The World Economy in the Autumn of 1996

An abridged version of the Evaluation of the Economic Situation by the following members of the working party of the German Economic Research Institutes, Berlin, Germany

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This year global economic activity has expanded slightly faster than last year. Growth in the developing and newly industrialising countries has remained, on the whole, buoyant, while the economic dynamic in the central European reform countries slowed and output growth in the western industrialised countries accelerated slightly: cyclical expansion in the USA temporarily intensified slightly, and in western Europe the virtual stagnation experienced last winter was overcome. The recovery in Japan has failed to strengthen significantly, despite the sharp rise in real GDP at the start of the year. There has been a further improvement in the labour market situation in the USA, whereas unemployment in western Europe and Japan has stagnated at a high level. Given little change in capacity utilisation and moderate wage growth, inflation in the industrialised countries remains subdued. On global primary goods markets the prices of industrial raw materials have eased substantially; on the other hand there has been a marked rise in the price of oil.

The decline in long-term interest rates in the course of 1995 has served to stimulate demand in the western industrialised countries; in the case of Japan and western Europe this effect was reinforced by the depreciation of their currencies against the dollar. More particularly, monetary policy in most countries has been providing a strong impetus to economic activity since the spring of 1995. Faced with sluggish economic growth and given the low and, in some cases, declining rates of inflation, west European central banks have cut their base rates substantially. Consequently, the rates of money supply growth have accelerated perceptibly and the gap between long- and short-term interest rates has widened. Japan has maintained its low-interest policy. The US Federal Reserve, though, saw no call for a further relaxation of its policy stance as the economic dynamic strengthened somewhat in the course of the year; conversely, moderate price and cost trends meant that the widely expected increase in base rates have not materialised.

There is no sign of a change of monetary policy course in the industrialised countries. Although the Federal Reserve is thought likely to increase short-term interest rates marginally in the coming months in order to underline its commitment to price stability, this does not means that further interest rate increases will follow in 1997. US monetary policy moved over to a neutral course already back in 1994, so that high inflation is unlikely in the near future. In Japan, too, the central bank will probably raise interest rates only moderately, and, given the relatively sluggish economic recovery, any such in-creases are not expected until the second half of 1997. In western Europe a further fall in interest rates is initially expected in many countries, particularly in those in which rates had been maintained at a rather high level following last year's currency depreciation and the temporary rise in inflation. Not until the upturn is seen as entrenched – at the earliest, in the latter course of next year – are some west European central banks likely to raise short-term rates slightly in order to counter inflationary expectations. All in all, monetary conditions are conducive to a continued cyclical expansion in the industrialised countries. This trend is underpinned further by the low level of long-term rates. Although capital market rates initially rose slightly this year, they have subsequently given ground, and rates are now only slightly higher than at the end of 1995. Indeed, in a number of west European countries they have fallen drastically, not least as a consequence of actual and expected successes in reducing inflation.

Fiscal policy in virtually all the industrialised countries has remained oriented towards reducing the size of government deficits. In western Europe these efforts were intensified because, in many countries, the deficits had turned out higher than planned due to the weakness of economic growth. In addition, many of those EU Member States, whose participation in European Monetary Union (EMU) was considered unlikely not all that long ago, have intensified their efforts to qualify. In many cases countries are making use of "creative accounting" to push the deficit below the reference value (3% of GDP). In both the current and coming years fiscal policy measures will exert a restrictive effect on economic activity in western Europe. By contrast, fiscal policy in the USA is now more or less neutral in its impact on the economy; the medium-term aim is for a gradual further consolidation of the budget deficit. The Japanese government is attempting to reduce the sharp

