The economic background

The world economy

Overview

Since the publication of our last Commentary in January 2001 the extent of the slowdown in the world economy has become a little clearer. There has been a further easing of monetary policy in the United States and Japan, although interest rates in the Euro zone have yet to be cut. Most commentators expect that the US economy will start to recover later in the year, though it is extremely unlikely that growth will return to the levels experienced over the past four years. Prospects for the European Union look more positive, partly due to the weakness of the Euro, while there must be concern that there are indications that the Japanese economy is faltering.

It seems unlikely that the global slowdown will result in a major recession, although there are some risks attached to this relatively benign view. Forecasters often point to the difficulties of making accurate projections at turning points in the economic cycle and in particular judging how severe a downturn will be. On this occasion there are a number of additional complicating factors:

- → There is still considerable uncertainty about the financial position of the personal and corporate sectors in general and the consequences for aggregate demand. The financial imbalances and high levels of debt in the US could still lead to severe cut backs in spending if equity markets fall further. Recent work by the IMF also suggests that, contrary to the conventional wisdom, there is a strong possibility that the European economies may be just as vulnerable as the US to declines in technology stocks;
- → The outlook for the US technology sector is particularly uncertain. There is a danger that firms in this sector may make dramatic adjustments in spending and that the knock on effects rapidly spread through the international economy; and
- → Conventional economic theory suggests that the US Dollar ought to have weakened in recent months as the US economy slowed down and, possibly more importantly, the Federal Reserve cut interest rates. Instead the US Dollar has remained strong and the Euro weak. If this pattern continues it will further reduce demand in the US and add to the depth of the slowdown. On the other had the European economies are currently benefiting from a weak Euro and should continue to do so.

Table 1 summarises forecasts for a number of international indicators produced by the IMF for their May Economic Outlook. At the time of writing these forecasts are among the most recent to have been produced by a major international economic organisation.

Growth rates in the US, Japan and the Euro zone are all projected to fall when compared with the 2000 out turns. The slowdown in the US is the most dramatic with 2001 growth projected to be less than a third of the 2000 figure. Growth in Japan more than halves, though from a lower starting point than the US, while the Euro zone enjoys a much milder reduction in forecast growth. Longer-term prospects are more benign in the sense that growth is projected to rise again in 2002 in all three blocs, although not to the levels seen in 2000. In the case of the US the gap is particularly dramatic with projected growth in 2002 of 2.5 percent compared with rates before the slowdown in the range of 4 to 5 percent.

There is less uniformity in the projections for unemployment. Unemployment tends to lag behind downturns in the economic cycle, as firms are initially reluctant to lay off staff that they have spent time and money recruiting and training. It is unlikely that these staff can be simply re-engaged again if demand picks up and so most firms prefer to hoard excess labour in the short term. The rise in US unemployment forecast in Table 1 in 2001 and 2002 despite the projected recovery in output in 2001 fits in with this pattern. In contrast Euro zone unemployment is projected to fall in 2001 and 2001, partly as a result of the far milder downturn expected in Europe and new social legislation in some major European economies.

Exchange rates and commodity prices

The continuing strength of the Dollar despite the cuts in US interest rates is both surprising and also a matter for some concern. Conventional economic theory predicts that cuts in US interest rates ought to have lowered the rate of return on holding the Dollar resulting in a movement into other currencies. In turn this should have led to a weakening of the US Dollar relative to other currencies. Instead the Dollar has actually strengthened during 2001, particularly during February and March. The flip side of the Dollar's current strength is the corresponding weakness of the Euro. In contrast the Yen has weakened against the Dollar as Japanese monetary policy has been further relaxed in recent months.

It is difficult to attach numbers to the impact of the Dollar's strength and the Euro's weakness that take full account of the wider impacts of exchange rates. However, it is undoubtedly the case that the strength of the expected recovery in the US economy starting in late 2001 will be impeded if the Dollar maintains its strength. US exports will be more expensive on international markets, or if their price is reduced then margins will be reduced and the incentive to export will be reduced. At the same time imports into the US become more competitive leading US residents to switch their demand away from domestic producers. Mirror images of these effects work to boost activity within the Euro zone where the exchange rate remains weak.

