

# The World Economy in the Spring of 1999

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

**Deutsches Institut für Wirtschaftsforschung, Berlin**

**HWWA-Institut für Wirtschaftsforschung, Hamburg**

**Ifo Institut für Wirtschaftsforschung, Munich**

**Institut für Weltwirtschaft at the University of Kiel**

**Institut für Wirtschaftsforschung Halle**

**Rheinisch-Westfälisches Institut für Wirtschaftsforschung, Essen**

Finalised in Kiel, 22 April 1999

Since the summer of 1998 global economic growth has slowed further. This has been a consequence of the crisis in Asia, the effects of which have increasingly been felt in the industrialised countries. On top of this came the sharp decline in output in Russia and South America.

Although the situation in south-east Asia has gradually stabilised, not least thanks to the restructuring measures implemented, this has so far scarcely affected imports from the industrialised countries. The economic crisis in Russia was set off by the dramatic decline in the ability of Russian government to meet its obligations. In Brazil the combination of rising current account deficits resulting from sustained real currency revaluation caused by the exchange-rate peg, and the inability of government to consolidate its finances resulted in a sudden loss of confidence. This, in turn, led to a substantial outflow of capital and the abandonment of the exchange-rate peg. Other countries in the region also sought to prevent capital flight in the wake of the crisis in Russia by raising interest rates and imposing restrictive fiscal policy measures last summer; the situation has since improved, however. Other important factors were the sustained decline in export receipts resulting from falling prices for petroleum and other primary goods, and the marked decline in exports to south-east Asia and Japan. Together this led to a recession in South America in the course of the year.

The retarding effects of the crises made themselves felt in the industrialised countries, after a time lag and with varying intensity. The Japanese economy was particularly hard hit by the collapse of demand from the Asian developing and newly industrialised countries. This helped to ensure that total output declined further,

despite efforts by economic policy to stimulate the economy. In the USA, the restrictive effects, which were felt at an early stage, subsequently appear to have attenuated significantly. Given the continued very strong growth of domestic demand, economic expansion remains robust. Economic growth in western Europe has been retarded significantly since last summer. Initially the improvements in the terms of trade stimulated domestic demand and exerted a compensatory effect, but the impact of the weakening of economic activity in many parts of the global economy caused by the crisis increasingly gained the upper hand. On top of this came the improved competitiveness of south-east Asian firms both in Europe and on third markets following currency depreciation there. Moreover, exports to Russia declined sharply in the wake of that country's economic crisis. In the light of these developments, sales and profitability expectations deteriorated markedly and export growth flattened out. This reduced the propensity to invest, although the growth of private consumption has remained strong.

In the industrialised countries as a whole the situation on the labour market has continued to improve slightly. The unemployment rate in the USA has reached a very low level, whereas it remains high in western Europe despite the decline. In Japan unemployment has risen to its highest level for decades. Inflation remains subdued in almost all the industrialised countries, largely reflecting the fall in import prices. The growth of unit labour costs was also weaker, however, and indeed in the euro zone they have actually fallen slightly.

## Monetary policy stimulation in the industrialised countries

The monetary policy stance in the industrialised countries has become successively more relaxed since the autumn of last year. Against the background of the deterioration in the global economic environment and low inflation rates, central bank rates were cut in stages, beginning in the USA, in particular with the aim of avoiding fears of a credit squeeze. In the euro zone the decline in interest rates resulting from the convergence of money market rates in the run-up to European Monetary Union was intensified slightly in December by cuts in central bank rates. Given the continued weakening of economic growth and the very low rates of inflation, the European Central Bank (ECB) has been attempting to provide a stronger impulse to economic activity, cutting its base rates by half a percentage point at the start of April. The monetary reins were also slackened in other

west European countries. In Japan, finally, the central bank attempted to counter the recession by once again reducing money market rates, which are now virtually zero.

In the USA the monetary policy stance has been noticeably expansionary since the autumn of last year. Given the very high level of capacity utilisation and the still strong growth of output, and in view of a renewed rise in share prices, the central bank is expected to raise interest rates slightly, in order to prevent inflationary expectations taking hold.

