The World Economy in the Autumn of 1997

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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The world economy has continued to grow rapidly during the current year; global economic growth is at around 4%. Growth in the developing and newly industrialising countries has been above this average, although recently the turbulence on the financial and foreign-exchange markets of certain South-east Asian countries and the adjustment measures implemented in response have retarded the expansionary trend. The economic growth dynamic in the central European reforming countries has once again increased somewhat; in a number of CIS countries the persistent decline in output appears to be coming to an end. In most industrialised countries demand and output have been accelerating. Economic growth in North America has been very strong, while the recovery in western Europe has firmed. In Japan, on the other hand, the business cycle was temporarily dampened in the summer by fiscal consolidation measures. Demand in the industrialised countries was stimulated by the still favourable monetary conditions, and received a further boost from overseas demand. Fiscal policy, by contrast, exerted a restrictive impact.

In the USA unemployment has fallen further. In western Europe the level of unemployment has remained at a high level, and in Japan there has been a slight increase. Given still moderate wage increases, prices in the industrialised countries have continued to rise only slightly. The prices of primary goods on world markets were broadly stable as a whole; during the first half of the year the price of oil has declined.

Monetary policy still expansionary – fiscal policy less restrictive

In view of the fact that price and cost inflation remained generally weak, in most cases the monetary policy stance has remained expansionary. Long-term interest rates have remained at a low level in historically comparative terms. In the USA the Federal Reserve has seen no occasion, in spite of the strong growth of output, to tighten its course further following the slight increase in base rates in the spring of this year, as wage and price trends have remained moderate. Given depressed domestic demand, the Japanese central bank has left its base rates at the extremely low level of 0.5%. In western Europe the monetary policy reins were tightened slightly in a number of countries after the German Bundesbank raised its rates somewhat at the start of October, but the overall monetary policy stance has remained expansionary

The decision by the Bundesbank to raise its most important base rates slightly is largely to be seen in the context of the run-up to European Monetary Union (EMU). It appears that the Bundesbank is seeking to bring interest rates into line at a level that is higher than that currently prevailing in the low-interest-rate countries, but below the current average of the prospective EMU countries. Once the circle of participants[1] and the procedure to determine the conversion rate have been determined – this is to occur in May 1998 – there will de facto no longer be any scope for an independent monetary policy. Short-term interest rates will quickly come into line. This means that the central banks of those countries whose money market rates are currently still high – Italy, Spain, Portugal and Ireland – will cut their base rates substantially. Clearly, the Bundesbank intends to stifle inflationary expectations from the outset. It can therefore be expected to raise its base rates again slightly during the winter months.

Given the interest rate trends assumed here, the monetary policy stance in western Europe will remain expansionary during the forecast period. A moderate rise in interest rates in the majority of countries participating in EMU will be accompanied by shop cuts in rates in the low-interest-rate countries. The Japanese central bank will continue its efforts to bolster economic activity through low interest rates. In the USA the monetary authorities will stick to their neutral course; in view of the highest overall level of capacity utilisation it is likely that base rates will be increased slightly during the winter months in order to counter any acceleration of inflation. Overall, monetary policy in the industrialised countries will not constitute an obstacle to a continuation of the cyclical recovery in the coming year.

[1] It is assumed here that a large-scale monetary union comes about on schedule on 1 January 1999. Greece, the only country to miss the criteria by a large margin will not participate, while Great Britain, Sweden and possibly Denmark will not opt to participate from the outset.

