World Economic Survey*

World Economy: Downward Trend Stopped?

In January 2003 the world economic climate as reported by the latest World Economic Survey improved slightly. But at 85.9 (1995 = 100) it is still significantly below its long-term average (94.1 in the period 1982 to 2002), though slightly higher than the revised figure of the previous survey (83.2). The little brighter economic climate is solely attributable to the somewhat improved expectations for the next six months, whereas the assessment of the current economic situation, the other component of world economic climate, remained negative and has not changed since October 2002.

Given the geopolitical uncertainty at the time of the survey, we dare not interpret the modest improvement of the world economic climate as a clear sign of an imminent worldwide recovery. It cannot be ruled out that the downward trend has only temporarily been interrupted. The April survey will provide the additional evidence.

World economy: Slight improvement of economic climate

The downturn of the world economic climate indicator, which had accelerated in the period from August to October 2002, reversed in January 2003 (see Figure 1). The slight improvement of the overall climate indicator resulted exclusively from somewhat more positive expectations for the coming six months, whereas the current economic situation remained at the low October 2002 level. The capital investment sector is still performing worse than the consumption sector.

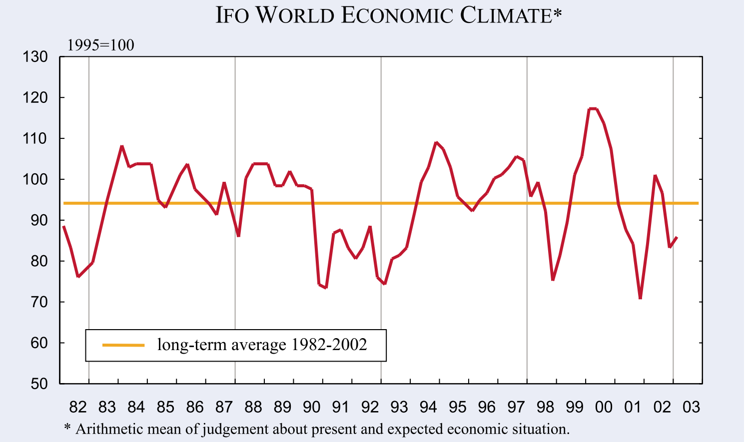
United States: Slight improvement of economic climate

After a setback of the economic climate in the fourth quarter of last year, a slight improvement was recorded in January 2003. Both the assessment of the present economic situation as well as the expectations for the next six months point upwards, although the present economic situation is still regarded as less than satisfactory. This is mainly due to the still unsatisfactory level of the hard-hit capital expenditure sector which is, however, expected to improve within the next six months, giving rise to the hope for a brighter outlook for the entire economy (see Figure 2).

European Union: Downward trend of economic climate halted

In contrast to the world average, the climate indicator in Western Europe has stalled rather than risen since the October 2002 survey. This stagnation results from a more negative assessment of the present economic situation, whereas the expecta-

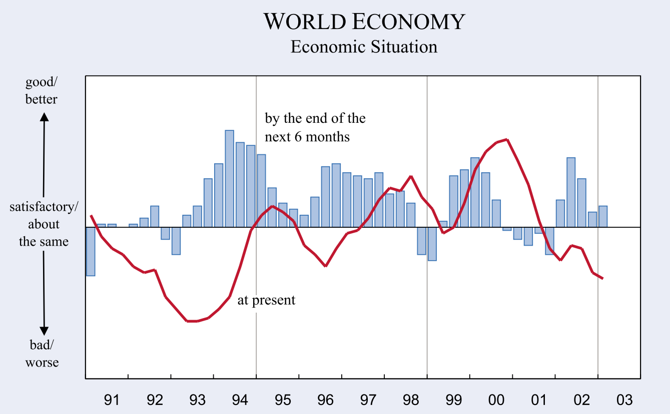
Figure 1



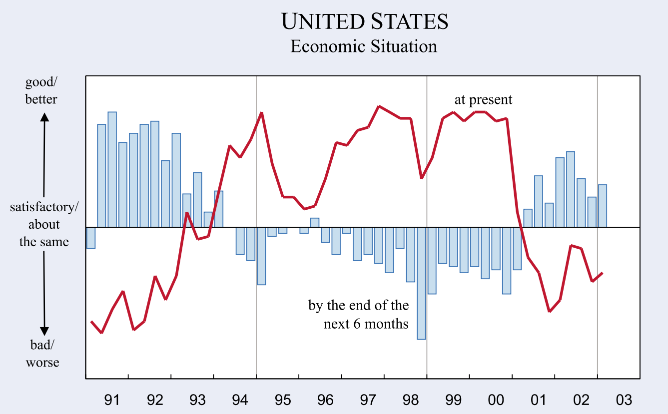
* Arithmetic mean of judgement about present and expected economic situation.
Source: Ifo World Economic Survey (WES) QI/2003 in corporation with ICC, Paris.