In Japan there has been no strong growth of the money supply despite the low level of central bank interest rates. It is expected that money market rates will, at most, rise only marginally during the prognosis period. As progress is made in restructuring the financial sector, it will become more likely that lending will expand at an accelerated rate.

Further cuts in interest rates are to be expected in the west European countries outside the euro zone, given weak economic growth and the marked decline in inflation. The ECB, on the other hand, will not relax its monetary policy stance any further; which is already clearly expansionary. In the course of the coming year it is likely to tighten the monetary reins slightly, against the background of renewed stronger economic growth, in order to prevent any acceleration of inflation.

Overall, monetary policy in the industrialised countries will remain significantly expansionary in the prognosis period.

### **Fiscal policy more or less neutral in cyclical terms**

In the industrialised countries as a whole, fiscal policy exerted only minor effects on economic activity last year. In the USA the impact was somewhat restrictive, whereas in Japan it was expansionary. Fiscal policy in western Europe was no longer restrictive to any significant degree. Here, following the substantial progress in reducing deficit-to-output ratios, especially in the course of the process of qualifying for participation in EMU, little further progress has been made in consolidating government finances. Although in 1998 deficits continued to decline as a share of output in most countries, this was not primarily due to additional cutbacks, but primarily to the economic upturn and the reduced burden of interest payments.

In the prognosis period fiscal policy in the EMU will, at most, be only slightly expansionary. There will be no further decline this year in deficit-to-output ratios, despite the renewed fall in interest rates; this implies

that the targets indicated in the stability and growth programmes will in many cases not be met. This is because economic growth will be less favourable than assumed in budget plans; spending would not be cut back or additional taxes imposed in order to stick to the planned deficits. Government can rather be expected to allow the built-in stabilisers to work, in order not to weaken economic activity further. Deficit-to-output ratios will decline only slightly in the coming year; although the improved economic situation and low interest rates will serve to reduce deficits, in a number of countries measures to reduce the burden of taxation will cut tax revenues as a share of output, perhaps even causing the deficit to rise once more.

In Japan fiscal policy will for the time being remain expansionary, and the budget deficit will again increase perceptibly as a share of output; the expansionary impulses will weaken in the coming year, however. In the USA the restrictive impact of fiscal policy will gradually attenuate, and in the coming year services will be reduced as the economy slows down.

### **Outlook: economic trends positive on balance**

As the restrictive demand effects emanating from the regions hit by crisis attenuate, the forces for economic expansion in the global economy will regain the upper hand in the course of this year. In the Asian developing and newly industrialised countries economic growth will broaden out and become more dynamic, now that their balance of payments difficulties have largely been overcome. The recovery will remain modest, however, not least due to the retarding effects of ongoing restructuring in the business sector; this is indispensable, however, if the Asian economies are to return to a higher growth trajectory. Economic expansion here can be expected to benefit in the current and the coming year from the improvement in economic prospects for Japan in the wake of the expansionary economic policy measures implemented there.

Prospects for the Russian economy remain bleak. Given the heavy burden of debt service payments and the sluggishness with which structural reforms are being implemented, no recovery is to be expected. Similar considerations apply to the Ukraine and Belarus. Given the expected pick-up in global economic output, the prospects for the central European reform countries, on the other hand, will become re-favourable.

In South America the recession will probably be overcome in the latter part of this year. The impact of recession on the global economy has been significantly

less serious than in the case of the Asian crisis, partly because trade linkages with the rest of the world are not so well developed, and partly because the devaluation of the Brazilian real has not led to comparable distortions on international capital markets.

The US economy cannot be expected to continue to expand at the rapid rates observed recently. Expansion has largely been on the back of dynamic growth of private consumption, which has partially reflected the income effects of the sharp rise in share prices; continued growth in the value of assets at a similar rate is unlikely, given the current stagnation of corporate profits. On the other hand, share prices are not expected to collapse, an event which, via negative asset effects, potentially could dampen consumer demand significantly.

