

# The economic background

## The world economy

### Overview

Since our last Commentary the prospects for the world economy have, once again, deteriorated. It is now clear that the global economy is in the grip of a slowdown that is being felt in all of the major trading blocs and in nearly every economy. Within Europe only France and the UK appear to be insulated from the worst of the slowdown. It now looks as if a recovery is unlikely until late 2002 or early 2003.

There has now been time for commentators to assess the potential impact of the events of September 11<sup>th</sup> upon the global economy. Recent studies include that by the IMF in their World Economic Outlook, the OECD in their Economic Outlook and the National Institute of Economic and Social Research in their Review. A number of common points are made in these studies:

- The direct impact in terms of lost output and disruption was quite small in global terms. The IMF made comparisons with the scale of output lost following the 1995 Kobe earthquake in Japan where the scale of destruction was far larger.
- The events of September 11<sup>th</sup> have already had a clear impact upon consumer and business confidence in the US, and to a lesser extent elsewhere in the world. It is, however, the case that the global economy was exhibiting considerable weakness before the terrorist attacks, even though there were some very early signs of a potential turnaround later in 2001. It is therefore quite difficult at the moment to disentangle the impact of September 11<sup>th</sup> from the general global slowdown. We can probably be fairly confident that the fallout from September 11<sup>th</sup> has put paid to any immediate global recovery.
- The longer-term impact is likely to come from changes in transaction costs, including air travel and insurance premiums. At the moment it is difficult to assess the nature of these changes, let alone their economic impact.

### Outlook

Table 1 summarises forecasts for a number of international indicators produced by the OECD for their Economic Outlook. These projections are taken from the Preliminary Edition published in November 2001 and are subject to revision in the final version of the document. At the time of writing these forecasts are amongst the most recent to be produced by a major international forecasting body. They include estimates of the impact of the events of September 11<sup>th</sup> that have been fed through the OECD's world economic model.

**Table 1: Forecasts of the main world economy indicators**

	Growth in real GDP (%)				Unemployment rate (%)			
	2000	2001	2002	2003	2000	2001	2002	2003
US	4.1	1.1	0.7	3.8	4.0	4.8	6.2	6.0
Japan	1.5	-0.7	-1.0	0.8	4.7	5.0	5.5	5.4
Euro zone	3.5	1.6	1.4	3.0	8.9	8.5	8.9	8.8
Germany	3.0	0.7	1.0	2.9	7.5	7.5	8.1	8.0
France	3.4	2.0	1.6	3.0	9.5	8.9	9.4	9.3
OECD	3.7	1.0	1.0	3.2	6.2	6.5	7.2	7.0

  

	Inflation rate (%)				Short term interest rate (%)			
	2000	2001	2002	2003	2000	2001	2002	2003
US	2.7	1.8	1.0	1.4	6.5	3.8	2.1	3.1
Japan	-1.1	-1.3	-1.5	-1.5	0.2	0.1	0.0	0.0
Euro zone	2.2	2.5	1.6	1.7	4.4	4.2	3.0	3.8
Germany	1.4	1.9	1.0	1.1	n/a	n/a	n/a	n/a
France	1.2	1.7	1.4	1.7	n/a	n/a	n/a	n/a
OECD	2.1	2.8	2.1	1.8	n/a	n/a	n/a	n/a

Source: OECD Economic Outlook, Preliminary Edition, November 2001; Inflation rate is measured by consumer prices, historical data taken from National Institute Economic Review, October 2001.

The prospects for 2002 are gloomy. Low GDP growth is expected almost everywhere. The exceptions are France and the UK (see the UK economy section) where the slowdown is milder than the norm for Europe. Japan is particularly badly hit with output actually projected to fall in 2002.

Growth is expected to recover throughout the OECD in 2003 with growth rates returning to numbers usually associated with trend growth rates, although not to the levels observed in economies such as the US in the late nineties.

Although the projections included in Table 1 are fairly pessimistic for next year there are still a number of downside risks associated with global economic prospects suggesting that the outcome could actually be worse. The downside risks include:

→ Oil prices may not continue to be as weak as they have been over the past few months. Low oil prices are helping the current situation by reducing inflationary pressures and allowing monetary room to cut interest rates without fear of stoking price rises. In large part the weakness of oil prices reflects slowing world activity and also reduced demand for aviation fuel following the cuts in flights since September 11<sup>th</sup>. However, it is possible that oil producers attempt to push prices up again by restricting supply. The motiva-

tion for this may be economic, or perhaps more worryingly, political if the US anti-terrorism coalition breaks down.

→ The fall out from the greater economic uncertainty following September 11<sup>th</sup> may deepen. Financial markets typically react to uncertainty in two ways: they mark down expected future profits and they increase the risk premium on the discount factor they use to calculate the present value of future income streams. This last effect is particularly worrying, as it will inevitably lead to further weaknesses in equity markets as share prices fall. We can gain an idea of the size of these effects from some simulation results reported in the National Institute of Economic and Social Research's October Review. Using their world economic model the Institute look at the effects of an increase in the risk premium of the order of magnitude required to generate the falls in equity prices seen between July and October this year. Both the US and the euro area suffer reductions in output growth of nearly 1 percentage point in the first year and of over 1.5 percentage points in the second year.