Table 1: Forecasts of main world economy indicators

	% Growth in real GDP				Unemployment rate			
	1999	2000	2001	2002	1999	2000	2001	2002
US	4.2	5.0	1.5	2.5	4.2	4.0	4.4	5.0
Japan	0.8	1.7	0.6	1.5	4.7	4.7	5.3	5.2
Euro zone	2.6	3.4	2.4	2.8	9.9	9.0	8.4	8.1
Germany	1.6	3.0	1.9	2.6	8.3	7.8	7.6	7.4
France	3.2	3.2	2.6	2.6	11.3	9.7	8.8	8.2
Advanced economies	3.4	4.1	1.9	2.7	6.4	5.9	5.9	5.9
	Inflation rate				Short term interest rate			
	1999	2000	2001	2002	1999	2000	2001	2002
US	2.2	3.4	2.6	2.2	5.0	6.3	5.7	n/a
Japan	-0.3	-0.6	-0.7	0.4	0.1	0.1	0.2	n/a
Euro zone	1.2	2.4	2.3	1.7	2.7	4.0	4.8	n/a
Germany	0.7	2.1	2.0	1.3	2.7	4.0	4.8	n/a
France	0.6	1.8	1.5	1.4	2.7	4.0	4.8	n/a
Advanced economies	1.4	2.3	2.1	1.8	n/a	n/a	n/a	n/a

Source: IMF World Economic Outlook, May 2001; Advanced economies follow IMF definition; inflation is calculated using consumer prices

Most commentators take the view that the US reacts to exchange rates movements more quickly than other economies and in particular the principal Euro economies. If this is the case then the recent movements in exchange rates will not just simply redistribute world trade between the US and the Euro zone. There may be a net short run reduction in total trade as the US balance of trade deteriorates more quickly than the Euro zone balance of trade improves. In turn this will retard global growth and the recovery in late 2001 and 2002.

In our last Commentary we highlighted concerns about the potential impact of high oil prices upon the world economy. Oil prices had risen from a low of $11 a barrel to a peak of $25 in 1999 mainly as a result of OPEC production restrictions against the background of a strong world demand for oil driven by growth in the US and elsewhere. During 2000 oil prices had peaked at $35 and although they had fallen back by the year-end there was a concern that further OPEC restrictions could push prices up again adding to the negative prospects for the world economy. A by-product of the slowing world economy in 2001 has been the easing of these concerns. The ability of OPEC to restrict supplies and push oil prices upwards is reduced as world demand moderates and commentators are expecting a price of around US$ 25 in 2001 and US$ 22.50 in 2002, compared with an average price of US$ 28.1 in 2000. Nevertheless, there are still some concerns about the potential short-run volatility of oil prices if OPEC does attempt to impose production controls.

United States

The US economy started to slowdown significantly in the third quarter of 2000 when real GDP growth fell to an annualised rate of 2.2 percent from annualised rates of 4.8 and 5.6 percent in 2000 Q1 and 2000 Q2 respectively. The fourth quarter annualised growth rate was even lower at 1 percent. The latest GDP data is more encouraging with the advance estimate for 2001 Q1 showing an annualised growth in GDP of 2 percent. Although most commentators were encouraged by this estimate it is based on incomplete sources and is liable to be revised in future months when the preliminary and final estimates are published. Using previous revisions to advance estimates the Bureau of Economic Analysis believes the current estimate is unlikely to be revised below 1.4 percent or above 2.9 percent.

The projections for US GDP shown in Table 1 were released a day before the publication of the 2001 Q1 advance GDP data and so may be slightly less optimistic than current sentiment. They are, however, in line with recent forecasts for 2001 published by the OECD and the National Institute for Economic Research. There is an expectation that the US economy will recover during 2002 although the forecasts for growth are more dispersed ranging from 2.3 to 3.1 percent. It seems highly unlikely though that the US economy will return to the annual growth rates of four and five percent seen in the late 1990s and in 2000. The National Institute's medium range forecast projects an average annual growth of 2.8 percent for the five years 2003 to 2007.

