

OUTLOOK ON THE WORLD ECONOMY AND THE EUROPEAN ECONOMY

On 1–2 March 2001, the ifo Institute conducted an international conference in Munich at which macro-economic forecasts and policies were discussed during the first day and the outlook and driving forces for individual industries in various European countries were the topics of the second day. Three papers presented on the first day on the world economy, the U.S. economy, and the European economy are reproduced here.

CHALLENGES AND RISKS FOR THE WORLD ECONOMY

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Introduction

Developments since the previous OECD *Economic Outlook* was finalised in autumn 2000 have brought substantial changes to the short-term outlook for the world economy. Even if a U.S. slowdown – after some 6 percent output growth in the first half of 2000 – was anticipated, such an abrupt correction as appears to have taken place was only indicated as a risk. In addition, the economic situation in Japan, while difficult to interpret, appears poised for further deflation and disappointing growth. Finally, some financial instability has resurfaced in emerging markets, hitting the Turkish economy. The OECD is currently in the process of producing its new *Outlook*, and we are, of course, taking these developments into account in our projections. While it is too early to discuss a consistent set of short to medium-term projections, I shall, at this point, highlight what I see as the key issues affecting the outlook and provide an assess-

ment of developments based on the information currently at hand.

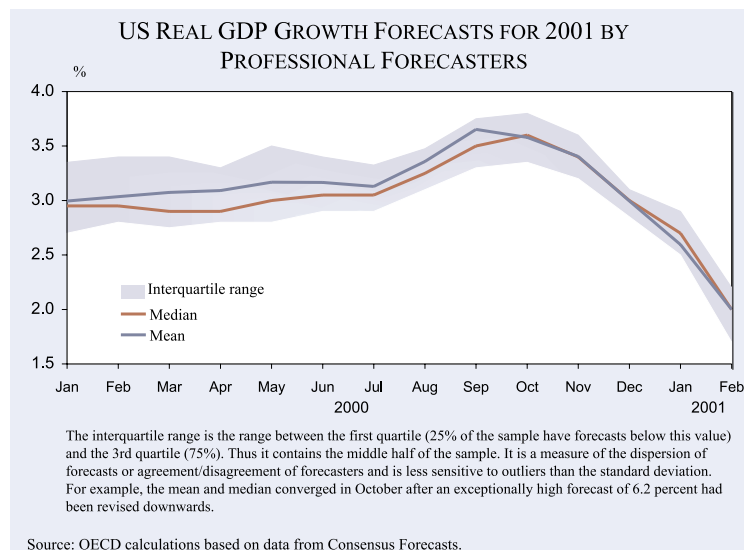
Recent developments

The outlook for US growth has changed rapidly since the end of last year, as the actual slowdown occurred substantially faster than the large majority of forecasters had considered as the most likely outcome (Figure 1). Some slowing of growth had been expected, driven by the tightening of US monetary policy since June 1999, the actual and projected weakening of equity prices, and the impact of rising energy prices on real incomes. In addition, a sharper slowdown had been considered (in particular in the most recent OECD *Economic Outlook*), although mainly as a risk that might result if financial market conditions (especially equity prices and risk premia) were to deteriorate

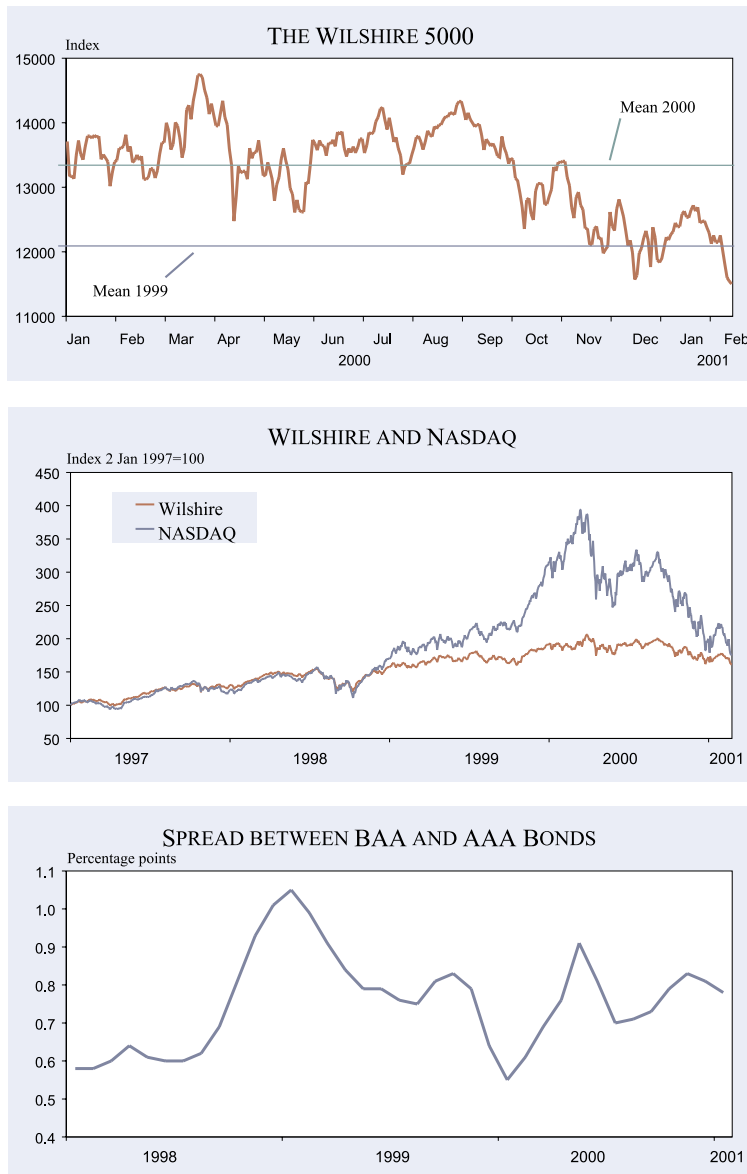


Slowdown in the U.S.