→ There may also be more direct effects on output resulting from long lasting changes in transaction costs and charges such as insurance premiums following September 11<sup>th</sup> that cannot be built into conventional forecasting models and that are still hard to anticipate.

## United States

GDP growth in the US first started to slow down in the third quarter of 2000 with major falls in investment in both fixed assets and inventories. Initially personal consumption was relatively robust with growth only falling slowly in 2000 and the first half of 2001, despite significant declines in consumer confidence from the middle of 2000. By the final quarter of 2000 export demand had started to fall, particularly exports of goods rather than services.

The latest release of GDP figures from the US Bureau of Economic Analysis shows that third quarter GDP fell at an annualised rate of 1.1% in 2001 Q3. The major contributions to the fall in GDP came from a reduction in real exports fell of some 17.7% and real investment of some 9.3%. The rate of growth of private consumption more than halved to an annualised rate of 1.1% from its second quarter rate of 2.5%. This represents the first major reduction in the growth of consumer spending, with earlier reductions being far gentler.

Conditions in the US labour market have deteriorated rapidly since the start of 2001. Non-farm employment started to fall in the middle of 2000 for a few months and then recovered with some employment gains towards the end of the year. Early 2001 saw further job losses with the latest data for October showing particularly large reductions in employment. The unemployment rate has risen steadily through 2001 and now stands at 5.4%.

The US policy position has loosened during the course of the year and now supports a potential recovery in late 2002 or 2003. The Federal Reserve has eased monetary policy significantly since it first cut the Federal Funds rate on January 3<sup>rd</sup> 2001 from 6.50% to 6.00%. After nine further cuts the rate currently stands at 2.0% with an expectation by some commentators that there will be a further cut at the FOMC meeting to be held on December 11<sup>th</sup>. There has also been an easing of fiscal policy during the course of 2001.

Before the events of September 11<sup>th</sup> there were some indications that the US economy could start to turn the corner in late 2001. Consumer confidence and share prices had started to stabilise and there were signs that the heavy de-stocking earlier in 2001 would result in a resurgence of productive activity. The six-month US leading indicator supported these hopes. However, the direct and indirect impact of the terrorist attacks put pay to any chance of an early turn around in the US economy. As Table 1 implies it now looks as if the recovery will not take place during 2002 and that the US will have to wait until 2003 before returning to anything approaching trend growth.

## Europe

Growth in the Euro zone economies is clearly slowing down

with a marked reduction in growth during 2001 Q1. Germany, Italy and Belgium appear to have been particularly badly hit with France suffering less than most of Europe. As Table 1 shows the prospects for next year are not that good, although there is a reasonable chance of a recovery by 2003.

There has been a relaxation of monetary policy over the past six months. Recently there have been three interest rate cuts by the ECB. The first was by 0.25% to 4.25% in mid-September following the September 11<sup>th</sup> terrorist attacks, with a subsequent cut on November 8<sup>th</sup> bringing interest rates down to 3.75%. Most commentators expect further cuts over the next six months.

German GDP growth has been subdued since the third quarter of 2000, with a small fall of 0.1% registered for the third quarter of this year. Exports have held up relatively well, showing growth of about 3.5% until the start of this year. Data for the third quarter of 2001 shows a slight rebound in growth following the fall in exports in 2001 Q1. There are significant areas of weakness in both private consumption and business investment. The immediate prospects for the German economy are not good with further falls in output expected in the fourth quarter of 2001 and the first quarter of next year. There seems to be greater optimism for 2003 with a reasonable recovery predicted, for example, as Table 1 shows the OECD is forecasting GDP growth of some 2.9%.

The latest French GDP growth figure was surprisingly high, standing at 0.5% quarter on quarter, reflecting a recovery in private consumption. However, this is to some extent a flash in the pan with lower quarterly growth in 2001 Q1 and Q2 and with prospects for the final quarter looking quite bleak as consumption is set to slow down and investment prospects look flat. The OECD predicts growth of 1.6% in 2002 with a recovery to 3.0% in 2003. These projections, along with the data for 2001, suggest that France is looking to be one of the more resilient European economies, alongside the UK.

## Japan

There has been a further slowing of the Japanese economy this year, with falling exports of electronics (particularly goods relating to information technology) leading to a contraction of industrial production and investment in the first half of the year. This contraction has now spread more generally within the economy.

As Table 1 suggests the prospects for the remainder of this year and for next year look bleak. Throughout 2000 the stock market in Japan suffered continuing price falls, although in the first half of 2001 there was some evidence that prices had stabilised. Unfortunately the third quarter of the year has seen renewed falls in share prices. In part these reversals reflect concern about expected profits in the future, however, the weak stock market has undoubtedly added to the pressures on Japanese firms and helped

eat away at business confidence.

Consumption expenditure remained relatively firm in Japan until the second half of 2001, however, falls in employment and in bonus income have started to feed through to weaker spending. Future prospects look bleak given the projected falls in output and the possibility of additional reductions in employment.

Further relaxation in the stance of monetary and fiscal policy may be hindered by the fact that short term interest rates are no virtually zero and the government's need to consolidate Japan's fiscal position at some point in the near future.

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