Table 1

Real Gross Domestic Product and Consumer Prices in the Main Industrial Countries

% change on the previous year

	Weights in %	Domestic product			Consumer prices		
		1995	1996	1997	1995	1996	1997
Germany	11.4	1.9	1.5	2.5	1.9	1.5	1.5
France	7.2	2.2	1.25	2.25	1.7	2	1.75
Great Britain	5.2	2.5	2	3	3.4	2.5	3.25
Italy	5.1	3.0	0.5	1.5	5.2	4	3.25
Spain	2.6	3.0	2	3	4.7	3.5	3
Netherlands	1.9	2.1	2.5	3	2.0	2	2
Switzerland	1.4	0.1	0	1.5	1.8	1	1
Belgium	1.3	1.9	1.5	2.5	1.5	2	2
Austria	1.1	1.8	1	2	2.2	2	2
Sweden	1.1	3.0	1.5	2.5	2.5	0.5	2
Denmark	0.8	2.8	1.5	2.5	2.1	2	2
Norway	0.7	3.3	4	3	2.4	1.5	2
Finland	0.6	4.2	2	3	1.0	1	1.5
Western Europe[1)]	40.5	2.3	1.5	2.4	2.7	2.2	2.2
USA	32.8	2.0	2.5	2.25	2.8	3	3
Japan	24.1	0.9	3.75	2.25	–0.1	0	1.5
Canada	2.7	2.3	1.5	3	2.2	1.5	2
Total[1)]	100.0	1.9	2.4	2.3	2.0	1.9	2.3
Memo item:							
Total[2)]		2.1	1.6	2.4	2.5	2.2	2.3

1) Total of countries listed. Weighted by 1995 gross domestic product. — 2) Weighted by 1995 shares in German exports.
Sources: OECD; national data. 1996 and 1997 forecast by the participating Institutes, figures rounded.

increase in the deficit resulting from the demand-management programmes repeatedly initiated in recent years. In view of the comparatively moderate recovery, however, these efforts are not likely to be pursued too vigorously.

For the prognosis it was assumed that the dollar will, on balance, continue to appreciate, given a slight increase in the interest rate differential between the USA and the other western industrialised countries. In view of the continued efforts on the part of most of the EU countries to meet the criteria set out in the Maastricht Treaty, there will be little change in exchange rate parities between the European currencies. Following a figure of just over US $ 17 per barrel in 1995, the annual average price of oil will be around US $ 21 in both the current and the coming years; this implies that in the course of 1997 it will decline from its currently rather high level.

Under these conditions economic expansion in western Europe will become more firmly established in 1997, following the recovery in the current year. This is largely due to the low rate of interest, but also to the depreciation of most European currencies against the dollar; on top of these effects come demand impulses from abroad. The attempts at fiscal consolidation, on the other hand, will exert a restrictive effect. The upturn will be on the back of rising investment in equipment and, initially, of rising stock levels. The average rate of

Table 2

Real Gross Domestic Product and Domestic Expenditure in Selected Industrial Countries

% change on the previous year

	Weights in %	Gross domestic product			Weights in %	Domestic expenditure		
		1995	1996	1997		1995	1996	1997
Germany	12.9	1.9	1.5	2.5	12.6	2.1	1	2
France	8.2	2.2	1.25	2.25	7.9	2.0	1	2.25
Great Britain	5.9	2.5	2	3	5.9	1.5	2.5	3
Italy	5.8	3.0	0.5	1.5	5.6	2.3	0.5	1
Western Europe[1)]	32.8	2.3	1.4	2.4	32.0	2.0	1.2	2.1
USA	37.0	2.0	2.5	2.25	38.7	2.0	2.5	2
Japan	27.2	0.9	3.75	2.25	26.4	1.7	4.75	2.75
Canada	3.0	2.3	1.5	3	2.9	1.2	1.25	3
Industrial countries[1)]	100.0	1.8	2.4	2.3	100.0	1.7	2.4	2.1

1) Total of countries listed. Weighted by 1995 gross domestic product and domestic expenditure respectively.
Sources: OECD; national data. 1996 and 1997 forecast by the participating Institutes.

GDP growth in 1997 will be around 2½%, compared with 1½% in 1996. There will be a slight increase in the rate of real capital utilisation in the course of 1997, employment will begin to rise and unemployment will fall, although only marginally. With overall cyclical trends remaining moderate, cost and price inflation will remain subdued. In the USA – against the background of a still neutral monetary policy stance – investment and private consumption will expand at about the same rate as in 1996. Exports will remain decidedly expansionary, a trend boosted by buoyant demand from Canada, Latin America and Europe, even though dragged down slightly by the appreciation of the dollar. Real GDP will grow by around 2¼% in the coming year, i.e. at a similar rate to potential output. Despite the high level of capacity utilisation, cost and price inflation will remain moderate. In Japan the private sector's propensity to invest will solidate given low interest rates and following the substantial reduction in overcapacity. However, compared with earlier recovery phases, the growth of domestic demand will be subdued, not least due to the country's unsolved structural problems. Increasingly, though, expansionary impulses are to be expected from exports, largely due to the considerable depreciation of the yen since the middle of last year. Given a rate of real GDP growth of 2¼% in 1997, unemployment will remain at a relatively – i.e. for Japan – high level.

