The economic background

The world economy

Overview

Since the publication of our last Commentary in May 2001 most commentators have marked down their views of the short-term prospects for the world economy. In part this reflects poor out-turn data for the second quarter of the year in many economies and in part particular concerns about the future strength of the US economy. That said there still good reasons to expect a mild recovery during the course of 2002 in the US, Europe and Japan. It seems likely though that this growth will be below historical trend rates and there are significant downside risks, particularly given the potential consequences of the terrorist attacks in the US.

Output data for the first and second quarters this year have been weak in comparison with last year. Industrial output within the OECD as a whole fell by an annualised rate of about 6% in Q1 and by 5% in Q2. Over 2000 as a whole the growth rate was 2%, with far higher quarter on quarter growth rates in Q1 and Q2. In the US the preliminary annualised quarter on quarter estimate for real GDP growth in 2001 Q2 was 0.2%, lower than the comparable figure of 1.2% for 2001 Q1 and 4.1% (revised down from 5.0%) for 2000 as a whole. The euro zone and Japan have shown similar, though less dramatic falls, in GDP.

Table 1 summarises forecasts for a number of international indicators produced by the National Institute of Economic and Social Research for their July Economic Review. At the time of writing these forecasts are among the most recent to have been produced by a major forecasting organisation. However, the preparatory work would have been completed before the publication of most of the second quarter activity indicators so the forecasts are likely to be on the optimistic side when compared with current sentiment.

Nevertheless, the forecasts do illustrate a number of broad trends that are still relevant:

→ The slowdown across the entire OECD region should start to be reversed in 2002 with further increases in activity in 2003. However, growth is unlikely to return to the rates seen in the late 1990s and 2000. Current sentiment would probably mark down the growth rates for 2001 and 2002 reflecting a pushing back of expected start of the recovery;

→ Movements in the unemployment rate are expected to diverge with US rates rising whilst those in Europe are flat or falling despite the slowdown in 2001 and lower medium term output growth;

→ Inflation rates will probably fall or stabilise. Short-term interest rates are unlikely to rise significantly over the next few years reflecting subdued output growth at or below trend rates.

Despite the recent weakening in sentiment most commentators still expect a mild recovery in the world economy during 2002. This expectation is based upon:

→ A recovery in demand for manufacturing output following on from the inventory adjustment over recent quarters. The level of US inventories fell back dramatically in 2001 Q2 when compared with GDP and there were similar, although milder, movements in many of the Euro zone economies. This is a familiar pattern in a slowdown as firms at first build up inventories in the light of falling sales. Output is then disproportionately reduced as inventories are run down and finally firms start to raise output, albeit it a lower rate, to service current sales;

→ The relaxation in the stance of monetary and fiscal policy since the end of 2000 will take some time to impact upon the global economy. Indeed the current slowdown can in part be attributed to the earlier tightening of policy in the late 1990s. Recent work by the National Institute of Economic and Social Research suggests that the impact of lower interest rates will depend upon the stance adopted after the initial cut. The effects of a one percentage point cut held for two years (a "firm hand") are disproportionately larger than a one point cut held for one year or even a two year cut held for one year (a "panic").

→ Inflation prospects are subdued in part because of the mildness of the recovery expected in 2002. This suggests that there is room for further modest relaxation in monetary and fiscal policy adding to the likelihood of a mild but sustainable recovery.

→ There the are some weak signs that the prospects for consumer spending are brighter. In the US lower mortgage rates helped real consumption to grow at an annualised rate of 2.5% in Q2. The first tax rebates from the Bush tax cuts will have fed through during August and should assist this trend. Consumer spending in the euro zone also looks healthier, with annualised growth rates of about 4% in real German spending seen in both Q1 and Q2.

Despite this muted optimism there are a number of downside risks that could damage prospects for even a fragile recovery:

→ There is still some risk that there will be further significant falls in financial markets will feed through to firm and household spending. Perhaps the greatest risk here lies in the volatility seen in financial markets recently, even if the falls in prices are reversed;

Table 1: Forecasts of main world economy indicators

	% Growth in real GDP					*Unemployment rate*			
	1999	*2000*	*2001*	*2002*	*2003*	*1999*	*2000*	*2001*	*2002*
US	4.2	5.0	1.7	2.3	2.6	4.2	4.0	4.5	5.0
Japan	0.8	1.5	0.6	1.3	1.7	4.7	4.7	4.9	5.1
Euro zone	2.5	3.4	2.1	2.4	2.9	9.9	8.9	8.5	8.3
Germany	1.4	3.1	1.3	2.2	2.6	8.6	7.9	8.0	8.1
France	3.0	3.3	2.3	2.3	2.7	11.2	9.7	8.6	8.6
OECD	3.1	4.1	1.8	2.4	2.8	n/a	n/a	n/a	n/a

