

World Economic Trends: Moderate Expansion

Economic activity during 1996 was slightly more strongly expansionary than in the previous year. In North America the economic expansion accelerated a little as monetary policy was eased, whereas economic trends in Japan were patchy following an extremely strong growth in output in the first quarter of 1996. It was not until the second half of the year that western Europe enjoyed a perceptible economic recovery. Economic growth in central Europe continued, and strong growth was maintained in south-east Asia, albeit slightly less pronounced than in recent years.

One factor behind the acceleration of economic growth in western Europe was that monetary policy was eased once more. The expansion cannot be expected to develop into a strong upturn, however, given the stringent consolidation efforts being made in the run-up to European Monetary Union. On top of this comes the fact that a turnaround in the trend of interest rates on capital markets, emanating from the USA, is likely. Moreover, foreign trade imbalances seem to be increasing, creating a potential for marked fluctuations in exchange rates.

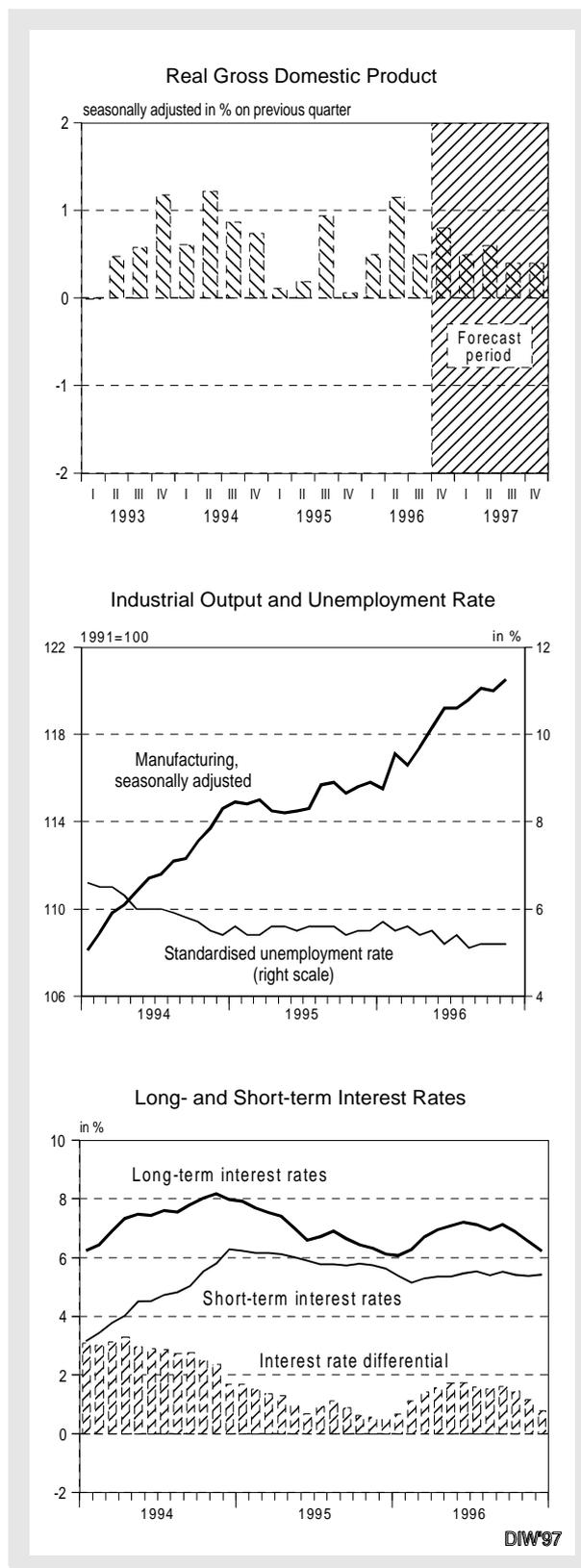
On annual averages, real GDP in the industrialised countries grew by just under 2½% in 1996, compared with about 2% the year before. Consumer price inflation was slightly higher in the non-European industrialised countries; inflation does not pose a problem in any country, however. In western Europe the rate of inflation declined from just under 3% to just less than 2½%.

Steady expansion in the USA

Economic expansion in the USA has now returned to a steady path, now that the "exaggerated" – in terms of the underlying cyclical trend – growth recorded in the summer of 1996, caused primarily by a temporary sharp increase in public spending, has attenuated (cf. figure 1).