* The survey is jointly conducted by the Ifo Institute and the Paris-based International Chamber of Commerce (ICC).

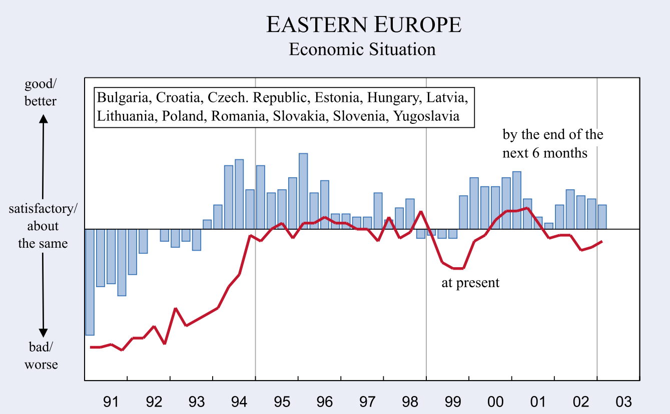
Figure 2



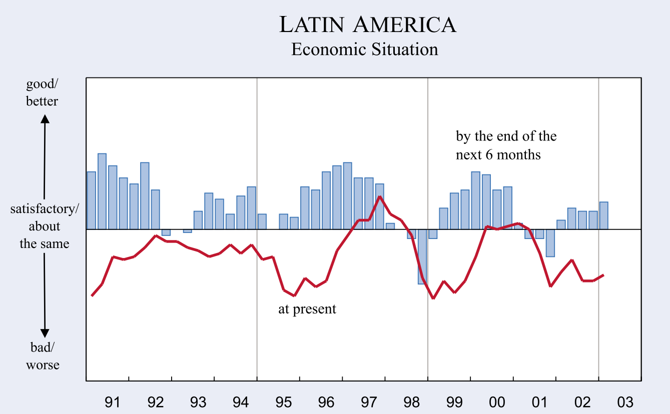
Source: Ifo World Economic Survey (WES).



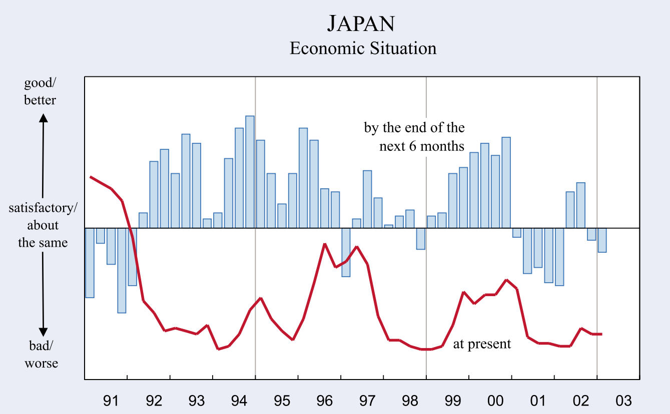
Source: Ifo World Economic Survey (WES).



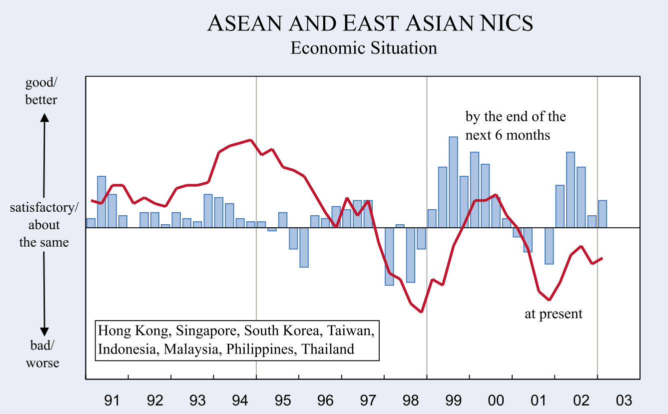
Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).

tions for the coming months have improved slightly since the October 2002 survey (see Figure 3).

Among the euro area countries only *Finland, Spain* and *Ireland* assess the present economic performance as satisfactory or good. The economic expectations in Finland also remained optimistic, probably due to the high level of private consumption and a continuation of favorable export growth expected in coming months. In *Ireland* and *Spain* the economic performance is expected to remain on a satisfactory level in the next six months.

As in the previous survey, *Germany* again shows the lowest level by far of assessments of the present economic situation and together with *Austria, Portugal, Italy* and the *Netherlands* is in the bottom group of EU countries. However, there is some hope for the second half of the year: WES experts see signs of an economic recovery in the next six months particularly in *Italy* and *Germany*, where the prospects for exports are positive. In the other countries, the short-term expectations are moderately positive, although they do not really raise hopes for a reversal of the negative trend.