	Inflation rate					*Short term interest rate*				
	1999	*2000*	*2001*	*2002*	*2003*	*1999*	*2000*	*2001*	*2002*	*2003*
US	1.8	2.4	2.1	1.1	0.9	5.3	6.5	4.2	4.4	5.1
Japan	-0.7	-1.1	-0.3	-0.2	0.7	0.2	0.3	0.2	0.2	0.7
Euro zone	1.3	2.2	2.4	2.0	1.8	3.0	4.4	4.5	4.3	4.3
Germany	0.3	1.5	2.0	1.3	1.4	3.0	4.4	4.5	4.3	4.3
France	0.2	1.2	1.8	1.9	1.4	3.0	4.4	4.5	4.3	4.3
OECD	1.2	1.8	2.0	1.4	1.3	n/a	n/a	n/a	n/a	n/a

Source: National Institute Economic Review, July 2001; inflation is calculated using consumer prices.

- → The potential knock on effects of reduced profits on the household sector as total compensation is increasingly linked to firm profits. One particular problem here is that profit linked bonuses tend to be paid out with a lag so take home pay will not suffer until early 2002, exactly the time at which a weak recovery could be endangered;

- → The economic consequences of the terrorist attacks in the US are difficult to judge at this stage. There must, however, be a significant risk of greater distress on financial markets as well as more direct impacts, including higher oil prices, on the global economy. This said, it is clear that the US and other authorities are willing to intervene in the markets to mitigate the immediate after effects of the terrorist action.

United States

We now turn to the US economy where real GDP growth has continued to fall since the start of the year. Growth in Q1 on an annualised quarter on quarter basis was 1.2%, falling to 0.2% in Q2. Revisions to the US national accounts have lowered the estimate of growth during 2000 to 4.1% from 5.0%, the comparison with the lower growth rates in 2001 is still dramatic. Although the very weak figure for Q2 GDP growth lead to most commentators marking down their forecasts and a feeling that the US economy was particularly fragile it is worth remembering that this estimate is only preliminary. It is based on incomplete data and the Bureau of Economic Analysis caution that estimates can be revised, although from a study previous revisions it is unlikely that the estimate will fall beneath -0.4% or go above 1.1%.

A key feature of the US slowdown has been the decline in fixed investment. This was initially centred on information and communications technology (ICT) and is now spreading to structures and non-ICT equipment. In the first two quarters of 2001 private domestic investment fell at an annualised rate of over 12% with non-residential fixed investment falling at an annualised rate of over 9% in Q2. Revisions to the profit elements of the US national accounts have lead commentators to re-assess their views on the prospects for future capital spending. The significant downward revisions in non-financial corporate profits since 1997 with, for example, nearly 22% taken off the 2001 Q1 figure, mean that real profits for this sector in 2001 were no higher than their 1995 Q1 level. Commentators at Goldman Sachs have pointed out that given the additions to the capital stock since 1995 there has been a significant fall in the rate of return on capital. This reduces the likelihood of a rapid turn around in private fixed investment.

Real personal consumption grew at annualised rates of 3.0% and 2.5% in the first two quarters of 2001; down from rates well over 5.5% in late 1999 and early 2000. Expenditure on durable goods seems to be holding up better than non-durable and services spending. It is now clear from the revised national accounts data that the fall in the savings rate seen since 1997 came to an end in early 2000 and is now rising slowly. This is encouraging from the point of view of sustainability of the personal sector in the medium term, although part of the rise in no doubt explained by reductions in the value of personal holdings of financial assets. Indeed, some analysts have expressed concerns that a further rise in the savings rate (and an accompanying cut in consumption) is needed to ensure medium term financial equilibrium. One bright spot on consumption is the potential feed through of tax rebates into disposable income and hence consumption as the result of President Bush's tax cuts. The first rebates were distributed at the end of July, with the bulk due during the remainder of the third quarter.

Europe

The performance of the euro zone economies has been similar to the US in the sense that GDP growth has declined since 1999 and 2000, however, the decline is much more muted thanks to the fact that growth in the late 1990s was far slower than in the US. Of more concern perhaps are the particular weakness of the German economy and the acceleration of inflation in the zone during the first half of 2001.

The European Central Bank (ECB) reduced its central interest rate by 0.25 percentage points to 4.25 at the end of August. This should give some impetus towards increased activity in the next six to eighteen months. It also suggests that future inflationary pressures have abated sufficiently for the ECB not to be concerned about recent rises in the inflation rate feeding through the wage-price spiral in the short term.

Japan

As Table 1 indicates the immediate prospects for the Japanese economy are poor. Activity has been very weak during the first part of 2001 and this looks set to continue during the remainder of the year. The slowdown in the global economy has hit Japan hard with substantial reductions in exports. The general weakness of demand for ICT products in the world economy suggests that trade figures for the remainder of the year are likely to continue to be poor. Domestic consumption is also weak and surveys of consumer confidence hold out little hope for the immediate future.

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