Figure 1



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Figure 2: Financial Indicators in the United States

Source: Bloomberg; Board of Governors of the Federal Reserve System.

further and spill over into business and consumer confidence.

US financial market conditions did in fact deteriorate further in the fourth quarter. Equity prices fell sharply and risk spreads on corporate bonds picked up (Figure 2). Real economy indicators also softened, driven by exceptionally weak capital goods spending, a drop in real exports and a marked slowing in consumption (Figure 3). At the same time, real inventories increased while final sales of goods declined. Initial claims for unemployment compensation continued to rise throughout the quarter, and both the purchasing managers' index of business conditions in the manufacturing

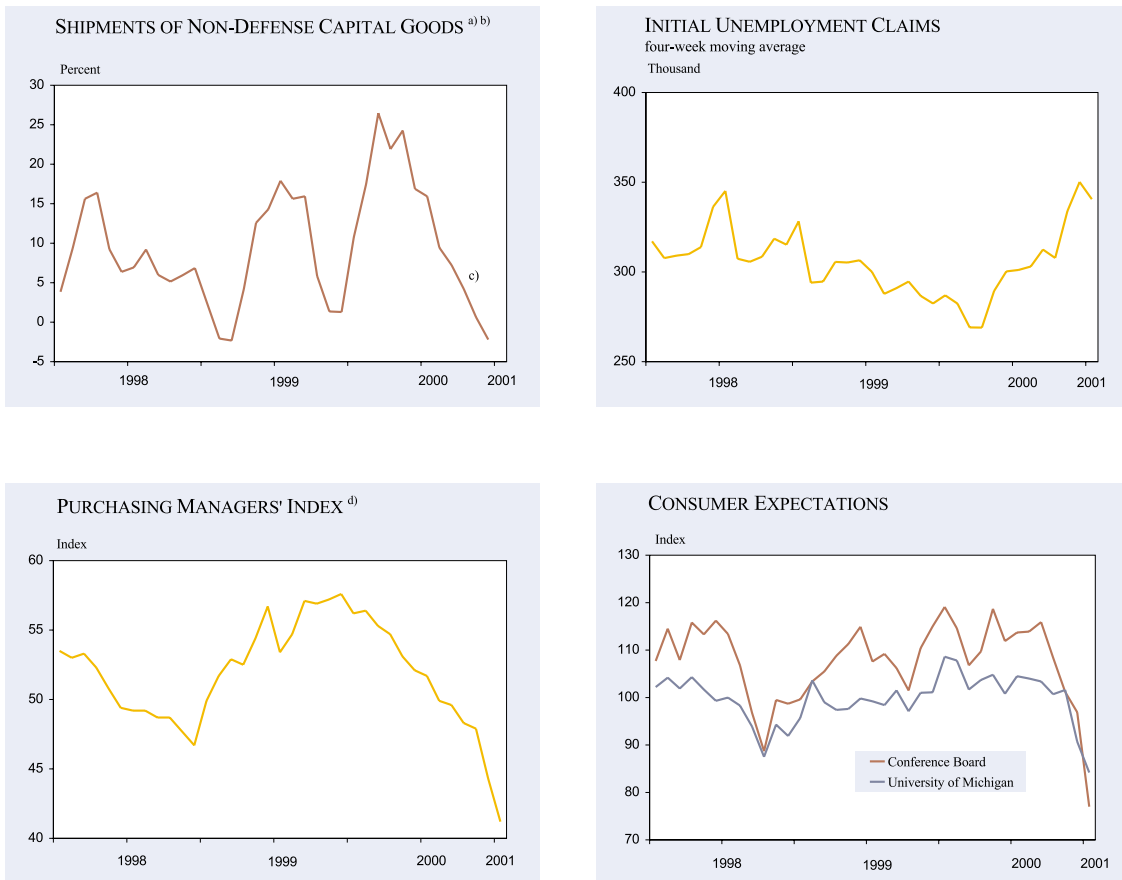
sector and widely looked at measures of consumer sentiment/confidence dropped sharply in the final months of the year and continued to fall in January and February.

In Japan, economic activity has seemed unable to pick up in a self-sustaining fashion, and deflation has continued. While recovery in Japan may still be underway, the pace appears to be slower than had been thought. Corporate sector profits and a weaker yen have helped, despite higher real interest rates, to underpin business investment, but while, as expected, public investment has slowed, real net exports have started to decline with weaker growth in the United States and the economies of East Asia. Moreover, the weak income growth, due in part to restructuring, has evidently restrained private consumption. Even more importantly, perhaps, there are renewed concerns about the financial sector in Japan, amid indications of the need for further significant balance sheet adjustments by banks and some major adjustments as well by life insurance companies. Finally, wholesale and consumer prices are continuing to decline despite higher energy prices, in

part due to deregulation in a number of key sectors, but probably also in response to sustained weakness in aggregate demand.

Economic activity in Europe also appears to be slowing a bit, but its performance still looks relatively good and is not much different from what was expected a few months ago. Export growth has slowed in part as the boost from the earlier depreciation of the euro ended and foreign demand dropped. The growth of investment spending has softened as business confidence indicators have slipped slightly. Consumption spending has remained strong, however, with consumer confidence near record levels and employment continuing to grow rapidly.

No rebound in Japan

Figure 3: Recent Economic Indicators in the United States

a) Excluding aircraft. – b) Three-month moving average, percentage change from three months earlier at annual rate. – c) Level of shipments in December relative to fourth quarter at an annual rate. – d) The average balance of opinions on production expectations, order-books and stocks.

Source: Bloomberg, Bureau of the Census, Bureau of Economic Analysis, Datastream, Employment and Training Administration.

For most of the rest of the OECD area, developments seem to be broadly in line with what was expected some months ago. Korea, however, may be affected more than others by the U.S. slowdown and the fall in demand of ICT products, given its export specialisation in the ICT component producing sector. In Turkey, the situation is serious in that it marks a significant setback in the attempt to achieve stabilisation objectives.

