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Günter Weinert*

Weaker World Economy

Last year's marked slowdown in the world economy, which followed a phase of very rapid expansion, has led to fears that a recessionary climate may be at hand. A key role in this is played by economic trends in the USA. How reliant is the rest of the world on the tractive power of what has up to now been the engine of economic growth? Is the drop in oil prices sufficient to stabilise economic activity?

With nearly 5% growth compared to 1999, global output last year increased at a faster rate than in the previous 15 years.¹ However, this high rate of increase is a reflection of the extremely vigorous expansion that took place up to last summer. In the second half of the year there was a marked loss of economic vitality along a wide front, although the global economy nonetheless maintained a course of modest growth. Expansion in the USA, in particular, weakened to a greater extent than expected. Aggregate output in the USA increased at an even slower rate than in the euro area, which also experienced a distinct economic slowdown. In Japan, recovery remained fundamentally weak, partly because of a markedly slower – though nonetheless strong – rate of expansion in the emerging economies of East Asia. The same is true of Latin America and eastern Europe.

The pronounced cooling of the world economy was due above all to monetary policy, which was slightly restrictive in many countries, and to the rise in oil prices. In order to pre-empt the risk of inflation generated by tensions within the economy and by inflationary impulses emanating from international trade, leading central banks began to raise their key interest rates in the second half of 1999. In the USA, in particular, monetary policy shifted to a more restrictive course. The same is probably true for the euro area following the ECB's latest interest rate rise last October. In the wake of the interest rate increases, developments in capital assets have at least ceased to be the source of expansionary effects for some time now. So far, the steep drop in share prices experienced on many stock markets since the autumn in particular has probably only partially affected demand for consumer goods. However, the relatively abrupt slowdown in the economy which took place after the middle of the year is above all the result of further increases in the price of oil. From the

beginning of 1999 to last autumn (since when it has fallen again), the price of Brent crude rose by around 200% to almost US\$ 35 per barrel (\$/b), and in so doing placed particular strain on the current accounts and real incomes of the oil importing countries. Nor was the related loss of domestic demand in these countries offset by a corresponding increase in demand in the oil exporting countries, since some of the OPEC states used part of their additional foreign exchange revenues for debt repayments.

The duration of these dampening effects varies quite considerably, however. Monetary policy works towards a sustained economic slowdown. The rise in oil prices, on the other hand, only has a temporary dampening effect on demand – at least as far as the direct effect is concerned. However, it can trigger reactions which have a more long-term influence on economic trends. In particular, there is a risk of a sustained acceleration of prices should the inflation spawned by oil price rises lead to higher wage increases, as was the case following the oil price explosions of 1973 and 1979. So far, however, there have yet to be any struggles over wages. Disregarding energy prices, the acceleration in price increases has been moderate. Given that, generally speaking, there has been little change in wage behaviour, this acceleration, too, should be short-lived; it is not least a reflection of the indirect effects of the oil price developments, i.e. the passing on of higher costs for oil as a production resource and intermediate product. Nonetheless, increases in the cost of living of private households, excluding energy, remained within the stability range in almost all of the industrialised countries.

However, the dampening effects caused by a drastic rise in oil prices can also contribute to an accumulative downward process. Weaker demand

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¹ For a more detailed analysis cf. G. Weinert, E. Wohlers et al.: Finanzpolitik stützt Konjunktur, HWWA Report No. 206, 2001.

caused by a loss of purchasing power can thus lead to an inferior earnings situation, a loss of wealth and property, and growing financing problems resulting from sharply declining share prices and a pessimistic economic climate, and so ultimately to a self-sustaining downswing.

Indeed, capital asset prices in particular have slumped along a wide front. Share prices in particular, where the underlying trend had been one of virtual stagnation over a relatively long period of time, fell quite sharply in some cases during the latter part of last year, with technology stocks suffering a particularly drastic decline. In countries with a relatively large number of shareholders this can lead to a higher savings ratio of private households. It can also be expected to result in considerable dampening effects on company investments, since it is more difficult for firms to raise equity capital via the emission of new shares and – as a consequence of lower company valuations – to take up new loans.

