.5	6.2	9.0	11.3	11.0
Greece	2.0	2.6	2.5	2.5	14.7	8.2	6.0	5.0	8.5	10.4	10.4	10.2
Ireland	6.0	7.3	6.0	6.0	2.8	1.8	1.5	2.0	14.5	11.8	11.3	10.8
Italy	1.8	0.7	1.3	2.0	5.4	3.9	1.8	2.5	10.8	12.0	12.2	12.0
Luxembourg	6.2	3.9	4.0	4.0	2.5	1.4	1.5	1.8	1.9	3.3	3.2	3.0
Netherlands	2.7	2.8	3.0	3.0	2.3	2.1	2.3	2.5	7.1	6.3	5.5	5.0
Norway	2.5	5.3	3.0	2.5	3.4	1.3	2.8	2.8	5.1	4.9	4.7	4.5
Portugal ⁴	2.7	3.0	3.0	3.5	9.0	3.1	3.0	3.0	5.4	7.3	7.0	6.8
Spain	2.5	2.2	3.0	3.0	5.5	3.6	1.8	2.3	19.4	22.1	21.5	20.5
Sweden	1.0	1.1	1.8	2.0	5.4	0.5	0.5	1.5	5.4	10.0	10.8	10.5
Switzerland	1.1	-0.7	0.8	2.0	3.3	0.8	0.5	1.0	2.3	3.5	4.0	3.8
United Kingdom	1.7	2.3	3.0	2.0	4.9	2.4	3.0	3.3	8.8	8.2	7.5	7.0
Industrial countries (total) ⁵	2.3	2.5	2.3	2.4	3.3	2.0	2.1	2.2	7.0	7.6	7.6	7.4
Western Europe ⁶	2.1	1.7	2.3	2.6	3.9	2.3	1.8	2.1	9.3	10.7	11.1	10.7
European Union ⁶	2.1	1.7	2.3	2.6	3.9	2.4	1.9	2.1	9.5	11.0	11.3	10.9
EWU ^{6,a}	2.3	1.6	2.2	2.7	3.5	2.3	1.6	1.9	9.8	11.7	12.4	12.0

¹ In % of the labour force, in most cases OECD standardised figures. ² Unemployment rates up to 1995: as a % of employees. ³ Gross domestic product and consumer prices up to 1991: West Germany. ⁴ Gross domestic product for 1996 estimated. ⁵ Weighted as appropriate by gross domestic product, private consumption, size of the labour force 1995; total of the countries listed. ⁶ European Monetary Union: countries wishing to join, except Greece. ^a Average year-on-year change. ^b Forecast; country figures rounded. ^c Changes in the recording methods not taken into account.

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

likely to be established at the same time as the initial membership of the EMU. If the central exchange rate method is chosen - currency exchange at central EMS rates - exchange rates between the currencies of the future members would be fixed as of spring 1998. Yet even if the average exchange rate method is chosen, in which the conversion rates correspond to a longer term (e.g. two-year) average of the exchange rates, exchange rate fluctuations will probably still be very small.

The assumption of a high degree of constancy among current exchange rates and the prognosis regarding monetary policy in continental Europe are subject to considerable risks, not least with regard to the decisions soon to be taken on start of the EMU and the extent to which the participants fulfil the Maastricht criteria in the longer term. The less stringent the interpretation of the criteria, the more the stability of the euro will be called into doubt and the greater is the danger of a further devaluation of the currencies converting to the euro. Above all, there would then probably be a continued rise in the US dollar exchange rate. In the past months, the rise in the value of the dollar was probably also furthered by the currency crises in some of the Asian countries with high and rising current account deficits which also caused considerable disturbances in the financial sectors of the countries in question. Should a bank crisis ensue in any of these countries, it is assumed here that such a crisis would be of local significance only. Strong growth is expected to continue in the emerging economies and the developing countries as a whole. It is also assumed here that the boom on the world's stock exchanges will only gradually tail off.

Sustained Fiscal Policy

With its shift towards a permanently sustainable income and expenditure development, fiscal policy has also made a decisive contribution to the re-valuation of some of Europe's long-standing "soft" currencies. This year and next will see almost all countries maintaining their consolidation policies. Many governments are "using" the economic recovery to reduce their structural budget deficits which are generally high in relation to gross domestic product. In Japan in particular, despite the fact that the strength of the economic upturn was still uncertain, the government nonetheless shifted to a policy of consolidation so as to avoid a loss of confidence in the stability of fiscal policy following years of massive deficit spending. While for many European countries the fast rate of

consolidation maintained in spite of muted economic recovery is determined by their efforts to achieve qualification for the EMU, the other European states also intend making further significant reductions in their deficit quotas.

In general, however, deficit reductions in western Europe will not have stronger direct dampening effects on demand than they did last year; the structural deficit quota will be lowered to a similar extent as in 1996, and - in the case of the EMU hopefuls - this will be achieved to a certain degree by creative bookkeeping. In 1998 governments will not bow down to consolidation pressure to quite the same extent. Firstly, budget shortfalls will continue to shrink as the economic recovery continues. Secondly, the disciplinary effects of the sanctions set out in the stability pact are unlikely to be nearly as effective as the danger of missing out on membership of the monetary union, even if the reference value for the public budget deficit continues to be overshot. The deficit quota in the USA is declining this year purely as a result of the strength of the economy. In the industrialised countries as a whole, therefore, demand will once again be considerably dampened this year as a direct result of fiscal policy. Next year, on the other hand, the contractive influence of fiscal policy will slacken off noticeably.