The situation in the non-OECD area softened in the second half of last year, as the U.S. slowdown and the fall in demand for semiconductors and other electrical goods is likely to have significantly reduced export growth also in dynamic Asia. South American countries, which have weaker trading ties with the United States, have been less affected than Asia by the slowing of economic activity in the United States. Output growth in the oil-exporting countries is rising in line with expectations and provided the

price of oil does not drop sharply the economic outlook for these countries is generally favourable.

The U.S. correction

Against this background, much of our revised view of the global outlook will depend on how we see economic activity in the United States evolving. In this regard, the key issue is to form an assessment on whether the slowdown since late 2000 is transitory and mostly due to temporary factors or whether it presages a protracted period of adjustment. It is important, therefore, to try to understand the nature of the factors behind the recent developments that have been taking place in the United States. Significant pieces of data are, however, still missing and, as a consequence, any analysis at this point can only be preliminary. Nonetheless, one can tentatively identify a few key

Relatively good performance in Europe

forces that likely contributed to the slowdown in the United States and speculate about others.

Transitory factors

One element that seems to have been important has been the exceptionally cold weather in the United States in November and December, which likely suppressed retail sales during that period and also construction activity. The impact, however, on the economy is transitory and may, to the extent that some purchases are only delayed, spur output in coming months.

High oil prices

A related factor has been the high price of energy (both oil and natural gas), which together with apparently limited stocks of refined products, such as home heating oil and gasoline, led to increased final product prices and must have absorbed a larger-than-normal share of discretionary income. Since December of last year, crude oil prices have eased back a bit from recent peaks, as additional crude oil production entered the market, heating oil stocks began to recover and energy demand softened. These developments were expected six months ago when the OECD was finalising its current published set of projections, but the changes have come earlier than anticipated. Moreover, while oil and commodity markets are inherently volatile, it is reasonable to believe that the risk of a substantial additional hike in oil prices has abated.

Other elements, advanced by some commentators, have been the protracted periods for settling the outcome of the US presidential election and the electricity utility crisis in California (one of the world's largest economies). These may have served to puncture confidence. The somewhat nebulous nature of confidence, however, makes it difficult to assess these influences. But to the extent that these forces did play a role, their impact is also likely to be transitory.

Areas of greater uncertainty

Stock adjustment effects appear to have been present in the demand for computing and telecommunications equipment, whose growth declined sharply at year-end. The slowdown followed a period of exceptional demand growth, which was reflected both in the process of strong capital

deepening and in the rapid rise in the equity price of ICT producing firms. ICT expenditures were by far the fastest growing component of investment spending over the past two to three years and accounted for more than a third of all business investment in 1999 and 2000. Recently, adverse profit movements have helped to reduce what have appeared for some time to be clearly overvalued stock prices of several ICT firms.

There also seems to have been a significant stock adjustment taking place in the demand for durable consumer goods in the last months of 2000, particularly in the motor vehicles sector, which had enjoyed several years of strong growth before the second half of the year. This downward adjustment in the demand for automobiles as consumers work off existing stocks was possibly influenced also by high gasoline prices. In addition, investment demand for trucks appears to have dropped off significantly at the end of last year, probably for similar reasons.

The fourth quarter also saw a fall of U.S. exports in nearly all categories of goods. A significant portion of the drop was in aircraft, which are typically volatile, and in semiconductors and ICT equipment. It is not clear, however, what factors were behind the generalised drop-off in exports.

Even if the slowdown in investment, given signs of over-capacity in some sectors, was to an extent anticipated, it appears to have exceeded expectations. Rather than occurring smoothly over time, a sharp correction has taken place. The interaction between profit movements, stock price developments, consumer and business confidence (the "animal spirits") is obviously very complex. Especially labour market consequences have to be watched with care, as they will be crucial in determining the path of consumer expenditures. Finally, as a result of the sharp correction in final demand, an inventory adjustment is also to be expected, which adds some uncertainty to the timing of the recovery in activity growth.

An assessment

Positive developments

In many respects, recent developments have been accompanied by adjustments that appear to be

Stock adjustment in
ICT equipment and
autos

appropriate and reasonable, even if their timing was not well predicted. In addition, the favourable background against which these adjustments have occurred might ease concerns about the likely severity of the slowdown overall.

An orderly decline in US equity prices

Equity prices, especially in the high-technology sectors, were by most estimates too high in recent years. It seemed almost inevitable that an adjustment would eventually occur, and the risk was that such an adjustment, when it did occur, might overshoot its true equilibrium and destabilise economic activity. However, what we saw in the past year was a large but reasonably orderly decline of equity prices, most notably in the high-technology sector, where it was believed that such an adjustment was most needed. Current prices clearly reflect more reasonable prospects for earnings growth than those of a year ago, although valuations may still be a bit high relative to historical norms.

Continuing productivity growth in the United States

US labour productivity continued to grow in the fourth quarter, at a rate similar to those of previous quarters. This is encouraging in part because the end of a cycle is typically accompanied by a sharp slowdown in labour productivity growth, as firms are less able to adjust employment when demand for output falls.

The productivity figures serve to reinforce the view that there has been a structural shift in the U.S. economy. Sustained strong increases in productivity compared with the performance of recent decades support the conclusion that the trend rate of growth of potential output in the United States has improved. Indeed, OECD estimates of U.S. potential growth have been revised up on several occasions over the past few years. The most recent upward revision was late last year, when potential growth was increased to around 4 per cent. This compares with an estimate of $2\frac{3}{4}$ per cent in 1998. An implication of the improvement in potential, which is consistent with temporarily subdued inflationary pressure, is a reassessment of the extent to which cyclical imbalances need to unwind and to which policies need to react. Furthermore, these imbalances can now unwind while maintaining a pace of economic growth that until quite recently

would have been considered reasonable macroeconomic performance.