In the USA, a development of this nature appeared imminent, apparently bearing the kind of characteristics which, six months ago, were only to be found in risk scenarios. As a result, the Fed was prompted to cut interest rates significantly at the beginning of this year. A further cut can be expected soon should consumer and investor confidence fail to stabilise in the near future.

Nonetheless, a further rapid relaxation of monetary policy could jeopardise the stability of both the internal and the external value of the dollar, primarily because of the distinct rise in prices and the macroeconomic imbalances that are apparent in the low savings ratio and the high current account deficit which has doubled since 1997 to 4¹/₂% of GDP.

In contrast to the USA, the countries of western Europe are unlikely to suffer a sustained decline in demand and production. Although here, too, the second half of last year was marked by a distinct economic slowdown, the deterioration in the economic climate was short-lived.² The sharp decline in the price of technology stocks had little effect on the real economy, probably as a result of the relatively small number of shareholders among the general public. Above all, however, consumer and investor confidence is being supported by the cuts in individual and corporate income tax rates which came into force in many countries at the beginning of the year.

In Japan, the economic climate has been subdued for some time now. This is primarily due to the fact that there has yet to be a sweeping recovery from the poor economic and growth situation in which the

country has been languishing for a decade, nor is there any sign of this happening in the near future.

Lower Oil Bills Again

Oil price movements will be of great significance for economic developments in the oil importing countries this year and next. There are a number of reasons to believe that the price peak has been passed. The price of Brent crude has already fallen to around 25 \$/b again. It is assumed here that the oil price will remain at this level this year and be slightly lower in 2002.³

The fall in oil prices provides considerable relief to the oil importing countries. Moreover, lower oil prices help to prevent the emergence of an inflation mentality in the oil importing countries where price rises – disregarding those related to the price of oil – have accelerated only slightly. So far, in the major industrialised countries at least, there have yet to be any notable signs of distribution struggles. This has been helped by the experience of the oil price crises in the 1970s, when wage struggles led to a sustained acceleration of inflation and ultimately to recession, as well as by the “stability culture” which generally emerged in the 1990s.

Fiscal policy is also helping to counteract a further weakening of the economy in the western industrialised countries. There was a cut in direct taxation in the euro area at the beginning of the year, resulting in a perceptible real increase in the level of personal disposable income. In the USA, the new government similarly intends to use the scope provided by the country's budget surplus for tax cuts during the course of the year. In Japan, on the other hand, years of sharp increases in government debt, which has now reached a very high level, have reduced the financial scope for government demand to such an extent that it will provide very little in the way of impulses to the economy. In view of the country's fragile recovery, however, the government is as yet unlikely to turn to a policy of significant fiscal consolidation.

Given the largely tension-free economic trends assumed for this year, monetary policy can be expected to maintain its current course, especially as the general monetary conditions continue to be cyclically neutral. Continuing expectations of stability, but also lower levels of new government borrowing in

² Consumer confidence rose again in November.

³ For an analysis of the oil market situation, cf. Klaus Matthies: Preiswende bei Erdöl, in: Wirtschaftsdienst, Vol. 81 (2001), No. 1, pp. 57 f.

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the USA and western Europe, have led to a perceptible drop in long-term interest rates since last autumn. In the euro area, however, there has also been a marked recovery in the external value of the euro. In contrast, there has been little change in the external value of the other western European currencies or the US dollar.

For this reason, along with the fact that the output gap in the euro area is now almost closed and output is increasing at about the same rate as production potential this year, the European Central Bank will probably leave its interest rates unchanged for the time being. Given that the economy is cooling off significantly and that the inflationary impulses emanating from foreign trade are on the wane, a further interest rate rise, which had until recently been expected in various quarters, now appears unlikely. A cut in key interest rates is likely to occur when the stimulating effects of the recent tax cuts begin to fade and when the inflation rate returns to significantly

lower levels again. The Fed will probably only further reduce its interest rates if, in spite of the latest move, the situation on the financial markets and the economic climate continue to deteriorate apace. Given the ongoing weakness of the domestic economy, the Japanese central bank will not deviate from its low interest rate policy.