Table 1

Industrial Countries' Real Gross Domestic Product, Consumer Prices and Unemployment Ratio

	Weight in per cent	GDP			Consumer prices			Unemployment ratio		
		% change on the previous year						in per cent		
		1996	1997	1998	1996	1997	1998	1996	1997	1998
Germany	10.8	1.4	2.4	2.8	1.5	1.8	1.9	10.3	11.4	11.5
France	7.0	1.5	2	2¾	2.0	1¼	1½	12.3	12½	12¼
Italy	5.6	0.7	1¼	2¼	3.9	1¾	2½	12.1	12¼	12
Great Britain	5.3	2.3	3¼	2½	2.4	3	3¼	7.5	6	5½
Spain	2.7	2.3	3	3½	3.6	2	2½	22.2	20½	19½
Netherlands	1.8	3.3	3	3½	2.1	2½	2½	6.6	6	5
Belgium	1.2	1.4	2½	3	2.1	2	2½	13.7	13½	13
Sweden	1.1	1.1	2½	3	0.5	½	1½	8.0	8½	8
Austria	1.0	1.3	1½	2½	1.9	1½	2	7.0	7	6½
Denmark	0.8	2.7	3	3	2.1	2½	3	8.7	8	7½
Finland	0.6	3.3	4	3½	0.6	1	1½	16	15	14
Greece	0.6	2.6	3	3	8.2	5½	4½	10.4	10½	10
Portugal	0.5	3.0	3	3½	3.2	2	2½	7.3	6½	6
Ireland	0.3	7.7	7	6½	1.8	1½	2	11.3	10½	10
Luxembourg	0.1	3.9	4	4	1.4	1½	2	3.3	3½	3½
EU[1)]	39.4	1.7	2.4	2.8	2.3	1.9	2.2	11.3	11.1	10.8
Switzerland	1.3	–0.2	1	2	0.8	½	1	4.7	5½	5½
Norway	0.7	5.3	3½	3½	1.3	2½	2½	4.9	4	4
Western Europe[1)]	41.4	1.7	2.4	2.8	2.3	1.9	2.2	11.1	10.9	10.6
USA	34.9	2.8	3½	2½	2.9	2½	2½	5.4	5	5
Japan	21	3.5	¾	2	0.1	1½	¾	3.4	3½	3½
Canada	2.7	1.5	3¾	3¼	1.5	2	2½	9.7	9¼	8½
Total[1)]	100.0	2.5	2.5	2.5	2.0	2.0	2.0	–	–	–
Memo item: Total[2)]		2.0	2.4	2.8	2.3	1.9	2.2	–	–	–

1) Total of countries listed. Weighted by GDP, unemployment ratio by 1990 labour force - 2) Total of countries listed. Weighted by country's shares in German exports 1996.
Sources: National statistics and forecasts; OECD; 1997 and 1998: institute's forecast; figures rounded.

In virtually all the industrialised countries fiscal policy remains oriented towards reducing budget deficits. In Europe the consolidation course will be maintained in the coming year, not least with a view to the requirement of the Maastricht Treaty that deficits must be cut lastingly. Even so, the impact will be significantly less restrictive than in 1997. In particular, public investment will not be cut as sharply as in previous years. In Japan, too, fiscal policy will also be perceptibly restrictive. The government has raised taxes and contributions, and also cut spending, particularly for investment in infrastructure, in order to reduce budget deficits. Fiscal policy will be less restrictive in 1998, however. In the USA the federal budget deficit will narrow in the fiscal year 1997, largely for cyclical reasons.

The economic recovery in the industrialised countries to continue – slower growth in the developing and newly industrialising countries

For the prognosis of developments in the industrialised countries it is assumed that, given a constant interest-rate differential between the USA and Europe, the

Table 2

Real GDP and Domestic Demand in Selected Industrial Countries

	Weight in per cent	GDP			Weight in per cent	Domestic demand		
		% change on the previous year				% change on the previous year		
		1996	1997	1998		1996	1997	1998
Germany	12.3	1.4	2.4	2.8	12.2	0.8	1.1	2.1
France	8.1	1.5	2	2¾	7.9	0.9	¾	2
Italy	6.3	0.7	1¼	2¼	6.1	0.2	1½	2¼
Great Britain	6.1	2.3	3¼	2¼	6.1	2.7	3½	3
Western Europe[1)]	32.8	1.5	2.2	2.6	32.3	1.1	1.5	2.3
USA	40	2.8	3½	2½	40.6	2.9	3¾	2¾
Japan	24.1	3.5	¾	2	24.1	4.5	0	1¾
Canada	3.1	1.5	3¾	3¼	3	1.7	5	4
Total[1)]	100	2.5	2.4	2.4	100	2.7	2.2	2.4