Low inflation and stable inflation expectations

The rise in oil prices since early 1999 has had little effect so far on underlying inflation trends. Excluding food and energy, the four-quarter changes in US consumer prices have increased only slightly (Figure 4). Consumer prices in the euro area have also remained low. In addition, there are no signs of higher long-term inflation expectations in the United States and a number of other economies, based on measures of inflation expectations derived from consumer and producer surveys, as well as from regular and index-linked government bonds. Market long-term inflation forecasts also continue to be low and stable relative to current inflation in the United States and Europe (Figure 5). These developments are all the more remarkable given that many economies have been either above estimated measures of potential output (e.g. the United States, the United Kingdom and Canada) or approaching it, in some cases rapidly (e.g. the euro area). The exception is Japan, where deflation is continuing.

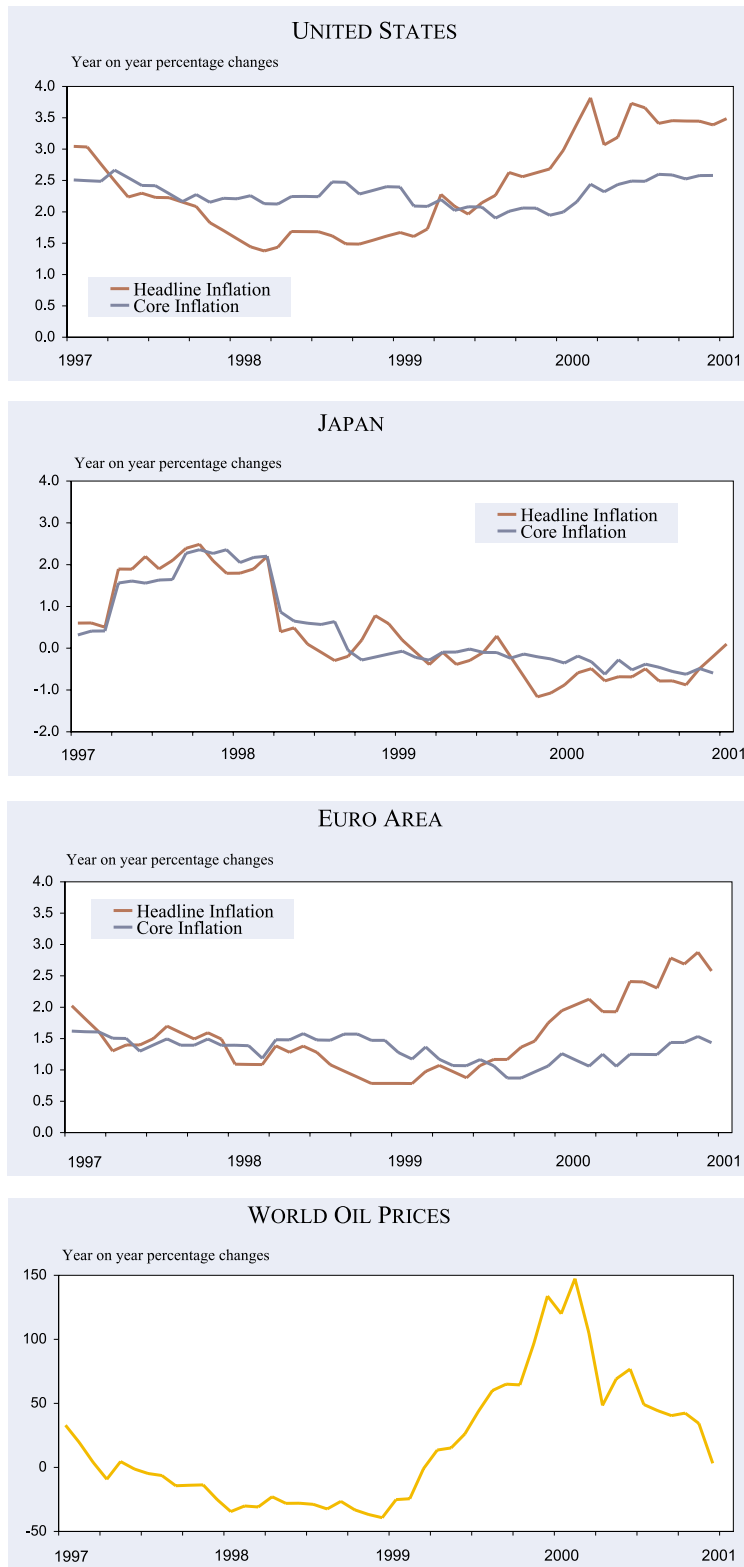
It is noteworthy that the general pattern of modest inflation outcomes has been occurring for a while and has not been well anticipated by forecasters. For example, while OECD projection errors for GDP have been somewhat evenly distributed around zero over the period from 1993 to 1999, projection errors for inflation over the past decade have generally been negative, indicating that actual inflation outcomes have generally been below the projections (Figure 6). This may highlight the occurrence of an important regime change in the state of inflation expectations, possibly linked to the success in the setting and conduct of monetary policy.

Improved employment conditions in the euro area

Labour market trends in the euro area have been favourable in recent years. More or less comprehensive reforms have been undertaken in many countries, with all of them adopting measures that lower labour costs and/or raise real wage flexibility. Also, reflecting policy measures to make European labour markets more flexible, part-time and temporary employment has contributed very significantly to overall employment growth. This

Productivity growth
and low inflation

Figure 4: Actual and core inflation in major OECD areas and world oil prices



Source: OECD Main Economic Indicators.

has occurred while demand conditions have been gradually improving, and it has been reflected in employment growth exceeding, over the past three years, that in the United States. The area unem-

ployment rate has declined from a peak of 11.5 per cent of the labour force to around 9 per cent, even as the participation rate improved.