In the euro zone economic growth is beginning to pick up. This trend is being bolstered not only by the improvement in the global economic environment, but also, and particularly, by domestic demand, which has received a substantial impulse from the favourable monetary conditions. Even so, the annual average rate of real GDP growth will be below last year's figure. It will increase in the coming year, however. Against this background employment will continue to expand, although initially at a slower rate, and unemployment will fall. In the coming years consumer prices will, at 1.7%, rise slightly faster than in 1999; this reflects higher import prices.

Against the background of a cyclical shift between the industrialised countries, their overall rates of GDP growth will remain broadly constant in the current and the coming year, at around 2% (cf. table 1). World trade will again expand more rapidly, largely thanks to economic stabilisation in Asia, following the marked slowdown in the course of last year. An annual average rate of expansion of just under 3% is expected for 1999, following just under 4% last year. In the year 2000 a rate of between 5 and 6% is expected. The price of oil is expected to amount to just over 13 dollars per barrel in the current year and around 15 dollars per barrel in the coming year (annual averages). The prices of industrial primary goods will also firm slightly as the global economy picks up once more.

## Western Europe

### Gradual recovery outside the euro zone

In those western European countries not participating in EMU, economic growth has weakened sharply since the middle of last year. Exports, were hit particularly hard by the crises in Asia, Russia and Latin America. In

Great Britain and Norway tight monetary policies have exerted an additional restrictive effect. In Denmark fiscal policy has intensified its attempts at consolidation, further restraining economic growth. Given the slowing of economic expansion, economic policy in most countries has now abandoned its rather restrictive course. Monetary policy will be loosened further. Fiscal policy in this group of countries is likely to be more or less neutral in cyclical terms during the current year.

Given these economic-policy parameters and the gradual improvements in the global economic climate, real GDP is expected to increase by more than 1% in the current year and by around 2% next year. In both years consumer prices will rise by less than 2%. The situation on the labour market will deteriorate temporarily.

### Cyclical weakening in the euro zone to give way to recovery

In the countries participating in European Monetary Union, economic growth lost much of its momentum in the course of last year, whereby cyclical differences between the countries remained significant. Whereas the growth of real GDP remained above average in Finland, the Netherlands, Portugal, Spain and especially Ireland, output growth in Germany and Italy has nearly come to a standstill.

There has been a perceptible fall in exports to the regions hit by crisis. In the wake of these crises, trade with other countries was also hit after a time lag. Last but not least, the restrictive knock-on effects from the external position on domestic economic activity within the euro zone has also reduced the volume of intra-European trade.

In the course of last year domestic demand was on a slower expansionary trajectory, although it continued to rise. This trend was bolstered by the further decline in interest rates, while fiscal policy virtually ceased to exert restrictive effects. Private consumption accelerated slightly, stimulated by higher real disposable income: wages have risen significantly, there has been a perceptible increase in employment, while prices have remained stable since last spring. Investment in plant and machinery expanded strongly, although the rate of expansion slowed in the latter part of the year; this reflected the restrictive effects of the less favourable sales and profitability expectations since the middle of the year and falling capacity utilisation. Construction activity has picked up slightly once more.

The unemployment rate fell as employment expanded significantly. The improvement was particularly marked on the labour market in Spain, Ireland and Finland. In Italy, by contrast, the situation has deteriorated slightly.