Expansion and Price Stability

Given this economic and political climate, expansion of the industrialised economies will generally continue at the basic speed seen in the first half of this year not only for the rest of this year, but also next year, with regional differences remaining small. This is due to a considerable extent to the recent strong shifts in exchange-rate relationships. Thus the strong revaluation of the American and British currencies supports the political efforts in the USA and the United Kingdom aimed at limiting increases in production to the growth of productive capacity.

Economic recovery in continental Europe will see further consolidation. Strong export growth will continue, not least as a result of improvements in international competitiveness which, in turn, are due to currency devaluations. Given the favourable monetary framework, this growth will gradually spread to domestic demand. Industrial investments in particular will increase again markedly as earnings and sales prospects continue to improve; in addition, the substantially higher valuation of capital stock as a result of the global stock market boom as well as

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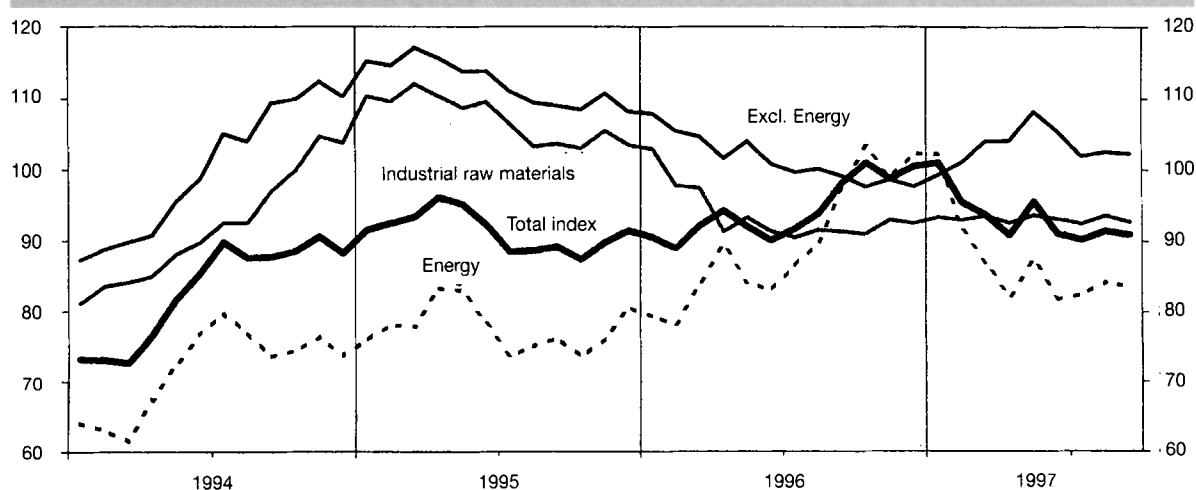
improved returns-to-interest ratios will probably encourage investments considerably. However, private consumption will also increase more noticeably, not least as a result of increased wealth. In Japan, expansion will remain restrained, particularly as the stimulus of external trade is growing weaker, both as a result of the recent marked revaluation of the yen and the considerable slowdown in growth in important eastern Asian partner countries.

Economic production in the industrialised countries as a whole will – compared to the previous year – increase at a rate of about 2¼ this year and nearly 2½% in 1998, almost the same rate as last year, with only a slight increase in capacity utilisation. Employment will expand again slowly, and the high level of unemployment will fall by a negligible amount only. Price increases will remain restrained. This is true both of prices on the international commodity

markets – oil prices will remain at current levels, prices for industrial raw materials will increase slightly – and for producer and consumer prices in the triad. A decisive contribution to price stability will be made by the avoidance of overheating in the countries where economic recovery is most advanced. In the countries of continental Europe, whose currencies have been valued at considerably lower levels for some time now, import prices are increasing markedly. However, since internal cost pressure continues to be low – wages are increasing only marginally faster than productivity – price rises will accelerate only slightly. On the whole, consumer prices in the industrialised countries will rise at an average of 2% this year – just as low an increase as in 1996; next year the inflation rate will be negligibly higher. With all that, world trade will increase by a good 7% this year and by 8% next year.

HWWA Index of World Market Prices of Raw Materials¹

(1990 = 100)



Raw Materials and Groups of Materials ¹	1996	March 97	April 97 ²	May 97	June 97	July 97	Aug. 97	Sept. 97 ³
Total Index	94.3 (3.3)	93.6 (1.6)	90.8 (-3.7)	95.5 (3.8)	91.1 (1.1)	91.1 (-1.7)	91.4 (-2.6)	91.2
Total excl. energy	101.4 (-9.6)	104.1 (-0.6)	104.1 (2.4)	108.1 (3.9)	105.4 (4.5)	102.0 (2.3)	102.6 (2.4)	102.1
Food, tropical beverages	124.6 (-2.1)	135.3 (7.1)	138.4 (4.4)	151.0 (11.1)	141.7 (9.8)	130.4 (2.7)	129.2 (2.8)	129.6
Industrial raw materials	93.7 (-12.6)	93.5 (-4.0)	92.6 (1.4)	93.7 (0.4)	93.1 (2.0)	92.5 (2.1)	93.6 (2.2)	92.8
Agricultural raw materials	96.0 (-13.8)	92.9 (-5.5)	93.0 (5.6)	92.7 (1.8)	92.2 (-0.6)	91.5 (-2.1)	92.8 (-2.3)	94.1
Non-ferrous metals	88.0 (-15.8)	93.7 (-1.6)	90.2 (-5.0)	94.3 (-1.6)	93.5 (8.5)	92.6 (12.5)	93.7 (13.4)	88.7
Energy	89.7 (15.5)	86.9 (3.5)	82.1 (-8.1)	87.3 (3.8)	81.8 (-1.5)	82.5 (-4.7)	84.2 (-6.2)	84.0

¹ On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.

² Corrected.

³ Up to and incl. 26th September.