High consumer confidence in Europe

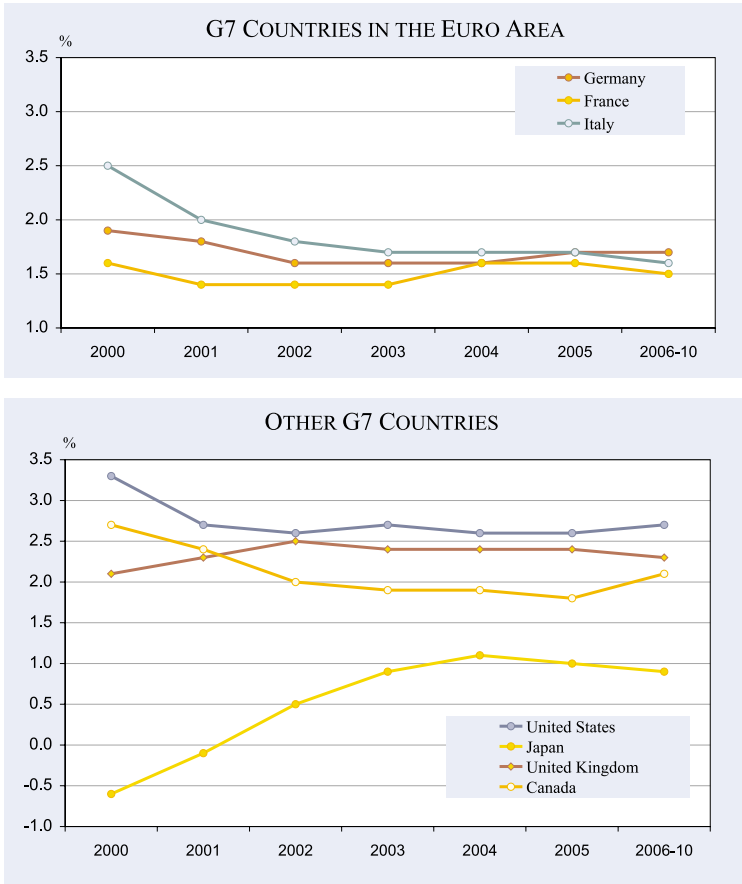
Consumer confidence, according to the European Commission Survey, remains near record levels in Europe, even if some signs of softening are beginning to appear (Figure 7). Provided that labour market trends continue to be favourable and that equity prices remain around their current levels, consumption should remain healthy. It is notable that consumer confidence measures in Europe have remained relatively strong overall, despite the sharp downturn in the United States.

Modest adjustment of the euro

The recent period has also witnessed a reversal in the foreign exchange value of the euro, which until October-November of last year had been on a declining trend since its inception. This sustained decline prompted renewed questions by some commentators about the relationship between foreign exchange market developments and economic fundamentals. The slide of the euro elicited both verbal and, ultimately, market intervention on the part of monetary authorities in Europe and elsewhere. The recent turnaround of the euro against the dollar and the yen constitutes, at this point, only a small reversal of its earlier slide. However, this reversal is consistent with a shift in views about the relative strength of economic activity in the euro area in the past few

Job growth and high consumer confidence in Europe

Figure 5: Long-term Inflation Forecasts According to Consensus Forecasts



Source: Consensus Forecasts (October 2000).

months and may mark the beginning of a period in which exchange rate movements contribute to the overall adjustment towards longer-run equilibrium.

More troubling developments

There is more uncertainty about certain other aspects of recent developments, which may serve to prolong or complicate the adjustment period.

Balance sheets in the United States

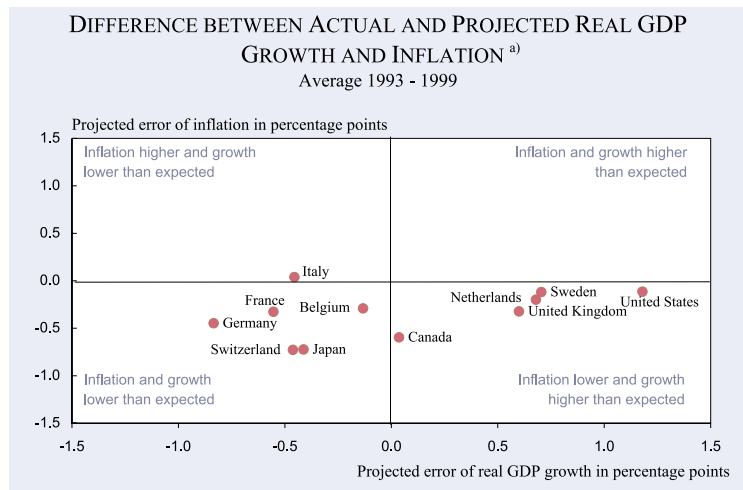
Balance sheet positions in the United States, which were important in prolonging the US recession of the early 1990s, do not appear to be restraining activity to the same extent now.

By most accounts, US banks are well-capitalised. Therefore, banks should not be reluctant to lend on the grounds that they need to work down bad debts or build up capital, as they were at the beginning of the 1990s. Non-financial corporations also appear to have reasonably comfortable balance sheet positions. While the debt levels of these firms have moved above previous highs, debt positions are quite low relative to the market value of enterprises (Figure 8). Furthermore, with interest rates low, net interest payments relative to cash flow are at easily sustainable levels. The household sector, however, is perhaps one area where some concern over balance sheets may arise. Debt loads are high and, because of the high levels of debt, debt-servicing costs have grown to be close to the peak levels of ten to fifteen years ago (Figure 9). Offsetting these concerns, to some extent, are the relatively large holdings of li-