The upturn continues to be largely on the back of the still strong growth of investment. Investment in machinery and equipment, in particular, rose markedly in 1996, as in earlier years, and there has been a perceptible pick-up in housing construction. It is to be noted that investment as a share of output has risen far more sharply during the current upturn than during the 1980s. A prime reason for this is likely to have been the favourable monetary framework, maintained over an extended

Figure 1
USA



Sources: OECD, main economic indicators; DIW.

Table 1

Trends of Gross Domestic Product and of Total Domestic Demand in Western Industrial Countries

Countries	Weight ¹⁾ 1995 in per cent		GDP, real			Total domestic demand, real ²⁾			Consumer prices ³⁾		
			% change on the previous year								
	GDP	German exports	1995	1996	1997	1995	1996	1997	1995	1996	1997
Germany	11.1		1.9	1.5	2.0	2.1	1.0	1.5	1.9	2.0	1.5
France	7.0	15.8	2.2	1¼	2¼	2.0	1.0	2.0	1.7	2.0	1¼
Great Britain	5.1	10.9	2.4	2.5	3.0	1.5	2.5	3.0	3.4	2.5	3¼
Italy	5.0	10.2	3.0	1.0	1¼	2.3	0.0	0.5	5.2	4.0	3¼
Spain	2.6	4.6	2.8	2.0	3.0	3.1	2.5	3.0	4.7	3.5	3.0
Netherlands	1.8	10.1	2.1	2.5	3.0	2.4	2.0	2.5	2.0	2.0	2.0
Belgium	1.2	8.8	1.9	1.5	2.5	1.5	1.5	1.0	1.5	2.0	2.0
Sweden	1.1	3.3	3.6	1.5	2.5	2.3	1.0	2.5	2.5	0.5	2.0
Austria	1.1	7.5	1.8	1.0	2.0	2.9	1.0	1.5	2.2	2.0	2.0
Denmark	0.8	2.6	2.8	2.0	3.0	4.6	3.0	3.5	2.1	2.0	2.5
Finland	0.6	1.2	4.2	2.0	3.0	3.4	3.0	3.0	1.0	1.0	1.5
Greece	0.5	1.0	2.0	2.0	2.0	2.1	2.0	2.0	9.3	7.5	6.5
Portugal	0.4	1.2	1.5	2.5	2.5	1.9	2.5	2.5	4.1	2.5	3.0
Ireland	0.3	0.6	10.3	6.0	5.0	5.7	5.0	3.5	2.4	1.5	2.0
EU	38.6		2.4	1.7	2.3	2.2	1.4	1.9	2.8	2.4	2.3
EU excl. Germany	27.5		2.6	1.7	2.4	2.3	1.5	2.1	3.2	2.6	2.6
EU excl. Germany ⁴⁾		77.8	2.4	1.7	2.4	2.3	1.5	2.0	2.8	2.4	2.4
Switzerland	1.4	7.1	0.1	0.0	1.0	1.9	0.0	0.5	1.8	1.0	1.0
Norway	0.6	1.1	3.3	4.0	3.0	3.7	3.0	3.0	2.4	1.5	2.0
Europ.indust. countries	40.6		2.3	1.6	2.3	2.2	1.3	1.9	2.8	2.4	2.2
Europ.indust. countries excl. Germany	29.5		2.5	1.7	2.4	2.3	1.5	2.0	3.1	2.5	2.5
Europ.indust. countries excl. Germany ⁴⁾		86.0	2.3	1.6	2.3	2.3	1.4	1.9	2.7	2.3	2.3
USA	33.3	9.8	2.0	2.5	2.5	2.0	2.5	3.0	2.8	3.0	3.5
Canada	2.6	0.8	2.3	1.5	3.0	1.1	0.5	2.0	2.2	2.0	1.5
Japan	23.5	3.4	0.9	3¼	2.0	1.7	4.5	2.0	-0.1	0.5	1.5
Non-European industrial countries	59.4		1.6	3.0	2.3	1.8	3.2	2.6	1.6	2.0	2.6
Non-European industrial countries ⁴⁾		14.0	1.7	2.8	2.4	1.9	2.9	2.7	2.1	2.3	2.9
Total	100.0		1.9	2.4	2.3	2.0	2.5	2.3	2.1	2.1	2.5
Total excl. Germany	88.9		1.9	2.5	2.3	2.0	2.6	2.4	2.1	2.2	2.6
Total excl. Germany ⁴⁾		100.0	2.2	1.8	2.3	2.2	1.6	2.0	2.6	2.3	2.4

1) On dollar basis at 1995 exchange rates (annual average).— 2) Consumption and gross investment by residents.— 3) Germany: deflator of private consumption.— 4) Weighted by country's shares in German exports 1995.