Given these economic conditions, with exchange rates more in line with fundamental determinants once again and with oil prices which are considerably lower than in the second half of the year 2000, the global economy is expected to maintain its upward trend during the forecast period. However, at an expected growth rate of just under 3% this year and slightly more next year, global output will increase at a perceptibly slower pace than last year, whereby the convergence of expansion rates seen in the second half of the year 2000 will be maintained. In the USA, the rise in output can even be expected to be significantly lower this year than in the euro area. In

Table 1
Real Gross Domestic Product, Consumer Prices and Unemployment Rates in Industrialised Countries

	Gross Domestic Product (year-on-year change in %)				Consumer Prices ¹ (year-on-year change in %)				Unemployment Rates ² (annual average)			
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
Austria	2.3	3.4	2.6	2.7	0.5	1.9	1.7	1.2	3.8	3.3	3.0	2.8
Belgium	2.7	3.7	3.1	3.0	1.1	3.0	2.3	1.5	9.1	8.5	8.2	7.8
Finland	3.5	5.7	4.5	4.2	1.3	3.0	2.4	1.8	10.2	9.8	9.3	8.9
France	2.9	3.1	2.8	2.7	0.6	1.8	1.6	1.3	11.3	9.8	8.7	8.3
Germany	1.6	3.1	2.7	2.5	0.6	1.9	1.9	1.3	8.8	8.3	7.9	7.6
Italy	1.4	2.6	2.4	2.4	1.7	2.6	2.3	1.8	11.3	10.6	10.1	9.7
Ireland	9.8	9.0	8.0	8.0	2.5	5.3	4.7	4.0	5.7	4.6	3.7	3.3
Luxembourg	7.5	7.0	6.2	6.0	1.0	3.7	2.5	2.0	2.3	2.2	1.9	1.8
Netherlands	3.6	3.9	3.5	3.5	2.0	2.5	3.1	2.0	3.3	2.8	2.5	2.3
Portugal	2.9	3.1	2.8	2.6	2.1	2.7	2.5	1.8	4.5	4.2	3.9	3.6
Spain	4.0	4.1	3.5	3.2	2.2	3.5	3.0	2.3	15.9	14.2	13.0	12.5
EUR 11 ³	2.4	3.3	2.9	2.8	1.1	2.3	2.1	1.5	10.0	9.1	8.5	8.1
Greece	3.4	3.8	4.0	4.5	2.2	2.8	3.0	2.0	11.7	11.2	10.5	10.0
EUR 12 ³	2.4	3.2	2.9	2.8	1.2	2.3	2.2	1.6	10.1	9.2	8.6	8.2
Denmark	1.6	2.0	2.0	2.5	2.1	2.8	2.4	2.1	5.2	4.9	4.9	4.7
Sweden	3.8	3.7	3.4	3.2	0.6	1.3	1.5	1.5	7.2	6.0	5.2	4.8
United Kingdom	2.2	3.0	2.8	2.7	1.3	0.8	1.3	1.2	6.1	5.4	5.3	4.9
European Union	2.4	3.2	2.9	2.8	1.2	2.0	2.0	1.5	9.3	8.4	7.9	7.5
Norway	0.9	3.2	3.0	2.6	2.2	3.0	2.5	2.5	3.2	3.3	3.1	3.0
Switzerland	1.5	3.2	2.4	2.3	0.8	1.6	1.5	1.2	2.7	2.0	1.8	1.7
Western Europe ³	2.4	3.2	2.9	2.8	1.2	2.0	2.0	1.5	9.0	8.2	7.7	7.3
Canada	4.5	5.0	3.5	3.0	1.7	2.7	3.0	2.5	7.6	6.8	6.3	6.0
Japan	0.3	1.9	1.5	1.5	-0.3	-0.6	0.5	0.8	4.7	4.7	4.7	4.7
USA	4.2	5.0	2.4	3.0	2.2	3.5	2.9	2.2	4.2	4.0	4.4	4.5
Total ³	2.8	3.7	2.5	2.6	1.4	2.2	2.1	1.7	6.6	6.1	6.0	5.8

¹ European Union: harmonised consumer price indices. ² Standardised; in % of labour force. ³ Total of listed countries; weighted by gross domestic product, private consumption and size of the labour force, respectively, for 1999.

Sources: Eurostat; OECD; national statistics; 2000 partly estimated; 2001 und 2002: HWWA forecasts.