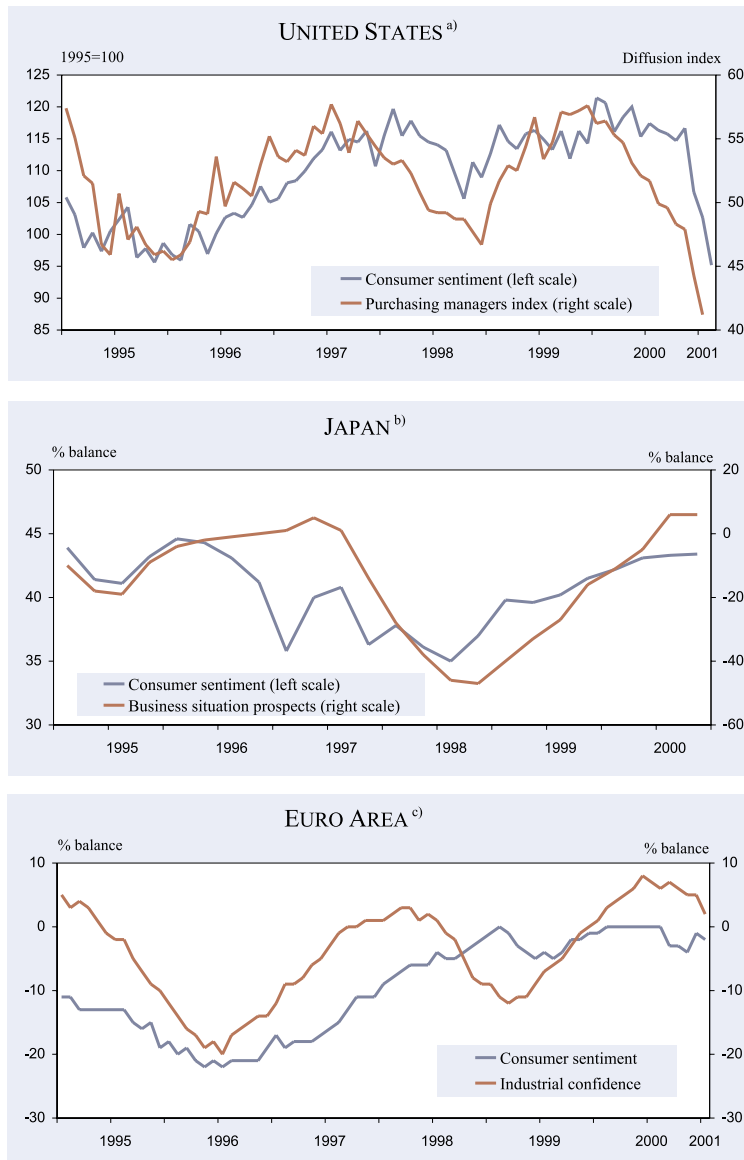
U.S. household debt in high

quid assets, which appear to offer a substantial cushion to households, although mutual fund holdings comprise a significant portion of this buffer, and their values may fall with equity prices.

Figure 6



^{a)} Unweighted average of projection errors for inflation and real GDP growth (actual minus projected) from 1993 to 1999. Projections are from the December *Economic Outlook* for the next year. Changing the starting date of the sample does not materially change the results.

Figure 7: Confidence Indicators

^{a)} Consumer sentiment is measured as 100 plus the balance of positive minus negative opinions. Purchasing managers' deliveries (15%) and inventories (10%). – ^{b)} Consumer sentiment is calculated as an average of five indicators concerning household standard of living, income growth, commodity price increases, employment environment and optimal time for durable goods purchases. The business situation prospects is the balance of positive over negative replies expressed as a percentage of total replied to questions concerning the business situation, stocks of finished goods and capacity utilisation. – ^{c)} Consumer sentiment refers to the average balance of positive and negative opinions on the expected financial situation, expected general economic situation and advantage to make major purchases at present. The purchasing managers' index refers to the average balance of opinions on production expectations, order-books and stocks.

Source: OECD *Main Economic Indicators*.

U.S. over-investment

Fuelling the exceptional growth performance of the United States, particularly in the period from mid-1999 through to the first half of 2000, were rapid increases in investment spending. Growth during this period was well above even the upwardly revised estimates of potential output growth for the

United States, and, combined with an economy that seemed already to be running beyond the limits of its capacity, it appeared that a period of downward adjustment would be inevitable. The decisions by the Federal Reserve to cumulatively raise short-term interest rates by 175 basis points between June 1999 and May 2000 were designed to help unwind this imbalance. Tighter monetary conditions may have started to bite in the second half of 2000, but that may have come too late to prevent a significant amount of over-investment in capital goods and consumer durables. How long it will take to complete this adjustment is not obvious, although continuing price declines for ICT equipment and software and its rapid depreciation should work to shorten the process to some extent.

Japan

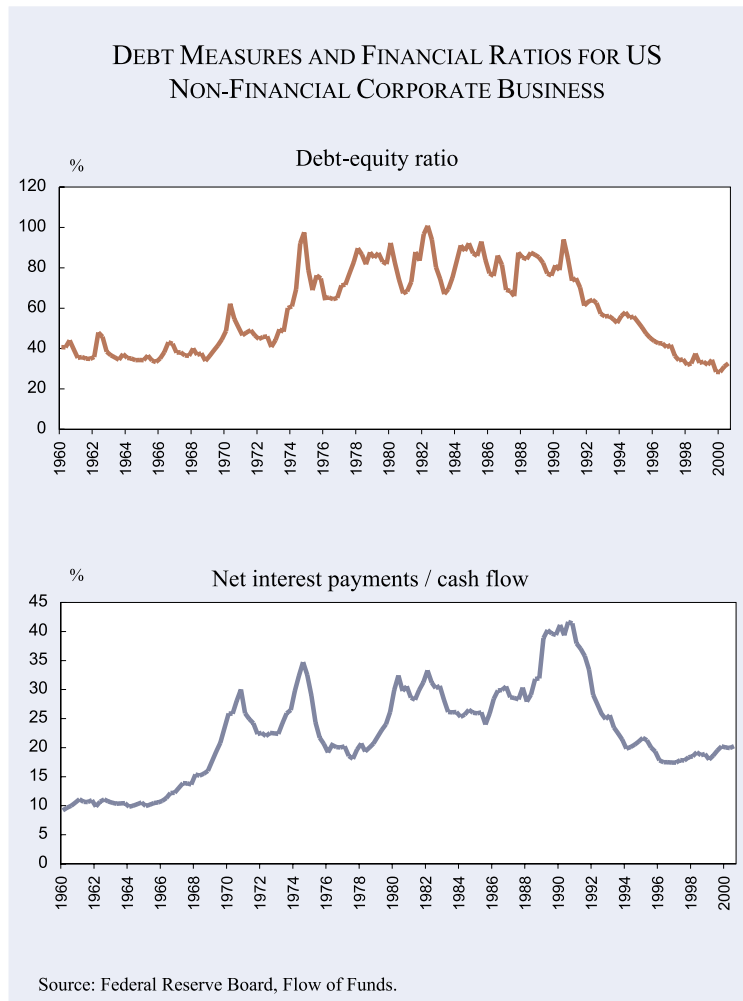
The chances that growth in Japan might deteriorate again look to have increased. If a downturn occurred, the situation would be made all the more difficult by the underlying structural problems. Balance sheet problems, which reflect poor future prospects for the heavily indebted parts of the corporate sector, are continuing to act as perhaps the major restraining force on growth. While dealing with them will create "head winds", delaying