Sources: National statistics and forecasts by official and private institutions and the DIW. Estimated and forecast rates of change rounded.

period, which initiated, and has accompanied, the upturn with low interest rates, while fiscal policy was restrictive over much of the period. There is a major difference in this respect to the upturn experienced during

the 1980s, which was largely initiated by an expansionary fiscal policy while monetary policy sought primarily to bring down the – then significantly higher – rates of inflation.

Table 2
Trends in GDP Components in Western Industrial Countries
real % change on the previous year

Countries	Private consumption			Government consumption			Gross fixed investment			Exports			Imports		
										of goods and services					
	1995	1996	1997	1995	1996	1997	1995	1996	1997	1995	1996	1997	1995	1996	1997
Germany	1.8	1.5	1.5	2.0	2.5	1.5	1.5	-0.5	1.0	5.9	4.0	5.5	6.4	2.0	4.0
France	1.8	2.5	1.5	0.9	1.5	1.5	2.7	0.5	3.0	6.0	2.0	4.5	5.4	0.5	3.5
Great Britain	2.0	3.0	3.5	1.0	1.0	1.0	-0.1	3.5	5.0	7.2	6.0	5.0	3.9	7.0	5.5
Italy	1.7	0.5	1.0	-0.5	-0.5	-0.5	5.9	2.0	1.0	11.6	0.0	3.5	9.6	-3.0	1.5
Spain	1.5	2.0	2.0	1.3	0.0	0.0	8.2	4.0	4.0	8.2	4.0	4.5	8.8	5.0	4.5
Netherlands	2.1	2.0	2.0	0.5	2.0	1.5	4.9	4.0	3.5	6.1	3.0	4.0	6.5	2.5	3.5
Belgium	2.0	1.5	1.0	1.0	0.0	0.5	4.0	2.5	2.5	4.0	3.0	4.0	3.5	3.0	3.0
Sweden	0.8	1.5	2.0	-1.0	-1.0	0.0	10.9	6.0	3.0	12.6	3.0	3.5	10.3	2.0	3.5
Austria	1.9	1.0	1.5	2.1	0.5	0.5	2.3	1.0	2.0	5.0	3.0	4.0	7.1	2.5	3.0
Denmark	2.3	2.0	2.0	0.8	1.0	1.0	10.2	3.0	4.0	3.7	2.0	3.5	8.2	4.5	4.5
Finland	3.8	2.5	2.5	1.3	1.0	1.0	7.7	4.5	4.5	8.3	2.5	4.5	6.3	7.5	5.5
Greece	1.5	1.5	1.5	1.0	0.0	1.0	8.0	5.0	5.0	4.0	3.0	4.5	3.5	3.0	4.0
Portugal	2.5	2.0	2.0	1.5	2.0	1.5	4.0	3.0	4.0	5.5	2.5	3.5	5.0	2.0	3.5
Ireland	3.7	6.0	3.0	3.0	2.0	1.5	10.0	8.0	5.0	17.0	10.0	10.0	12.3	10.0	10.0
EU ¹⁾	1.8	1.9	1.8	1.1	1.2	1.0	3.4	1.5	2.5	7.1	3.3	4.6	6.4	2.6	3.9
EU excl. Germany ¹⁾	1.9	2.0	1.9	0.7	0.7	0.8	4.4	2.5	3.2	7.5	3.1	4.4	6.4	2.8	3.8
Switzerland	0.7	0.5	0.5	-0.1	0.0	-1.0	2.3	0.5	0.5	3.0	2.0	3.5	6.6	1.7	2.5
Norway	2.6	3.5	2.5	0.2	1.5	2.0	4.5	7.0	5.0	3.8	6.0	4.0	5.1	4.5	4.0
European industrial countries ¹⁾	1.8	1.8	1.8	1.0	1.2	0.9	3.4	1.6	2.4	6.9	3.3	4.6	6.4	2.6	3.8
Europ. indust. countries excl. Germany ¹⁾	1.8	2.0	1.9	0.7	0.7	0.7	4.3	2.5	3.1	7.2	3.1	4.3	6.4	2.7	3.8
USA	2.3	2.5	2.5	-0.3	0.5	1.0	5.2	6.0	6.5	8.9	5.5	7.0	8.0	7.0	9.5
Canada	1.4	2.0	1.5	-0.7	-1.0	0.5	-0.1	3.5	4.5	12.0	5.0	8.5	8.7	3.5	6.5
Japan	1.7	2.5	2.0	2.0	1.0	-1.5	0.9	10.0	2.5	5.0	1.5	7.0	13.5	9.5	5.0
Non-European industrial countries ¹⁾	2.0	2.5	2.3	0.3	0.5	0.3	2.8	8.0	4.4	8.1	4.1	7.2	9.6	7.2	7.9
Total ¹⁾	2.0	2.2	2.1	0.7	0.9	0.6	3.0	5.6	3.6	7.3	3.6	5.5	7.6	4.3	5.4
Total excl. Germany ¹⁾	2.0	2.3	2.1	0.5	0.6	0.4	3.2	6.4	4.0	7.6	3.5	5.5	7.8	4.7	5.6

1) 1995 weights on dollar basis at 1995 exchange rates (annual average).