In the industrialised countries as a whole, real GDP in both the current and the coming years will increase by just under 2½%. In central Europe economic growth will once again become more dynamic due to the ongoing progress being made in economic restructuring and the cyclical recovery in western Europe – which already constitutes the market for around 60% of its goods exports. In most of the developing and newly industrialising countries of Asia, Latin America and the Middle East the expansionary output trend is set to continue. Under such conditions world trade, following the recovery in the current year, will increase on annual averages by 7½% in 1997 compared with 1996.

The prognosis for economic trends in western Europe is based on the assumption that interest rates and exchange rates do not change significantly. This assumption is subject to an above normal degree of uncertainty, however. In the run-up to the decision, due

Table 3
Real GDP, Consumer Prices and Unemployment Rates in Central and Eastern Europe

	Weights in %	Real gross domestic product			Consumer prices			Unemployment rates		
		% change on the previous year						in %		
		1995	1996	1997	1995	1996	1997	1995	1996	1997
Poland	16.7	7.0	5.5	5	27.8	20	15	14.9	14	13
Czech Republic	6.5	4.8	4.5	4.5	9.1	9	8	2.9	3	3.5
Hungary	6.2	1.5	1	2	28.2	23	20	10.9	11	11
Romania	5.0	6.9	4	4	32.3	35	25	8.9	9	9
Slovenia	2.6	3.5	3	4	12.6	10	8	13.9	13.5	13
Slovakia	2.5	7.4	6.5	5.5	9.9	6.5	6.5	13.1	12	11
Bulgaria	1.8	2.5	–1	0	62.2	110	100	11.1	12	13
Central Europe[2)]	41.4	5.4	4.1	4.1						
Russia	51.6	–4.0	–5	–2	203	40	25	8.2	10	12
Ukraine	5.1	–11.8	–7	–2	377	60	35	.	.	.
Belarus	2.0	–10.0	–5	–3	709	50	50	.	.	.
Total[2)]	100.0	–0.6	–1.3	0.5						
Memo item:										
Total[3)]		2.5	1.8	2.6						

1) Figures at the end of the year. — 2)Total of countries listed. Weighted with 1995 gross domestic product. — 3) Total of countries listed. Weighted by 1995 German exports.
Sources: Figures from domestic and international institutions; 1996 and 1997 forecast by the participating Institutes.

to be taken at the start of 1998, on the schedule for, and the participants in, European Monetary Union, substantial changes in interest and exchange rates in economic policy and thus in business cycle trends may occur. Such reactions are possible not only in the case of monetary union being postponed: if it seems likely that politicians will consider the circle of participating countries to be too small, and markets were consequently to take the view that the criteria set out in the Maastricht Treaty were not being taken seriously, this would pose a threat to the credibility of the monetary union as a "community of price stability". This could lead to a higher risk premium being demanded on capital market interest rates. Moreover, the currencies of participating countries could come under pressure against those of non-participating countries. On the other hand, market reactions and the impact on the business cycle could also be substantial if it were to become apparent that EU Member States which had made great efforts to meet the criteria of the Maastricht Treaty were not to be admitted: their currencies would then be expected to depreciate significantly and their long-term interest rates rise perceptibly.

Further decline in output in the CIS

Following the strong GDP growth recorded in most central European reform states last year, the forces for economic expansion have weakened during the current year. Only in the Czech and Slovak republics and in Poland has economic expansion continued almost unabated. Bulgaria, by contrast, suffered economic contraction, due partly to the government's indecisiveness on reform policy and the slow progress made in overcoming the banking crisis. In the countries of the CIS the expectation of a stabilisation of the economic situation has yet to be fulfilled. Output has continued to contract, primarily because of the lack of success in corporate restructuring.

Decisive for the flattening out of economic growth in central Europe has been the perceptible attenuation of growth stimuli from abroad. Some countries even experienced a decline in exports. The most important reasons for this were the cyclical weakening in western Europe and the continued real appreciation of central European countries' currencies, which led to a deterioration in their price competitiveness. In the Czech and Slovak republics and Poland the weakening export dynamic came up against unabated import demand, leading to a substantial deterioration in the balance of trade deficits. In Hungary, Bulgaria and Romania, on the other hand, imports declined in the wake of restrictive measures, such as additional import duties, import bans and restricted access to foreign exchange loans. Overall the deficit in the trade balance for central Europe as a whole widened further in the first half of 1996. Of the CIS countries, Russia and the Ukraine again earned substantial surpluses in trade with non-CIS countries, despite equally strong real currency appreciation, due to the continued buoyant foreign demand for raw materials, energy and basic goods.

