The economic background

The world economy

Overview

Since the publication of our last Commentary in October 2000 the prospects for the world economy have weakened considerably. The principal development has been the rapid turnaround in the US economy. As recently as mid-November last year the consensus view was that real growth in the US in 2001 would slow to about 3.5%, roughly consistent with stable inflation. Higher oil prices and a general tightening of monetary policy were expected to lead to a more general slowing of the world economy, although most forecasters thought it unlikely that that by themselves these two factors will lead to a major global recession.

Through late November and most of December there was growing concern that the US would suffer a more severe slowdown. In early December 2000, Alan Greenspan indicated that the emphasis in US monetary policy could well move away from further tightening towards reductions in interest rates. Later in the month the Federal Reserve confirmed this when the FOMC indicated that their assessment of the balance of policy risks had moved away from inflationary pressures towards the possibility of an over weak economy. On January 3rd the Federal Reserve surprised financial markets when the FOMC cut the federal funds rate by 0.5% ahead of their scheduled meeting at the end of the month.

The general view now is that the US economy will probably slow down to a real growth rate of around 2% in 2001. US output accounts for about a quarter of world GDP so there is bound to be a major impact upon the global economy as a whole. However, the impact on the Euro zone is likely to be more muted for a number of reasons that we discuss below, though there is some concern that Asia will suffer more.

Table 1 summarises forecasts for a number of the principal international indicators produced by the OECD in December 2000. These forecasts are the most recent to be produced by a major international economic organisation, but it should be borne in mind that the preparatory work on the forecasts would have been done in November when and that they were published before the cut in US interest rates.

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	5.2	3.5	3.3	4.2	4.0	4.2	4.5
Japan	0.2	1.9	2.3	2.0	4.7	4.7	4.6	4.6
Euro zone	2.5	3.5	3.1	2.8	9.9	9.0	8.3	7.7
Germany	1.6	3.0	2.7	2.5	8.3	7.7	6.9	6.3
France	2.9	3.3	2.9	2.5	11.1	9.7	8.8	8.2
OECD	3.0	4.3	3.3	3.1	6.7	6.2	6.0	5.9
	Inflation rate				Short term interest rate			
	1999	2000	2001	2002	1999	2000	2001	2002
US	1.8	2.5	2.1	2.2	5.4	6.5	7.0	7.0
Japan	-0.5	-0.5	0.0	-0.1	0.2	0.2	0.6	0.9
Euro zone	1.2	2.2	2.3	2.0	3.1	4.4	5.4	5.5
Germany	0.3	1.5	1.6	1.6	3.1	4.4	5.4	5.5
France	0.7	1.5	2.1	2.0	3.1	4.4	5.4	5.5
OECD	2.8	3.1	2.6	2.2	n/a	n/a	n/a	n/a

Source: OECD Economic Outlook, December 2000; inflation is calculated using the consumer expenditure deflator.

Judged by current sentiment the US forecasts in Table 1 are very optimistic. While the forecasts for other regions are also optimistic, they are more in line with current market expectations and they do illustrate a number of broad trends that are still relevant for the global economy:

→ There will be a general slowdown in the OECD economies from the peak in 2000, with the slowdown in the US being sharper than that in the Euro zone;

→ There are still some concerns about the balance between supply and demand in the Euro zone, although projected growth is roughly in line with the long term trend; and

→ There is an expectation that economic activity in Japan will recover, although demand will remain significantly lower than potential supply.

The causes of the global slowdown

A number of factors have contributed to the expectation that the world economy will slow down in 2001 and 2002:

→ Oil prices have been rising through out most of 1999 and 2000, although there has been some easing since late November 2000 when oil prices fell to about US$ 22 a barrel. We discuss the impact of energy costs in more detail below;

→ Monetary policy in the US and Europe has been tightened over the past eighteen months following concerns about inflationary pressures. There is some evidence that these higher interest rates have started to reduce demand in both continents, although it is probable that the full impact will not be evident until well into 2001. The likely reduction in growth is sizeable, yet until very recently there was still some concern that demand will still outstrip supply leading to a further tightening in monetary policy if central banks are to hit their inflation targets;

→ There are signs of weakness in asset prices, particularly in the US, and this may endanger the financial position of firms and households leading to reductions in demand. We discuss this in more detail below when we consider the US economy; and

→ The impact of a US slowdown upon Europe and Asia. This is discussed in more detail below when we consider Europe and Japan.

The impact of oil prices

During 1999 oil prices rose steadily through from a low of $11 a barrel at the start of year to roughly $25 by the end as OPEC restricted production. In 2000 oil prices were characterised by greater volatility with a fall back to $22 in April as OPEC relaxed its production quotas. The price quickly started climbing again though, rising to $27 in June. After a small fall in August the price peaked at just over $35 in September and was roughly constant until the end of November when it fell back to just over $20.

The short-term future will probably be one of relatively high oil prices compared with the generally low levels seen between 1985 and 1999. In addition a lack of spare production capacity and in the US and most OPEC countries (apart from Saudi Arabia) suggests that there will be little scope to stabilise prices in the face of potential shortages. This means that the marked increase in the volatility of oil prices that we have seen during 2000 is likely to continue until new capacity can be brought on stream and stocks replenished.