Sources: National statistics and forecasts by official and private institutions and the DIW. Estimated and forecast rates of change rounded.

Given that the dollar has increased in value significantly since the spring of 1995, raising the price of American exports, overall export growth was weak, and at some points actually negative. Other factors responsible for this trend were the still restrained expansion in Europe and the somewhat weaker economic dynamic in south-east Asia. Imports, on the other hand, continued

to expand at a virtually unchanged rate, leading to a marked negative trend in net exports.

Inflation remained subdued – the cost of living rising by around 3% – against the background of a slight decline in capacity utilisation. Wage growth accelerated somewhat. The, at times, extraordinarily dynamic rise in employment has recently flattened out rather, and the

Table 3

Trends in Gross Incomes, Unit Profits and Labour Costs per Unit of Output in Western Industrial Countries

% change on the previous year

Countries	Gross income from						Profit per unit of output ¹⁾			Labour costs per unit of output ²⁾				
	self-employment and property			employment										
	in national currencies												in SDR	
	1995	1996	1997	1995	1996	1997	1995	1996	1997	1995	1996	1997	1995	1996
Germany	9.4	4.0	8.0	3.0	1.5	1.5	7.3	2.5	6.0	1.1	0.0	-0.5	8.0	-0.1
France	3.7	4.0	6.5	3.8	3.0	3.0	1.4	2.5	4.5	1.5	2.0	1.0	6.5	4.2
Great Britain	6.0	11.0	11.5	3.5	3.0	3.5	3.5	8.5	8.0	1.1	0.5	0.5	-1.7	1.8
Italy	12.6	6.5	5.5	4.4	4.5	4.0	9.3	5.5	4.5	1.4	3.5	2.5	-5.3	13.1
Spain	11.0	7.0	9.0	5.5	5.5	4.5	8.0	4.5	6.0	2.5	3.5	1.5	3.9	6.9
Netherlands	2.2	7.0	8.0	4.1	3.5	3.5	-0.1	4.5	5.0	1.7	1.0	0.5	8.8	1.0
Belgium	4.1	3.5	6.5	4.0	3.5	3.5	2.2	2.0	4.0	2.1	2.0	1.0	9.4	2.0
Sweden	21.5	2.0	10.0	5.0	4.0	4.0	17.1	0.5	7.5	1.4	2.5	1.5	3.5	13.3
Austria	9.3	6.5	9.0	3.8	2.5	2.5	7.3	5.5	7.0	1.9	1.5	0.5	9.0	1.4
Denmark	3.9	6.5	8.5	5.6	4.0	4.5	1.1	4.0	5.5	2.7	2.0	1.5	10.1	3.2
Finland	14.1	-0.5	6.5	6.6	4.5	3.0	9.5	-2.5	3.5	2.3	2.5	0.0	15.5	1.4
Greece	14.3	10.0	9.0	10.5	7.5	7.0	12.0	8.0	6.5	8.3	5.5	5.0	7.1	5.8
Portugal	9.7	5.5	6.5	6.0	5.5	5.0	8.1	3.0	3.5	4.4	3.0	2.5	8.2	5.2
Ireland	22.0	10.0	10.0	6.5	6.0	5.0	10.6	3.5	4.5	-3.5	0.0	0.0	-2.5	2.9
EU ³⁾	8.8	5.9	7.8	3.9	3.0	3.0	5.6	3.8	5.6	1.5	1.5	0.7	4.9	3.7
EU excl. Germany ³⁾	8.6	6.5	7.8	4.3	3.7	3.6	5.0	4.3	5.4	1.6	2.0	1.1	3.8	5.0
Switzerland	3.1	9.0	8.5	2.4	1.0	1.0	3.0	9.0	7.5	2.3	1.0	0.0	11.7	2.2
Norway	8.9	8.0	6.5	5.0	5.0	5.0	5.5	4.0	3.5	1.6	1.0	2.0	6.8	3.3
European industrial countries ³⁾	8.6	6.1	7.8	3.9	3.0	2.9	5.5	4.0	5.6	1.5	1.4	0.7	5.2	3.7
Europ. indust. countries excl. Germany ³⁾	8.3	6.7	7.8	4.2	3.6	3.5	4.9	4.5	5.5	1.6	1.9	1.1	4.2	4.8
USA	6.6	8.5	4.0	5.3	5.0	6.0	4.5	6.0	1.5	3.2	2.5	3.5	-2.6	6.8
Canada	7.6	4.5	10.5	3.2	3.5	4.5	5.2	3.0	7.5	0.8	2.0	1.5	-5.3	6.7
Japan	1.5	11.0	1.5	1.6	2.0	2.5	0.6	7.0	-0.5	0.7	-1.5	0.5	3.3	-9.9
Non-European industrial countries ³⁾	4.7	9.3	3.3	3.8	3.8	4.6	3.2	5.9	1.7	1.9	1.0	2.1	-0.9	0.7
Total ³⁾	6.4	7.8	5.4	3.8	3.5	3.9	4.6	4.7	4.2	1.6	1.3	1.2	2.9	2.6
Total excl. Germany ³⁾	6.1	8.3	5.1	3.9	3.7	4.2	4.2	5.1	3.9	1.7	1.5	1.5	2.0	3.1