WES experts in *France* and *Belgium* assessed the present economic performance as poor, whereas the expectations remained positive for the next six months.

The non-euro area countries *Denmark, United Kingdom* and *Norway* appear to be faring significantly better economically than the other European countries. Only in *Sweden* did the current economic situation deteriorate slightly, though remaining close to the satisfactory level. On the other hand, in *Norway* the economic expectations for the next six months are worse than the euro area average. In the *United Kingdom* the economic development is still characterised by falling exports, and a further deterioration of the trade balance is expected in the next six months.

Eastern Europe: Stabilization of economic climate continues

According to the WES experts in Eastern Europe, the current economic situation has improved slightly since the October 2002 poll. On average, the outlook remained mostly unchanged, reflecting the general uncertainty concerning the future of these economies.

The current economic situation continues to be good particularly in the Baltic countries *(Estonia, Lithuania* and to a lesser degree *Latvia)* and in *Slovenia*. Expectations for the next six months also remained bright.

Economic activity in Croatia continues to be on an upward trend and is assessed as almost satisfactory. The prospects for the next six months remain highly positive. Similarly in *Bulgaria*, the assessment of the present situation improved considerably. To a lesser degree this holds true also for the *Czech Republic*, where the economic situation is now regarded as satisfactory. However, the economic outlook for the *Czech* economy appears to be clouded; growth of capital expenditures, private consumption and exports is expected to slow down in the course of the next six months.

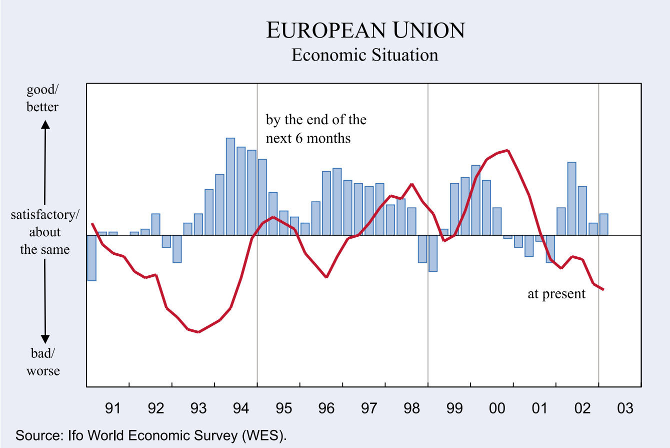
In *Poland, Romania* and *Yugoslavia* the present state of the economies remained clearly below the “satisfactory” level but is expected to brighten somewhat in the course of the next six months. The reason for the optimistic forecast is probably the more buoyant consumption sector in these countries, which is also expected to grow during coming months.

Latin America: Current economic situation still unsatisfactory

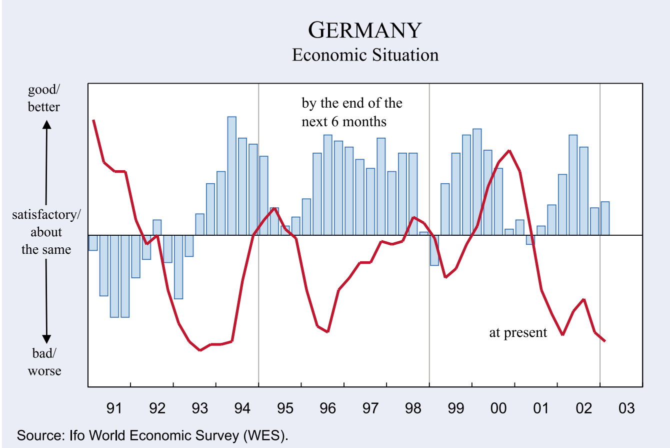
Brazil, Chile, Peru, Costa Rica and *El Salvador* currently show the relatively best economic performance – judged as almost satisfactory. Economic expectations became highly positive particularly in *Brazil, Chile, Peru* and *El Salvador*, which is also reflected in a relatively optimistic view on the future trend of capital expenditures, consumer outlays and exports.