Japan, aggregate output will continue along its path of slow growth. In most of the emerging economies, output growth will remain fundamentally strong. The more restrained global economy is also reflected in the development of world trade, which will increase by 7% and 8% in real terms in 2001 and 2002 respectively, compared to 12½% last year.

With only minor differences in output growth remaining between the various countries and regions of the world, the conditions are favourable for exchange rate developments which are once again more in line with fundamental determinants. The recovery of the euro, in particular, will help reduce the risk of global economic disturbances which could result from a rapid sharp reversal in exchange rate developments.

Considerable Risks Remain

Other risks of a downturn remain, however. Notwithstanding the uncertainties arising from the interactions of the simultaneously decelerated expansion in the oil importing countries, the susceptibility to negative shocks is generally greater during a phase of slower economic growth. Risk factors have been gaining significance since last summer. For example, a marked rise in oil prices, which are once more strongly influenced by cartel policy, cannot be ruled out should OPEC again curb production by a significant amount. Furthermore, the slowdown in the rate of output growth in a number of emerging economies has revealed more clearly the structural problems which still continue to exist. Considerable shortcomings are still evident in the banking sectors of certain East Asian countries in particular. Developments in the real economy could thus be subjected to renewed disturbances originating from the financial sector. This danger is magnified in several countries by a considerable degree of political instability.

A further weakening of output growth in the emerging economies would be probable if the economic slowdown in the USA – the primary source of economic stimulus for the global economy in the second half of the 1990s – were to take place more rapidly than has been assumed here. This cannot be ruled out despite the latest interest rate cut and despite the swift reaction to be expected on the part of the Fed to any further marked weakening of the economy.

Soft Landing in the USA Still Probable

In the USA, the reasons which recently prompted the Fed to lower its interest rates are not yet apparent in the statistics. Aggregate output figures are only

available for the first three quarters of the year, during which time real gross domestic product increased at an annual rate of 2.2%. While this was not even half as high as the growth rate in the first half of the year, it should be borne in mind that it was an objective of economic policy to slow down economic growth to a sustainable long-term level. Moreover, a considerable contribution to slower growth was made by a decline in government consumption which, in view of the healthy state of the country's public finances, can be expected to be of a temporary nature only. However, investments in plant and equipment also grew at a distinctly slower rate.

Fiscal policy will support business and private household confidence as well as private demand during the rest of this year. In view of the rapid economic slowdown, the new government will implement the income tax cuts promised during the election campaign at the earliest possible opportunity. However, a certain amount of time will be required for the exact design of the tax reform to take shape and for the subsequent parliamentary procedures to be carried through. It is assumed here that a significant cut in taxation will take place in the autumn. However, announcements of the government's intentions will have the effect of bolstering demand as soon as the tax reduction programme is more clearly outlined.

The temporary uncertainty with regard to future fiscal policy makes it more difficult for the central bank to exercise an appropriate monetary policy. It is assumed here that it will maintain its current, slightly restrictive course for the time being. In the case of a rapid and enduring deterioration of the economic climate or of financing conditions, it would probably attempt to reduce the risks to the economy by further loosening the monetary reins.

Given these general conditions, aggregate output will at first increase at a slower rate than the production potential, which is expected to grow at a little more than 3%. This initial rate of expansion only just corresponds to the soft landing that has been the policy objective for some time now. The dampening effects on private consumption attributable to employment, where growth rates are now relatively slight, to the deterioration of the capital asset situation and to the savings ratio, which is expected to halt its decline at least, will however be offset by the tax reforms. Businesses' propensity to invest will also be strengthened by the tax cuts. Despite the lower exchange rate of the dollar, exports will expand at a markedly slower rate in the wake of the economic slowdown experienced by major trading partners.

Aggregate output will this year exceed the previous year's mark by just under 2½%; in the year 2000 the growth rate was twice as high. Next year, the increase will be a little stronger again as a result of the stimulus provided by economic policy measures. At the same time there will be a slight increase in the unemployment rate. With the upward pressure of oil prices no longer in effect and with the economy in calmer waters, the rate of increase of the cost of living for private households, which last year rose to an average of 3.4% as a result of the rise in oil prices, will fall to 2.8% this year and 2¼% next year. A further increase in the current account deficit, which amounted to 4.3% of GDP last year, is unlikely.