1) Gross income from self-employment and property per unit of real Gross Domestic Product. — 2) Gross income from employment per unit of real Gross Domestic Product. — 3) 1995 weights on dollar basis at 1995 exchange rates. To 1) and 2): Weighted with export shares on which the calculations of the SDR are based (with the exception of the USA).

Sources: OECD Economic Outlook, EEC Statistical Office, National Accounts; national statistics and DIW forecasts. Estimated and forecast rates of change rounded.

unemployment rate remains virtually unchanged at its low level.

Fiscal policy makers abandoned their clearly consolidation-oriented course in 1996. In real terms and on annual averages, public spending increased marginally. In the wake of the economic upturn that has now lasted for four years, the federal budget deficit has declined

from 4.5% of GDP in 1992 to 1.5%. As the government is not expected to intensify its consolidation efforts in the coming year, overall public spending will continue to expand cautiously.

The monetary authorities have adopted a wait-and-see approach, with no change in base rates since the start of 1996. If signs of tension arise on goods and

labour markets, however, the Federal Reserve will not hesitate to take preventive action – i.e. before inflation actually begins to accelerate – by signalling the likelihood of higher interest rates. If the current pace of wage growth is maintained, there is much to support the view that this will be the case during the current year. There is already evidence of a perceptible rise in unit labour costs, which is likely to be interpreted by the monetary authorities as auguring the expected acceleration of inflation.

Despite the expected interest rate rises, the moderate economic expansion is initially expected to continue in the USA during 1997. Investment growth will remain strong. Private consumption, too, will be clearly expansionary given the significantly higher incomes. The balance of payments will give cause for concern, however. Given the hesitancy of the upturn in Europe and the slight weakening of the rates of growth in Japan and south-east Asia, and the higher value of the dollar, there is the real danger that the USA's foreign trade imbalance, manifested in the serious current account deficits, will worsen. This will build up a potential for a future decline in the external value of the dollar which, in the longer term, could damage cyclical developments in the rest of the world.