Table 1

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

	Weight in %	GDP			Consumer prices			Unemployment ratio		
		% change on the previous year						in %		
		1998	1999	2000	1998	1999	2000	1998	1999	2000
Germany	9.9	2.8	1.7	2.6	1.0	0.7	1.5	11.2	10.6	9.9
France	6.6	3.2	2.2	2.8	0.7	0.5	1.2	11.8	11.2	10.7
Italy	5.4	1.4	1.7	2.7	1.7	1.5	2.0	12.3	12.2	11.7
Spain	2.5	3.8	3.0	3.5	1.8	2.0	2.3	18.8	17.5	16.0
The Netherlands	1.7	3.7	2.0	2.5	2.0	1.7	2.0	4.2	3.8	3.8
Belgium	1.1	2.9	2.0	2.5	0.9	1.0	1.5	12.6	12.2	12.0
Austria	1.0	3.3	2.3	2.7	0.9	0.8	1.3	4.4	4.5	4.0
Finland	0.6	4.9	3.0	3.5	1.4	1.0	1.5	11.4	10.5	10.0
Portugal	0.5	4.0	3.0	3.2	2.7	3.0	3.2	4.9	4.3	4.0
Ireland	0.4	8.5	6.0	6.0	2.5	2.0	2.5	9.0	8.5	8.0
Luxembourg	0.1	4.7	3.0	3.5	0.9	1.0	1.5	2.8	2.8	2.5
EMU countries <sup>1</sup>	29.8	2.9	2.1	2.8	1.2	1.0	1.7	11.5	11.0	10.4
Great Britain	6.1	2.3	0.7	1.8	3.4	2.0	2.0	4.7	5.0	5.0
Sweden	1.1	2.9	2.2	2.7	-0.1	0.5	1.0	6.5	6.0	6.0
Denmark	0.8	3.0	1.5	2.0	1.9	1.7	2.0	6.5	6.5	6.5
Greece	0.6	3.0	3.0	3.0	4.8	3.5	3.0	9.6	9.5	9.0
EU <sup>1</sup>	38.3	2.8	1.9	2.6	1.6	1.2	1.7	10.0	9.7	9.2
Switzerland	1.2	2.0	1.5	2.0	0.0	0.5	1.0	3.9	3.5	3.3
Norway	0.7	2.5	0.5	1.5	2.2	2.5	2.5	3.2	3.5	4.0
Western Europe <sup>1</sup>	40.2	2.8	1.8	2.6	1.6	1.2	1.7	9.8	9.4	9.0
USA	37.0	3.9	3.5	2.5	1.6	2.0	2.5	4.5	4.5	4.7
Japan	19.8	-2.8	-0.5	0.5	0.6	-0.3	0.0	4.1	5.0	5.5
Canada	2.9	3.0	2.7	2.5	0.9	1.0	1.5	8.3	8.0	8.3
Total <sup>1</sup>	100.0	2.1	3.0	2.1	1.4	1.2	1.7	6.8	6.8	6.8
Memo item: Total <sup>2</sup>		2.8	2.1	2.5	1.5	1.3	1.7			

<sup>1</sup> Total of countries listed. Weighted by 1997 GDP, unemployment ratio by 1997 labour force. — <sup>2</sup> Total of countries listed. Weighted by country's shares in German exports in 1997.

Sources: National and international statistics and forecasts; Institutes' calculations; 1999 and 2000: Institutes' forecast.

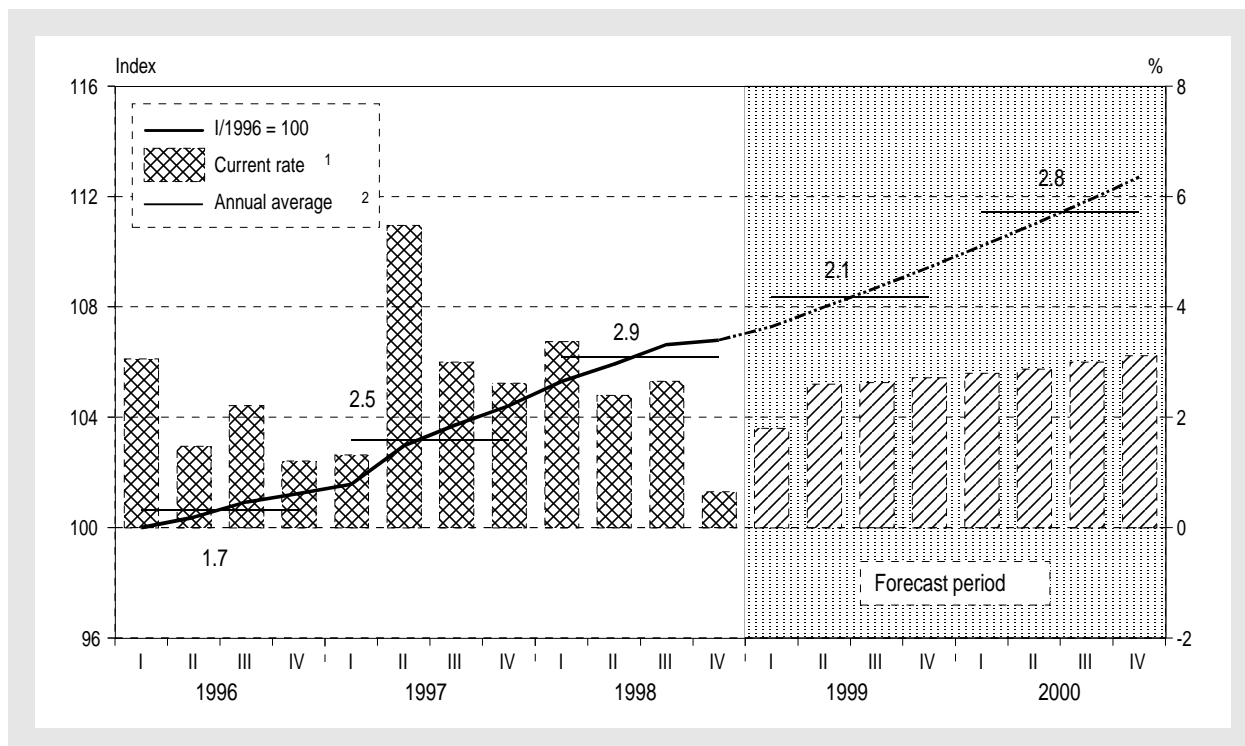
Inflation has remained moderate. Consumer prices are currently rising by only around one percentage point on the respective level 12 months earlier. Indeed, producer prices have actually fallen slightly. While this partly reflects the significant fall in import prices, domestic price rises were also marginal. Against the background of a significant improvement in labour productivity, unit labour costs declined slightly last year, according to ECB figures.