Japanese Economy Remains Weak

In Japan, there is still no end to the poor growth situation which has continued since the early 1990s. The severe structural problems which became apparent when the speculation bubble burst at the beginning of the last decade have only been partially solved. In addition, sweeping recovery has been hampered since last summer by the cooling off of the economy in the rest of the world. This is reflected, for example, in Japan's export figures, which saw strong growth up to the middle of the year but have hardly increased at all since then. While the underlying growth rate of public sector investments – which, in recent years, have been geared to strengthening demand but have been subject to considerable fluctuations – is slower, private demand appears to be strengthening. Although private consumption stagnated again during the second and third quarters of last year, private investments have been showing a marked upward trend – following a long decline – since the autumn of 1999, not least because of an improvement in business earnings resulting from a series of extensive adjustment measures. The continuing weakness of the economy is reflected not least in the further slight drop in price levels. Despite the oil price shock, consumer prices were approximately 1% lower than the previous year's level.

In view of the country's fragile economic recovery, which still requires active support, key interest rates will probably be maintained at an extremely low level, even though they were raised slightly last summer. The impulses provided by low interest rates have as yet been limited, however; the money supply continues to expand at a modest rate. Moreover, years of high budget deficits and a drastic increase in public debt mean there is only very limited scope for an expansionary fiscal policy. Although the budget deficit will probably be reduced by no more than a marginal amount this year and next, there will hardly be any

additional impulses from public sector finances. At the same time, any stimulus from foreign trade will probably remain restrained in view of the economic slowdown in major partner countries, even though the competitiveness of Japanese suppliers has improved as a result of the lower external value of the yen.

Private domestic demand will continue to recover on the whole. Given the structural adjustments which have been carried out in the corporate sector, and in view of Japan's more favourable international competitiveness, the outlook for business earnings should improve further. While corporate investments will thus probably continue to increase, the rate of increase will be muted as sales expectations continue to be subdued. With little improvement expected in employment and income prospects, private households will continue to keep their consumption in check. With around 1½% growth expected for this year and next, aggregate output will increase at a slower pace than last year, if only because of the lack of state-induced stimuli. Significant price increases are not expected, despite the depreciation of the yen.

Slower Expansion in the Euro Area Too

The euro area, too, has seen a marked economic slowdown. Private consumption in particular weakened significantly due to the loss of purchasing power caused by the rise in import prices. Exports, on the other hand, encouraged by the low external value of the euro, have tended to increase at an accelerated rate. Even so, there was a marginal fall in real net exports.

Consumer prices increased significantly during the course of the year as a result of the inflationary impetus originating from foreign trade. With inflation running at 2¼%, the ECB medium-term stability target of 2% was clearly exceeded. Wage increases, however, remained moderate. This was doubtless partly due to the still high level of unemployment, which recently stood at 8.9%.

Thus the stability target does not appear to be in danger in the medium term. With oil prices returning to lower levels and with wage developments on the whole remaining moderate, the inflation rate will drop to below 2% again during the course of this year. Given this prospect for prices, the ECB is unlikely to raise its interest rates again. On the other hand, the ECB cannot be expected to follow the interest rate move in the USA, if only because this might stimulate aggregate demand to a level that would jeopardise the stability target. This is because fiscal policy, especially with its primarily growth-oriented cut in

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direct tax rates, but also with the compensation measures aimed at softening the blow to incomes suffered by individual groups as a result of the high oil prices, will this year counteract the dampening effects arising from foreign trade.