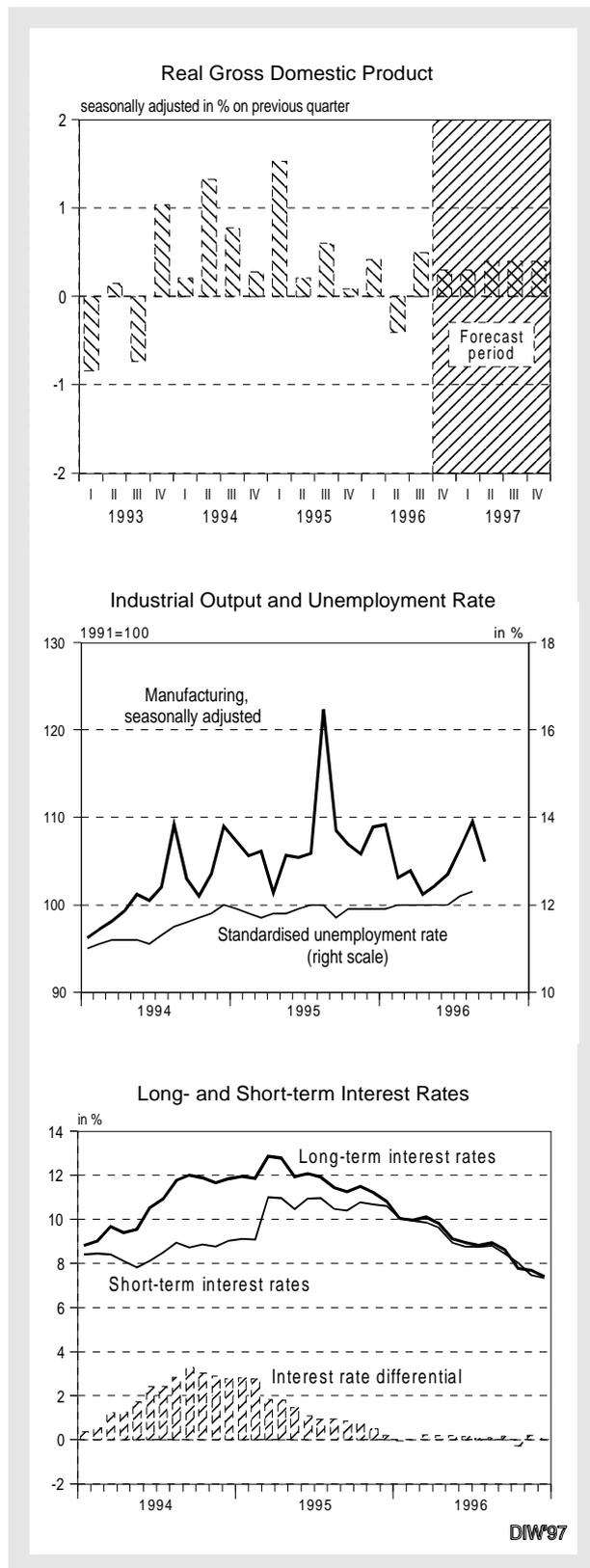
Concerted restrictive fiscal policy blocks upturn in western Europe

Since mid-1996 economic trends in western Europe have begun to show initial signs of accelerating economic growth. It seems that the long phase of growth weakness that began in the autumn of 1994 has come to an end. Although the monetary authorities did react to the economic slowdown, their response was too little and too late. Last year, however, the central banks did finally cut interest rates substantially, so that monetary policy is now exerting a more expansionary impulse. The distortions on foreign exchange markets have also largely been overcome.

Italy experienced a sharp weakening of economic growth in 1996, partly due to the rather restrictive monetary policy stance; not until recently has the central bank begun to change course. At least equally significant was the drastic consolidation course adopted by fiscal policy in order to comply with the reference values of the Maastricht Treaty (cf. figure 2).

Any prognosis for 1997 must take account of the restrictive overall impact of Italian economic policy. The policy of fiscal consolidation, in particular, will hit domestic demand. On the other hand, the global economic environment, particularly in Europe, has become

Figure 2
Italy



Sources: OECD, main economic indicators; DIW.

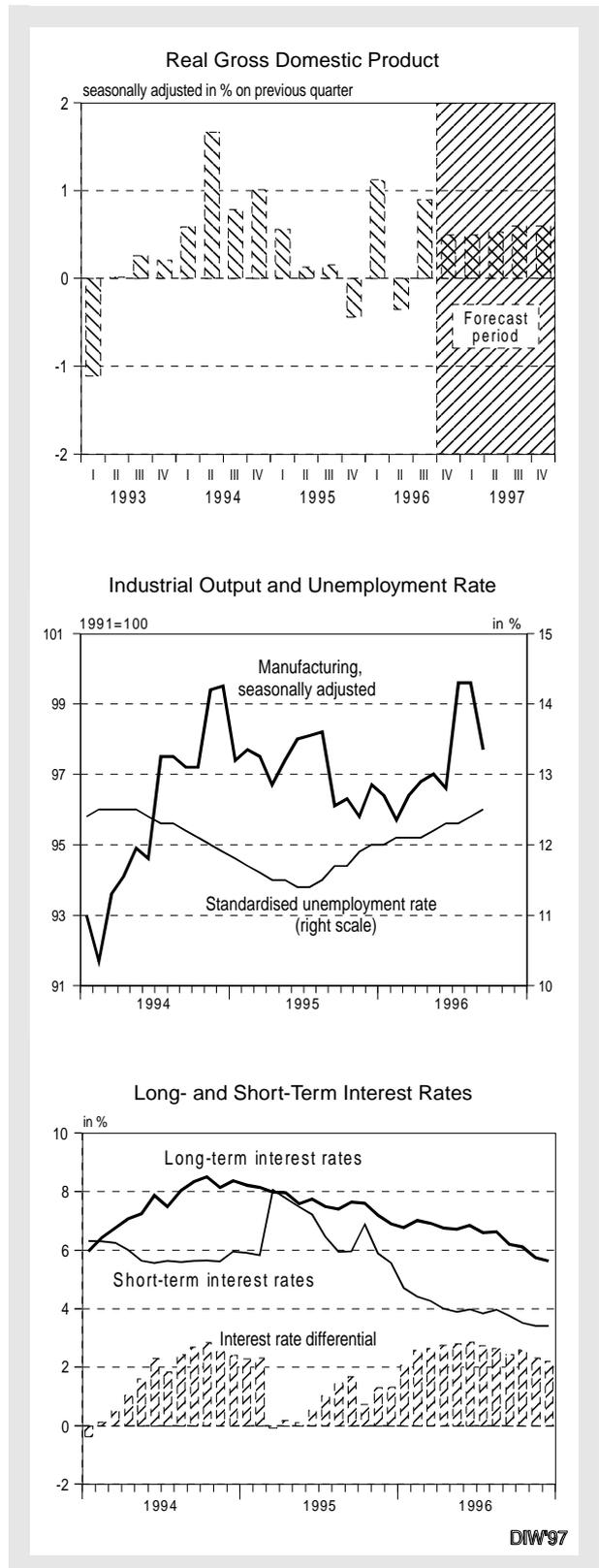
more favourable, and there are no grounds for expecting the lira to appreciate. Italy can point to considerable success in the fight against inflation and in the public sector reform; these have improved the conditions for economic development in the longer term. Economic growth in 1997, though, will suffer seriously from the fiscal squeeze. The only positive impulses will come from abroad; the propensity to invest remains weak. The prospects for inflation also remain relatively favourable, with the rate of inflation falling to 3%. There will be a further rise in unemployment.