## Monetary policy stimulates economic activity<sup>1</sup>

Three months after assuming responsibility for monetary policy in the euro zone, at the start of April the European Central Bank reduced its main refinancing

<sup>1</sup> Current monetary policy is evaluated in the economic policy section of the report on the German economy.

Figure 1  
Real GDP in the Euro Zone



1 % change on previous quarter, extrapolated to annual rate (right-hand scale).— 2 Figures: % change on previous quarter. Sources: OECD; calculations by the Institutes; 1999 and 2000 prognoses by the Institutes.

rate to 2.5%. Back in December the 11 national central banks of what is now the euro zone cut their base rates to 3%. The rate of interest on three-month money is currently 2.6% in the euro zone, that is one percentage point lower than in October 1998 and 1.3 percentage points lower than a year ago. Long-term interest rates have also given ground, and are currently almost half of a percentage point below their autumn level. The main factors behind the fall in interest rates were the easing of inflationary expectations and the weakening of economic growth.

Both short and longer-term interest rates are currently at very low levels in the euro zone. In real terms, too, interest rates are significantly below the average figure for the past 20 years. Overall, the level of interest rates is such as to exert a stimulatory effect on economic activity. A similar effect emanates from the decline in the real external value of the euro since the start of the year. The growth of M3 was marginally higher than the reference value announced by the ECB at the start of the year. In view of the uncertainties surrounding the start of European Monetary Union, however, the value of money supply trends as an indicator is currently limited.

Inflation remains subdued. In recent months the harmonised consumer price index has been rising at year-

on-year rates of less than 1%. However, this figure understates underlying inflationary pressure, given the sharp fall in primary goods prices. In the current and the coming year the price of primary goods will pick up once more, but even so the inflation rate will remain below the ceiling of 2% considered by the ECB to be compatible with price stability.

All in all, monetary policy is currently exerting an expansionary effect. The Institutes expect base rates to be increased around the middle of next year in order to avert a threat to the price stability target. Capital market rates will also rise during the prognosis period as economic activity recovers slightly.

### Fiscal policy virtually neutral

Government deficits have declined as a share of GDP from 2.5% in 1997 to 2.1% in 1998. Substantial differences between the countries remain, however. Whereas France and Italy are only slightly below the reference value set out in the Maastricht Treaty, at 2.9% and 2.7% respectively, Finland, Ireland and Luxembourg have actually managed to achieve surpluses. The narrowing of deficits in the euro zone primarily reflects