Growth of domestic demand was faster in the central European reform countries, with the exception of Bulgaria and Hungary. Investment growth was particularly strong in the Czech Republic, Poland and Slovenia; the growth of private consumption accelerated in most of the countries. By contrast, in the CIS countries the process of declining investment continued, reflecting the high interest rates and the still unfavourable climate for investment. Foreign direct investment, which in 1995 had almost doubled on the previous year in central and eastern Europe to US $ 12.8 billion, again increased, particularly in high-growth central European countries. Direct investment in Russia increased to more than US $ 2 billion in 1995, but remained low in relative terms.

In the course of 1996 the pace at which employment is contracting eased in most central European countries. In industry, however, where deconcentration and privatisation have in most cases continued at a rapid pace, the number of employees has continued to decline rapidly, despite output growth. Even so, registered unemployment has in many cases declined, not least due to falling participation rates in many countries. However, with very few exceptions the unemployment rate remains in two-digit figures. The official figures understate the true magnitude of unemployment particularly strongly in Bulgaria and Romania, in which hidden unemployment, particularly in agriculture and craft work is rife. This problem is even more acute in the CIS countries.

Inflation has subsided only gradually in the central European countries over the course of this year. Above all it was (in some cases substantial) wage increases, the rise in administered prices and also the ongoing cuts in subsidies on services and consumer goods that prevented a more pronounced fall in the rate of inflation. In the Slovak Republic consumer prices have risen more slowly than in the other reform countries. Bulgaria, by contrast, experienced a dramatic acceleration of inflation beginning in May: energy prices, tariffs and value-added tax were all raised substantially, and the external value of the lev fell to a third of the previous year's level. In the CIS countries the monthly rate of inflation has declined substantially; on year-on-year figures inflation has returned to two-digit rates for the first time since 1991. The simultaneous exacerbation of the financial crisis (huge outstanding payments, primarily by state companies, to the tax authorities, workers and firms supplying inputs) shows, however, that the contradictions between a strict fiscal and monetary policy and the inadequate degree to which structural reforms have been realised at company level have deepened.

In central Europe a slight acceleration of economic growth is expected as the year goes on and in 1997. The annual average rate of GDP growth, though, will be less than last year due to the only slight increase in output in the year so far; even so it will amount to over 4%. In 1997 the rate is expected to be of a similar order of magnitude. The cyclical recovery in western Europe will underpin this trend. Inflation will ease slightly as the efforts by fiscal and monetary policy to ensure price stability continue. In an increasing number of countries the decline in employment is likely to come to a halt.

The CIS countries are still waiting for the "sea-change" in economic trends. The decline in output will continue throughout 1996 and will only gradually come to an end in the course of 1997. On annual averages, however, real GDP in 1997 will again be lower than in the previous year. Inflation will continue to flatten out, but will remain at a two-digit rate. Unemployment will continue to expand rapidly, and in view of the inadequacy of social security systems this could lead to growing tensions.

World trade expanding strongly

The growth of world trade has accelerated this year, following the slow-down experienced in 1995. Demand impulses emanated, in particular, from the cyclical recovery in western Europe and the renewed strength of output growth in the USA; in Japan, on the other hand, the previously extremely rapid growth of imports has flattened out. Many Asian and Latin American developing and newly industrialising countries have also sucked in imports, boosting world trade volumes. Central and east European imports have risen substantially given rapid economic growth in many of these countries and their progressive integration into the world economy. The oil-exporting developing countries were once again able significantly to expand their purchases abroad thanks to the marked improvement in their export revenue.

In 1997 western Europe and Japan are expected to experience strong import growth for cyclical reasons, whereas the demand impulses from the USA are likely to remain more or less constant. Import growth in the Asian developing and newly industrialising countries is expected to slow slightly. Additional impulses for world trade will, however, emanate from the economic recovery in leading Latin American countries. The rise in imports by oil-exporting developing countries will weaken only gradually. Overall there will be no further acceleration in world trade growth: on annual average results, however, it is forecast, at 7½%, to exceed this year's figure of 6½%.