In France, too, the economic growth dynamic remained weak in 1996. With the gradual real appreciation of the franc, export growth also stabilised. The weakness of economic activity in France's partner countries, the absence of impulses from abroad and the high level of interest rates have all affected investment, in particular. Private consumption, on the other hand, has proved more robust on the whole than had been expected. The framework of conditions for cyclical recovery improved during the course of last year. Short- and long-term interest rates have continued to fall rapidly and the interest rate structure has normalised (cf. figure 3). There has been a perceptible decline in real interest rates.

While the monetary conditions in 1997 are now rather favourable and inflation low, the scope for economic growth continues to be restricted by fiscal consolidation, although not to the same extent as in Italy. Under these conditions, somewhat stronger growth is expected for 1997, although not sufficient to achieve significant impact on the labour market. Prices will remain stable in 1997.

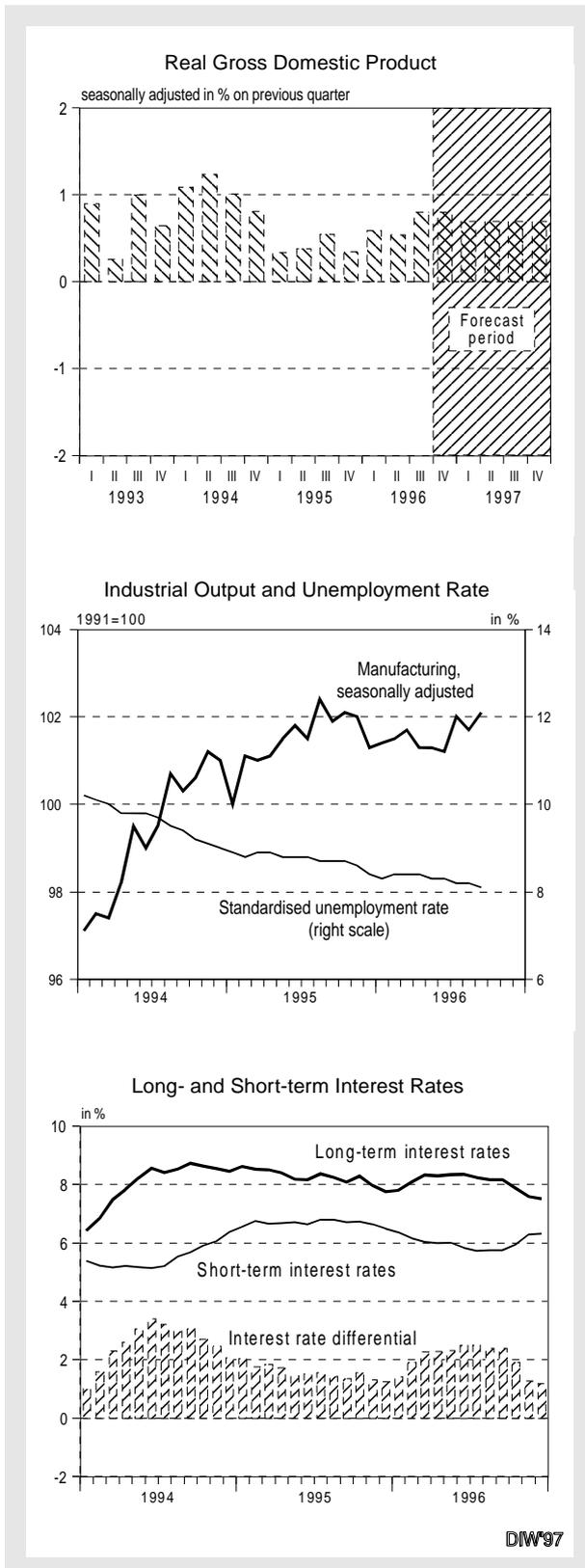
For some years now Great Britain has been pursuing completely different policies to those followed in most continental European countries. British monetary policy has been expansionary since 1992 and the government consciously accepted a cyclically induced rise in the budget deficit to around 8% of GDP (1993). This policy was accompanied by a substantial devaluation of the pound sterling. Together, all this meant that the upturn could develop on the back of an ever-broader foundation. Prolonged and comparatively strong economic growth led to falling unemployment as early as since 1993; the jobless total has declined from almost 3 million to around 2 million at the end of 1996. Despite the sharp fall in the external value of the currency, consumer price inflation accelerated only slightly, and last year declined once more. Since the autumn of 1996 the Bank of England has raised short-term interest rates in order to counter inflationary expectations in advance. Monetary policy remains expansionary, however. The lasting economic expansion has, along with other factors, resulted in a substantial narrowing of the fiscal deficit to 4½%

