The International Outlook

Andreas Hauskrecht

Visiting Assistant Professor,
Department of Business
Economics and Public Policy,
Kelley School of Business,
Indiana University,
Bloomington

Economic growth in the world in 2001 was projected at 2.6 percent (measured in terms of real GDP), compared to growth rates of 3.6 percent in 1999 and 4.7 percent in 2000. The International Monetary Fund in Washington forecasts world economic growth for 2002 at an optimistic 3.5 percent[1] without, or incompletely considering, the economic consequences of September 11th's tragic events. The Organization for Economic Co-Operation and Development in Paris predicts a modest growth rate of around 1.2 percent for the 30 most developed countries in 2002.[2]

In contrast to the past decade, the world currently lacks a growth locomotive. One has to go back almost three decades, to the year 1973, to find the coincidence of recession in the world's three largest economic areas, the U.S., Europe, and Japan. Events of September 11th contribute to the gloomy economic outlook, but are not the primary force of the worldwide economic slowdown.

The developing countries, especially those in Asia, face a sharp decline of economic growth rates for this and the following year, in particular due to sluggish demand for imports in the industrial centers. South America has been negatively affected by the sudden drop of capital imports from the United States and Europe.

Table 1
Current and Projected Indicators

	GDP		Consumer Prices		Current Account Percent of GDP		Unemployment	
	2001	2002	2001	2002	2001	2002	2001	2002
United States	**1.1**	**0.0**	**3.1**	**2.1**	**-4.0**	**-3.8**	**4.7**	**6.3**
Canada	1.6	1.8	2.8	2.0	1.9	0.9	7.4	7.3
Japan	-0.7	-0.8	-0.6	-0.6	2.2	2.6	5.0	5.6
France	1.9	1.6	1.9	1.5	2.5	2.6	8.7	8.5
Germany	0.7	1.0	2.4	1.4	-0.8	-0.5	7.5	7.9
Italy	1.8	1.5	2.7	1.8	-0.1	0.1	9.5	9.1
Euro area	1.6	1.5	2.6	1.7	0.3	0.4	8.4	8.4
United Kingdom	2.0	1.9	2.0	2.1	-1.7	-2.0	5.2	5.3
Mexico*	0.8	4.0	6.3	4.8	-2.8	-3.3		
China	7.4	7.1	1.0	1.5	0.9	0.1		
India	4.5	5.7	3.6	5.5	-0.8	-0.9		
Indonesia	3.0	4.3	10.8	7.0	3.2	2.0		
South Korea	2.5	4.5	4.4	3.4	2.6	2.1	4.0	3.5
Taiwan	-1.0	4.0	0.1	0.8	2.5	2.6	4.6	4.8

**This optimistic IMF estimate does not fully consider September 11th's consequences.*
Sources: Center for Econometric Model Research, Indiana University, IMF World Economic Outlook, Fall 2001, The Economist, October 20th-26th, 2001.

Forecast by Region

The core European countries have recently cut back their growth estimates for 2001 and 2002. Germany expects a mere 0.7 percent growth for this year and a modestly higher 1.0 percent growth rate for the coming year. France, Italy and the UK expect only slightly higher economic growth, between 2.1 to 2.3 percent for 2002. These moderate growth rates and the slow pace of necessary reforms, above all labor market reforms, will keep unemployment rates at existing high levels of around 12 percent for Spain and around 8 percent for the three big continental European countries, France, Germany and Italy (see **Table 1**).

The main causes for the continued growth weakness of Europe is its dependence on export growth and sluggish internal demand (investment as well as consumption expenditures). Despite these facts, neither national governments nor the European Central Bank (ECB) seem to be implementing appropriate counter cyclical policy measures. National governments see their hands tied by their commitment to reduce domestic debt, thereby limiting the scope for fiscal expansion. The ECB, still an untested institution, is fighting for its reputation and the future strength of the euro. This is the reason why the organization is so cautious in cutting money market interest rates. In sum, the somber estimates for world trade and the questionable passivity of economic policy give very limited hope for a stronger pick up of economic activity in Europe.

After a decade, the Japanese recession is developing into a permanent economic calamity. Real GDP growth is estimated to be at -0.7 percent in 2001 and -0.8 percent in 2002. Several previous fiscal stimulus packages have had ephemeral effects. Although short-term interest rates are close to zero, investment and consumption have failed to pick up. The unemployment rate reached 5 percent this year and is expected to rise further. In addition, deflation, that is, a continued decline of the price level, is darkening the economic outlook for the world's second largest economy.

The Japanese quandary is compounded by forestalled domestic reforms. There is insufficient political will to privatize and open the country to international competition. The Japanese financial crisis reflects the economic and political conditions of the country. After a decade, the size of non-performing loans has risen from the billions to the trillions of dollars. There will be no economic recovery without a clean up of the financial sector.

The best guess for the U.S. economy seems to be a modest recovery of economic dynamic next year with an estimated real GDP growth of 1 percent. Unemployment will reached almost 5 percent this year and will also rise next year. Monetary and fiscal policy point in the right direction, that is, at stimulating economic activity.

NAFTA members are closely trade integrated. Canada and Mexico are strongly depending on the U.S. demand for their exports. Real GDP growth for Mexico and Canada this year is expected to be around 0.8 percent and 1.6 percent, respectively, and slightly higher next year.

"The best guess for the U.S. economy seems to be a modest recovery of economic dynamic next year...."

The picture for emerging economies looks only slightly better than for the industrialized countries. Economic growth in the East European countries and in Russia is projected at 2.5 to 4.5 percent this year and next year.

Southeast Asian emerging economies have suffered a dramatic decline in output in the second half of this year, caused by a sharp slump of import demand in the United States. China and India have bucked the regional trend with projected growth rates of 7.5 and 4.5 percent, respectively, in 2001 and 7.0 and 5.7 percent in 2002.

Latin America, with much less intense trade with the United States, faces a sharp decrease of capital imports that are needed to finance the current account deficits. Exchange rates of several countries, especially the Argentine peso and the Brazilian real, came under pressure to devalue.

The Risk

The war against terrorism presents the largest risk in the forecast.

The projected U.S. current account deficit of $400 billion this and next year, around 4 percent of GDP, is problematic. The deficit indicates that internal absorption, the sum of consumer expenditure and investment, exceeds domestic production. The gap is financed by net capital inflows. Investing in the United States was attractive for foreigners expecting high rates of return. They might be less optimistic in the near future. Interest rates in Europe and the United States narrowed over the year, most industries announced lower rates of return for the coming future, equity investment became riskier. A reversal of net capital flows would either cause a sharp drop in consumption (a forced rise in private savings) with severe negative effects for economic growth or provoke a strong depreciation of the dollar, further reducing the attractiveness of foreign investment in the United States. A weaker dollar might be good for U.S. exporters, but will at the same time make the economy more vulnerable against imported price inflation. An increase of inflation would limit the scope for future interest rate cuts by the Fed.

Many commentators predict another speculative attack on the Argentine currency board (the peg of the peso), the domestic currency to the U.S. dollar. An implosion of Argentina's exchange rate regime would possibly cause a default on its government debt of approximately 132 billion U.S. dollars This would not only severely harm international creditors, but also provoke a wave of financial contagion around South America and other emerging markets.

References

1. International Monetary Fund, *World Economic Outlook*, Fall 2001.

2. Organization for Economic Co-Operation and Development, *World Economic Outlook*, November 2002 (forthcoming).