appropriate responses will only exacerbate the problem. In addition, despite the measures taken in March 1999 to address pressing problems with financial institutions, many underlying problems remain with the banking sector (particularly the major banks). Furthermore, as bankruptcy procedures continue to gather pace, the recognition is growing that banks will have to increase their pro-

U.S. investment
in downward
adjustment

Balance sheet prob-
lems in Japan

Figure 8



visions for bad loans (and disposing of bad loans is made more difficult by the small size of the market for asset-backed securities as well as the lengthy and inefficient bankruptcy procedures, which have nonetheless improved recently).

This effect could be compounded as the true extent of losses in the non-financial sector are recognised (following the introduction of tighter accounting standards) and by any additional weakness in real estate prices that might emerge, as banks typically value collateral at historical value and only provision against the difference. Finally, bank loans have fallen, as major sound clients restructure their own balance sheets, and loan margins remain low. There are also severe problems in the life insurance industry, where firms have extensive cross holdings with the banking sector. These problems stem from high promised returns, which in a number of cases now cannot be met and which can only be altered during bankruptcy proceedings. A restructuring system is in place, and a safety net, smaller than that for the

banks, has also been established. Nevertheless, the industry is likely to come under further stress in the period ahead.

Turkey

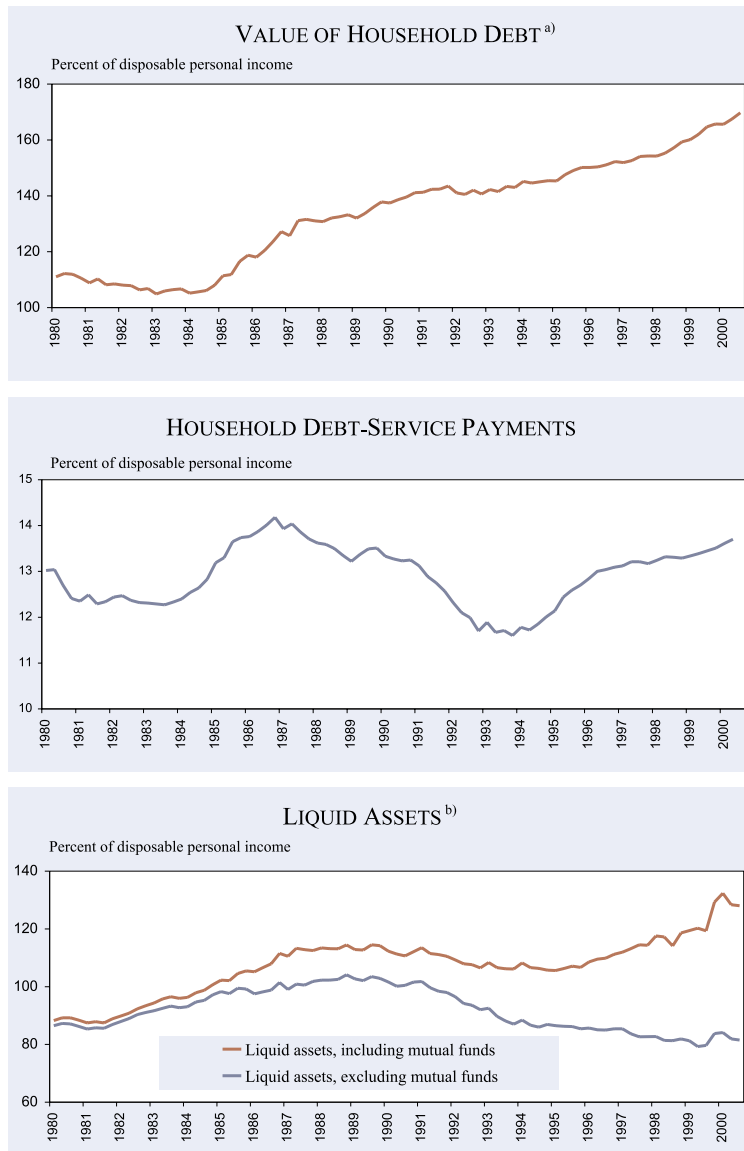
An important concern is the risk of contagion to other emerging market economies from the crisis in Turkey. One cannot predict with certainty what kinds of spillovers might result from the crisis in Turkey. Certainly those with exposure to Turkey will be affected. It is clear, however, that the Turkish crisis is very much linked to specific conditions in that country; and also that widespread international exposure to Turkish risk is not very high. These considerations suggest that spillovers, if any, should be modest and short-lived.