1) Total of countries listed. Weighted by GDP, unemployment ratio by 1996 labour force. - 2) Total of countries listed. Weighted by country's shares in German exports 1996.
Sources: National statistics and forecasts; OECD; 1997 and 1998: institute's forecast; figures rounded.

exchange rates of the European currencies against the US-dollar remain more or less constant. Exchange rates between the prospective candidates for participation in the EMU will remain stable due to the tight coordination of monetary policy. The prices of primary goods will follow a moderate upward trend as the economic recovery in the industrialised countries continues; given the very elastic supply, the price of oil will remain at around US-$ 19/barrel.

Under this framework of conditions, economic expansion in the industrialised countries as a whole will continue at approximately its current pace. The growth dynamic will ease slightly in the USA. This is due both to the decline in the impulse from exports; and to the fact that the impulse from economic policy has almost completely ceased. Domestic demand is currently expanding more slowly than recently. Consequently, the danger of inflationary tensions is expected to decline in the coming year. In Japan, demand is likely to expand slightly more strongly following the unexpectedly weak trend during summer, all the more so as the restrictive impact of the consolidation measures are attenuating. Further support comes from the rising yields on fixed capital and the extraordinarily low interest rate. All the same, the recovery will remain more hesitant than in previous upswings in view of the continuing efforts towards fiscal consolidation and the declining external impulses, not least in connection with the balance of payments crisis in South-east Asia. In western Europe there are signs of a slight strengthening of economic recovery. Although the rapid rate of export growth will not be maintained, particularly as the effects of depreciation against the dollar will attenuate, domestic demand will strengthen, given a less restrictive fiscal policy and a monetary policy whose expansive impact will weaken only slightly. Capacity utilisation will increase and employment will rise gradually, initially primarily in the form of longer working hours, increasingly, however, also via an increase in the level of employment. In the industrialised countries as a whole real GDP will grow by around 2½ % in both the current and coming year. Overall there is little danger of inflationary tension; the rate of inflation will remain at 2%.

In the central European reforming countries economic growth will strengthen further, and for the CIS countries a slight increase in output is to be expected for the coming year for the first time. In Latin America it is unlikely that economic growth will continue at the rates experienced recently. Unexpected climatic conditions (El Niño) have affected not only the agricultural sector of the continent, but also the transport and supply infrastructure and thus the entire economic process. On top of this, Brazil faces renewed balance of payments problems. Following last year's world trade growth of 6%, it will expand at around 8% this year; next year's growth rate will be only slightly lower.

Economic development in the dynamic Asian economies is uneven. Whereas in some countries rapid economic growth continues virtually unabated, output growth in Thailand, Malaysia, Indonesia and the Philippines has flattened out, in some cases markedly. Following the exchange-rate turbulence of last summer these countries have adopted a tough restrictive stance. Massive interest rate hikes, budget cutbacks and the conditions imposed by international organisations have depressed domestic demand and thus also imports. On the other hand, their price competitiveness has been increased by drastic currency depreciation.

South-east Asia has once again shown that a strategy of pegged exchange rates cannot succeed if the monetary authorities permit inflation rates to run over an extended period at a level that leads to an excessive real appreciation of the currency. This, especially, implies a substantial loss of competitiveness and a sharp rise in the current account deficits, which cannot be financed in the longer term. Sooner or later the markets will impose the, in their view, correct exchange rate, i.e. that appropriate to the monetary policy pursued. Substantial imbalances on the external position have also developed in a number of other countries pursuing a similar exchange-rate strategy. However, this will only have a substantial impact on world trade if confidence in the currencies of a large number of such countries were to be lost and there were to be massive capital flight. This is not considered likely for the purposes of this prognosis.