Most analysts agree that if oil prices were to stabilise at around $25 a barrel - a widely forecast figure - the impact on the world economy would be far less severe than was the case in the mid-1970s and between 1979 and 1985. This is partly because when measured in real terms a $25 price tag would be significantly less than in the 1979-85 episode, even though it would be roughly comparable with the real price during the 1974 oil crisis.

Other reasons why the impact of higher oil prices would be less severe than in earlier episodes include:

- The world economy is now less dependent on oil than it was in the early 1980s as the ratio of oil demand to GDP has halved. The impact of a higher oil price on the general price level will have roughly halved too. In turn this means that reductions in real income in oil consuming regions will be less and so any knock on effects on consumption will be smaller; and
- The general move to inflation targeting means that monetary authorities are now far less likely to accommodate general price rises resulting from a higher oil price. As a result any oil price rise is less likely to become part of the wage price spiral.

Nevertheless oil prices do have some impact upon economic activity. Estimates by the IMF using their world macroeconomic model MULTIMOD suggest that a permanent $5 increase in the price of oil would reduce world real GDP by about 0.3% per annum, with the impact upon both US and Euro zone real GDP being about 0.4% per annum. Inflation as measured by consumer prices would rise by about 0.5 percentage points in both areas.

United States

We now turn to the US economy where recent developments suggest that there is a higher probability of a hard landing than previously thought. It is probably fair to say that until early December 2000 most analysts were expecting that the upward trend in oil prices and monetary tightening would result in a reduction in US growth roughly of the magnitudes shown in Table 1. There was undoubtedly some concern that the expansion in the US economy was not sustainable and that this could lead to a reversal that would end in a US recession. Yet there was no strong evidence that this recession was actually around the corner.

More recently there have been three developments that suggest that a US recession is more likely:

- The dramatic nature in which monetary policy was based in early January when the US interest rate was cut between scheduled meetings of the FOMC and by 50 basis points, rather than the more usual 25 points;
- There has been a general decline in equity markets that is far more widespread than the problems with high technology stocks seen earlier in 2000; and
- There are signs that spending on IT will be far weaker in the immediate future than over the past few years.

The decline in share prices is particularly worrying given the size of the private sector financial deficit that has accumulated in the US over the past few years. Both companies and households have used part of the capital gains on equities to finance current spending or to back loans that have allowed spending in excess of income. Some analysts estimate that in 2000 the US private sector will have borrowed about 7% of GDP - with 2.5% coming from the public sector and the remainder coming from outside the US. The real danger is that if the widespread reverses in equity prices continue, the ability of the US private sector to fund deficits of this size will be undercut. This will inevitably lead to sharp reductions in current spending as the private sector attempts to turn around their financial position.

One factor behind the general rise in US equities over the past few years has undoubtedly been the expectations of long-term returns from productivity gains associated with IT and the "new economy". Growth in US investment in IT has been strong through most of the 1990s, with very strong growth since 1998 reaching annual rates of 25%. There are signs that this trend may now have been reversed: the growth rate in new electronics orders stopped rising in the second quarter of 2000 and the most recent data shows a dramatic fall in the growth rate. Given that IT investment accounted for roughly 4% of US GDP in 1999, a significant decline in new orders would by itself have a sizeable direct impact upon US demand. If the links between IT and economy wide capital gains mentioned above are taken into account the overall impact is likely to be far stronger.

Europe and the impact of a US slowdown

The prospects for Europe look healthier than the US. The business cycle is generally thought to be at an earlier stage than that in the US. More importantly there is less evidence of imbalances between supply and demand in the European economies, although there are some concerns about future overheating as capacity constraints bite. In particular, the European Commission's business survey suggests that capacity utilisation is above normal in the Euro zone. The weak Euro and oil prices may also feed into future inflation. Despite this, GDP growth towards the end of 2000 has been less than expected by most forecasters and early GDP estimates suggest that the annual growth rate may be marginally lower than the forecast 3.5% shown in Table 1.

A deeper US recession could influence the European economy through two principal mechanisms:

- → A potential decline in European exports as US residents and companies reduced their spending Here the likely effects are quite small given that exports to the US account for about 2% of Euro zone GDP. Therefore, even a sizeable reduction in imports by the US would only have a moderate effect upon Europe. Of course, there could be additional second round effects resulting from a general decline in world trade as the effects of US recession rippled through the global economy; and
- → The general reverses in equity markets in the US could spread to European equity markets. If they did, the consequences would probably be far less severe than in the US given that the private sector in Europe is in a much healthier position than in the US and the lower proportion of household wealth held in equities.

It seems reasonable to expect that Europe would be relatively secure in the face of a deeper US recession.

Japan

There are signs that the Japanese economy started to recover in early 2000 with stronger output growth in the first half of the year. There have also been improvements in industrial and consumer confidence that look set to continue. Most analysts suggest that the recovery will continue into 2002 although the recovery is expected to be relatively weak. New investment by the business sector should lead to a recovery in disposable income and personal consumption. The potential problems of the US economy and, in particular, a weak US demand for IT products could well mark down the speed of the Japanese recovery. There is an expectation that the deflation will continue, with the GDP deflator falling faster than the consumption deflator shown in Table 1.

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