Tentative outlook and risks

Our preliminary analysis leads us to think that the US economy is currently going through a period of needed adjustment. To be sure, it started earlier and more abruptly than all analysts and commentators had anticipated. But going forward, it appears that two different scenarios are likely. The more pessimistic scenario calls for a recession in the United States, which in the worst case could be protracted and have significant spillover effects on the rest of the world. The more optimistic scenario, which appears to be held by most analysts and towards which I personally lean at this point in time, is for significantly lower but still positive growth in 2001. This means that GDP growth might end up being, overall, around 2 per cent in the current year, and higher for 2002. This central scenario acknowledges that a sharp slowdown has occurred, but expects also the speed of correction to be relatively rapid, as temporary conditions pass, fuel prices stabilise or ease, potential output growth remains strong, and capital stock adjustment is concentrated in the rapidly evolving ICT sector. The sharp easing of US monetary policy in January and possible further cuts in interest rates will also serve to speed the adjustment.

Outlook: positive growth in the U.S.

Figure 9: Debt and Debt-Servicing Measures of U.S. Households and Non-Profit Organisations Relative to Disposable Personal Income



a) Home mortgage and consumer credit. – b) Deposits, credit market instruments and mutual funds.

Source: Federal Reserve Board, *Flow of Funds*.

Few policy options
for Japan

Slower growth in the United States will obviously bear on the economic outlook in the other major economic areas. But the impact on the rest of the world appears at this point to be manageable in most countries. Simulation results from the OECD's Interlink model show that, considering the direct trade linkages, a decline of US GDP growth of 1 to 1½ percentage points – about the magnitude of the recent adjustment to expectations for US growth in 2001 – would *ceteris paribus* lead to declines of roughly ½ of a percentage point for growth rates in both Europe and Japan.

measures for the injection of liquidity, such as through outright purchases of government bonds or foreign exchange. Absent such easing, Japan might suffer an even larger decline in aggregate demand if the yen were to rise in reaction to the relative easing of monetary policies elsewhere. Likewise, the scope to stimulate demand through expansionary fiscal policy is severely constrained by the already large budget deficit and rapidly growing size of outstanding government debt.

Outside the OECD area, the reduction of global interest rates should help in many cases to reduce

Nonetheless, the short-term outlook for Europe appears to remain solid. The high level of business and consumer confidence, the employment gains, and the tax cuts implemented in some countries should underpin growth in domestic demand and without stoking inflationary pressures. Recent falls in equity prices may detract from private demand, but the magnitudes should be buffered by the small proportion of European net worth held in the form of listed company stocks. A modest slowdown in activity with respect to 2000 is nonetheless the most likely outcome. As core inflation is predicted to remain low, there would probably be little risk to implementing some modest monetary easing relatively soon. In the event the size of the external shock is larger than anticipated, or if the domestic conjuncture substantially deteriorates, there would remain considerable scope to counter such weakness with further monetary policy easing.

In Japan, however, the monetary authorities may not see themselves as having the same degree of freedom. With policy targeting an interest rate that is already close to zero, further substantial easing to counter the decline in external demand might require alternative, quantitative mea-

financing costs in emerging markets. Most of these countries are also in a position to counter the effects of a slowdown in external demand by easing monetary policy. The impact, however, of the ICT stock adjustment in the United States may hit some countries in dynamic Asia hard, since a sizeable share of their output and exports comprise ICT components and equipment.

Risks

One risk to the outlook, however, is a more generalised cutback in investment and consumption outlays in the United States, which would detract from growth in domestic demand and, in time, impinge negatively on the US economy's growth potential. So far disappointing returns and revised profit expectations have been concentrated among high technology investments. And the slide in equity prices, which persisted through to the end of the year, has been largely in these sectors. There is a risk, however, that equity markets continue to fall, triggering even steeper declines in consumer and business confidence. Such declines in confidence might in turn affect consumption and investment spending for a more protracted period, generating a more negative impact on domestic demand and larger spillover effects to the rest of the world. However, there is still scope for further monetary policy easing, which would tend to offset some of these negative effects on growth in the United States and elsewhere.

Another, perhaps less likely, risk to the outlook arises if the impacts of higher energy prices are still to be fully felt. If the increases we have seen ultimately do pass through to core inflation and inflation expectations, especially at a time when output growth is slowing, they could complicate the policy response to the slowdown in activity throughout the OECD area.

Challenges for policy makers

The current economic environment, which in many respects is quite favourable, presents at the same time some difficult challenges for policy makers. In part this stems from recent changes in the nature of economic activity and the patterns of economic behaviour. For example, equities have in recent years become an important component of U.S. household wealth, with equity market develop-

ments exerting a stronger influence on consumption behaviour through fluctuations in wealth and through confidence. As a consequence, U.S. consumption spending may be becoming more volatile and difficult to forecast than it had been in the past.

In addition, as mentioned earlier, the relationships among inflation, inflation expectations, labour market pressures and fuel prices may have changed. Perhaps because of increased flexibility of labour and product markets and/or increased confidence in monetary policy making, inflation and inflation expectations seem to be responding less, in the current environment, to wage and commodity price pressures.

The increased rate of potential output growth in the United States, which has altered the speed limit for the economy, and the greater share of capital stock devoted to information and computing equipment, which depreciates more rapidly and would lead to faster unwinding of stock adjustment imbalances, also change key economic relationships. As a result, policy makers will need to be prepared to come to grips with new developments, to look for changes in relationships and indicators, and to adapt their policies as needed to the evolving character of economic activity. The success policy makers have in understanding and adapting to the new environment will have an important influence on the way in which the world economy evolves.

This is a very general prescription and implementing it in specific situations will, of course, be difficult. At the moment, one of the key challenges facing the United States is to avoid over-reacting to the slowing of economic growth, which might foster more volatility in activity and risk dissipating hard-won gains against inflation. This task is complicated by the difficulty of measuring potential with a high degree of precision, making policy setting uncertain. For Japan, the main challenge continues to be to devise the right policy configuration to avoid deflation and spark self-sustaining economic activity. This will likely require the rigorous implementation of financial system reforms, vigorous structural changes and the perhaps creative use of existing macro policy tools. For Europe, the challenge is to continue with smooth, non-inflationary growth while at the same time to boost the growth rate of potential, which may come with the further diffusion of information and communication technology and a higher degree of exposure to competition in product markets.

Changed economic relationships pose new challenges for policy makers