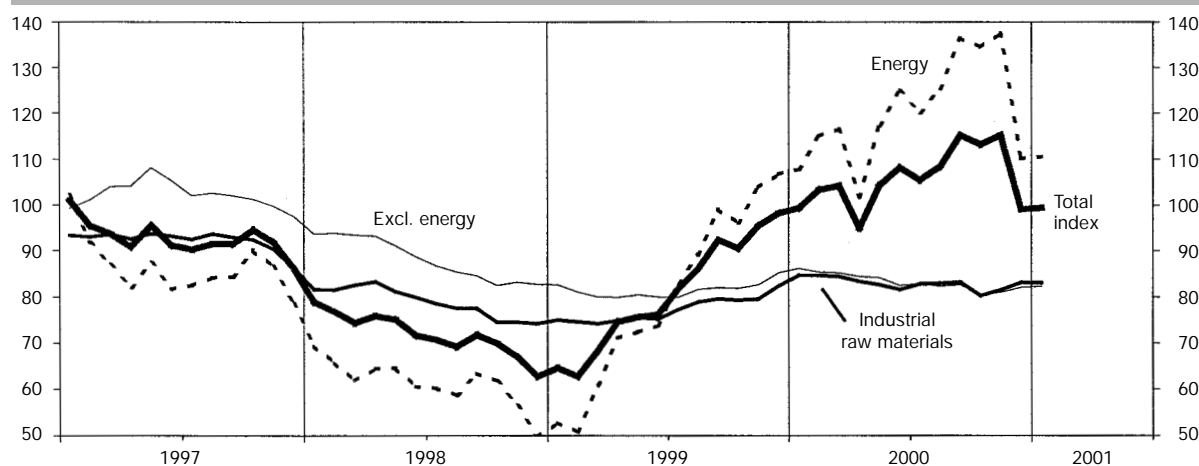
According to the national stability programmes, however, there will be no fundamental deviation from the course of fiscal consolidation. Thus the member states with budget deficits – i.e. the big four in particular – intend to reduce their deficits or even balance their budgets in the medium term. A continuation of the consolidation course appears credible not only given last year's widespread utilisation of exceptional revenues and the additional tax revenues spawned by the healthy state of the economy to reduce debt levels, but also in view of the caps on expenditure growth contained in current budgets.

Under these conditions, aggregate demand will initially increase at an accelerated rate. Private

consumption in particular will be strengthened by the cuts in taxation. This means that sales and earnings prospects remain relatively good despite the fact that there will be fewer impulses from foreign demand. As a result, the propensity to invest will hardly decline. All in all, output will expand at a rate of 2½% this year – roughly the same as that of the production potential. Once there has been a distinct decline in the rate of inflation and the impulses provided by fiscal policy have begun to fade, the ECB will loosen the monetary reins a little once more. Under these circumstances, there will be an increase in real gross domestic product of the same dimensions next year. The rise in price levels will slow down again markedly as the inflationary impulses from foreign trade diminish. Due to the large overhang, however, it will only be a little lower than last year, averaging a good 2% for the year. In 2002, the inflation rate will average 1½% for the year and will thus be back within the ECB stability corridor.

HWWA Index of World Market Prices of Raw Materials¹

(1990 = 100)



Raw Materials and Groups of Materials ¹	2000	July 00	Aug. 00	Sep. 00	Oct. 00	Nov. 00	Dec. 00	Jan. 01 ²
Total Index	105.9 (31.5)	105.4 (28.9)	108.3 (25.8)	115.2 (24.8)	113.2 (25.1)	115.2 (20.7)	99.1 (0.9)	99.4 (0.1)
Total, excl. energy	83.3 (2.3)	82.9 (3.7)	82.4 (0.9)	82.7 (0.8)	80.6 (-1.7)	81.0 (-2.0)	82.1 (-3.6)	82.3 (-4.4)
Food, tropical beverages	84.3 (-10.5)	83.0 (-5.6)	80.7 (-10.2)	81.2 (-9.1)	81.3 (-9.3)	79.4 (-13.5)	79.2 (-15.1)	80.3 (-11.3)
Industrial raw materials	83.0 (7.5)	82.9 (7.3)	83.0 (5.2)	83.2 (4.6)	80.3 (1.2)	81.6 (2.5)	83.1 (0.8)	83.0 (-2.0)
Agricultural raw materials	81.9 (4.2)	81.7 (4.4)	82.3 (2.9)	80.6 (1.8)	78.4 (-0.8)	81.9 (3.8)	83.0 (1.2)	82.9 (-0.6)
Non-ferrous metals	83.0 (15.5)	82.7 (12.6)	82.5 (9.5)	86.8 (9.5)	81.3 (3.6)	79.0 (-0.6)	82.1 (-0.5)	81.7 (-6.0)
Energy	120.6 (50.9)	120.1 (44.8)	125.2 (40.8)	136.4 (37.8)	134.5 (40.0)	137.5 (32.4)	110.1 (3.2)	110.5 (2.5)

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

² Up to and incl. 26th January.