We have already touched on several of the downside risks for the US economy over the next two years. These include:

- → The continuing strength of the US Dollar and the negative effects on US trade;
- → Further deterioration in the financial position of the personal and corporate sectors leading to cuts in their spending as they try to re-balance their balance sheets; and
- → The uncertainties facing the US technology sector.

Several leading firms in the US technology sector, including Cisco and Motorola, have issued profit warnings in recent months. The sector faces adjustment problems from the position where it has geared itself up to be capable of meeting phenomenal growth in demand for its products to coping with much lower growth, or even falls in demand. Over the year to 2001 Q1 output of high technology products grew by nearly 37% in the US. We have already seen severe cut backs in investment in IT equipment and software where annualised growth fell off from 20.6 and 17.9 percent in 2000 Q1 and Q2 to 5.6 and -3.3 percent in Q3 and Q4. The advance estimate for 2001 Q1 is also weak, showing a further fall of 2.2 percent.

On the upside both monetary and fiscal policy are now reinforcing each other with the Federal Reserve having reduced interest rates by a full two percentage points already this year and President Bush's tax cuts working their way through the political process. Although only part of the tax cuts programme is due to be introduced in the new fiscal year starting in October 2001, the pre-announcement of tax cuts over the next ten years mean that consumers will look forward and factor these cuts into their current consumption decisions.

Europe

As the forecasts in Table 1 show the downturn in the Euro zone is expected to be far milder than that in the US. Projected growth in the Euro zone outstrips that in the US in both 2001 and 2002. Nevertheless the Euro zone is not immune to the slowdown in the world economy with GDP growth falling back during the course of 2000. There is also some evidence of deteriorating business confidence amongst European firms. In addition there is uncertainty about the extent and distribution of layoffs and even plant closures by US firms based in Europe.

In a surprise move the ECB reduced its principal interest rate on May 10th by 0.25 percentage points to 4.25 percent. Until this decision the ECB had withstood international pressure to cut its rates and the markets were clearly expecting it to continue to do so in the short term. Initial reaction suggests that there is now more uncertainty associated with ECB policy.

In our January Commentary we pointed to two risk factors for Europe of a US downturn:

→ A decline in European exports as US residents and companies reduced their spending; and

→ The general reverses in equity markets in the US spreading to Europe.

We have already noted that the Dollar has continued to strengthen and the Euro remains relatively weak and so to some extent has been working against the first of these factors, as Euro zone exports appear competitive relative to US produced goods.

The conventional wisdom is that the second of these factors would be less of a risk for Europe than the US given the relatively healthy position of corporate and personal finances in Europe and the relatively low proportion of Euro zone wealth held as equities. Recent work at the IMF has, however, pointed to an interesting vulnerability of the European economies. Declines in market capitalisation of both technology and other equities have a similar effect on expenditure by companies and households in the US. In Europe a decline in market capitalisation of equities other than technology stocks reduces spending by about a fifth of the US and UK figure. However, declines in European technology stocks have a similar effect to declines in the US. Despite this the capitalisation of technology is small relative to all equities and so the aggregate effect of declines in European markets is still about a fifth of the size of US and UK reverses.

Japan

The immediate prospects for the Japanese economy in 2001 look relatively weak. In 2000 there was some evidence of a modest recovery, particularly in industrial production and international trade in the second half of the year. It now appears that sluggish consumer spending and record unemployment, coupled with falls in equity markets and poor business confidence have all contributed to a poor outlook for 2001. Table 1 above shows that the IMF projects slightly stronger growth in 2002. This is consistent with the recent political changes in Japan and the effective adoption of a target for price stability that should encourage people to spend rather than hoard cash. Linked to the new price target is a commitment to hold interest rates at zero for as long as required. Although the reduction in interest rates is marginal when measured in basis points, the underlying change in monetary arrangements does represent an easing of monetary policy in Japan.

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