Figure 3
France



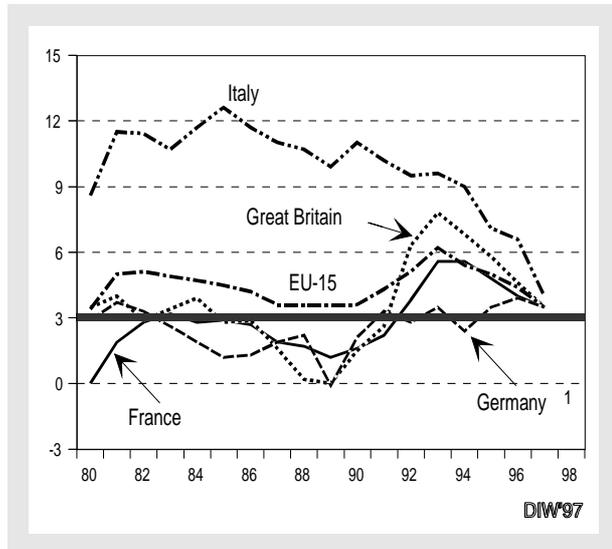
Sources: OECD, main economic indicators; DIW.

Figure 4
Great Britain



Sources: OECD, main economic indicators; DIW.

Figure 5
Financial Balance in the Public Sector
in % of GDP



The thick line indicates the reference value for the deficit specified in the Maastricht treaty.

1) For 1995 excl. unification-related debt.

Sources: European Commission; 1996 and 1997 DIW estimates.

of GDP in 1996. As the general election approaches, the government intends to use some of the scope for fiscal policy action so gained for tax cuts. This is likely to stimulate private consumption in 1997. All in all economic growth in 1997 is expected to mark a continuation of last year's expansion; on annual averages the rate of GDP growth will be slightly higher (cf. figure 4).

The prospects for stronger economic growth in western Europe have improved. This is largely due to the change in monetary policy. Compared with earlier expansionary phases, however, investment activity will initially remain weak in most countries. This may be due, at least in part, to the fact that investors are reacting less swiftly to the improved monetary conditions than in similar cyclical phases in the past because their confidence in a lasting upturn, following the premature end in 1995, is not yet sufficiently firmly established.

Moreover, monetary policy impulses will be offset by a consistently restrictive fiscal policy stance in western Europe (cf. figure 5). Only a few countries managed to attain the Maastricht reference values for the government deficit in 1996 – Denmark, the Netherlands, Ireland and Luxembourg. The greatest efforts at consolidation are being made in Italy, while Spain, too, is intensifying its attempts. Even now it is clear that many countries, including France and Germany, are highly unlikely to reach the reference values "on the dot". Between now and the start of 1998 there is therefore the danger that many countries will impose further spending cuts and/

or tax increases. This would exacerbate the danger of a fiscal policy "overkill", posing a serious threat to a continuation of the upturn. This would postpone indefinitely any improvement in the depressing state of European labour markets.

'Arbeitskreis Konjunktur' in the DIW
(Study Group 'Business Cycle')