In *Argentina* the present economic performance still remains at a very low level. However, the expectations for the next six months have improved somewhat. Especially the export sector in *Argentina* is expected to pick up in the coming months. In *Uruguay* and *Paraguay* the current economic performance is also rated as poor but is expected to improve in the near future. In *Panama* and *Mexico* the economic situation remains clearly

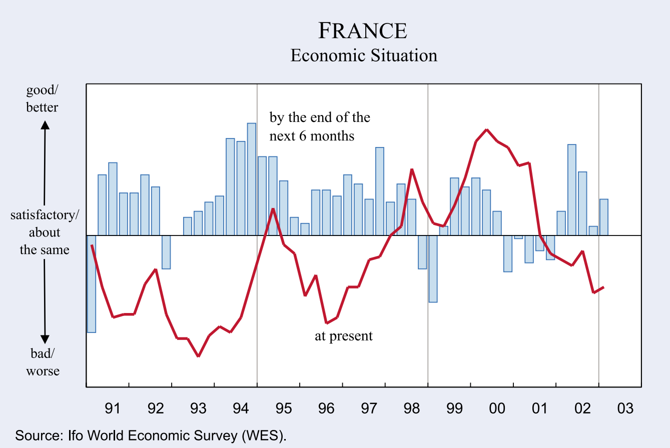
Figure 3



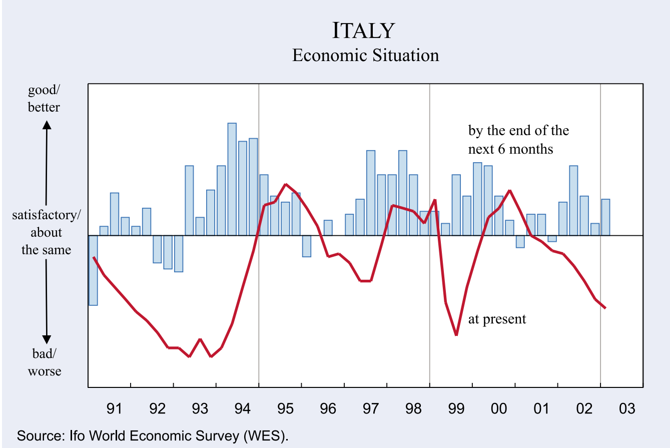
Source: Ifo World Economic Survey (WES).



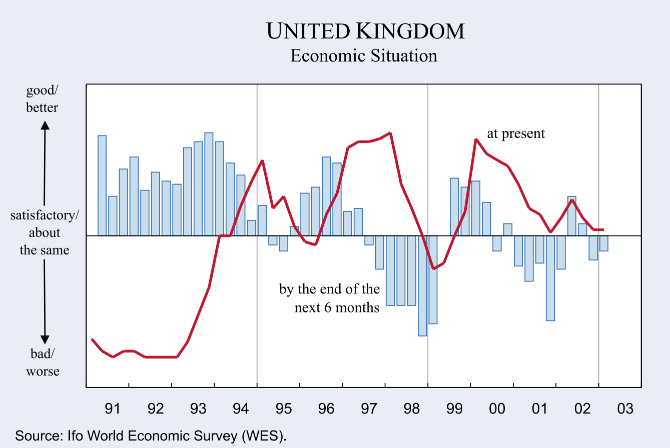
Source: Ifo World Economic Survey (WES).



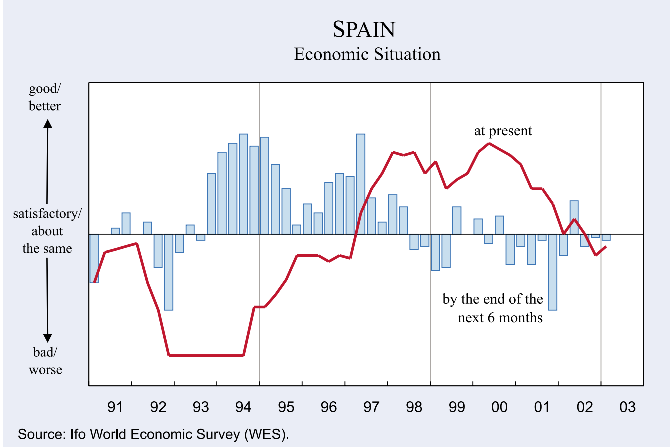
Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).

below the "satisfactory" level. However, in both cases expectations are positive.

In summary, almost all countries in Latin America expect the overall economy to strengthen in the coming months, accompanied by more dynamic growth of capital expenditures, private consumption and exports. The only exception, according to the WES experts, is Venezuela where the current economic situation is rated as very poor and is expected to deteriorate further during the next six months.

Asia: Somewhat better economic climate

According to the latest survey, the assessment of the current economic situation remained unchanged while expectations for the next six months improved. Compared with the previous survey, the overall economic climate indicator for Asia slightly improved but still remained below its long-term average.

In *Japan*, the economic climate remains subdued. The assessment of the current economic situation is in line with the negative expectations of last quarter and is well below the "satisfactory" level. The short-term expectations also point to further deterioration (see Figure 2). The less optimistic forecast for the next six months is probably related to the fact that WES experts there do not expect a significant recovery of private consumption that could end the deflationary trend in the country. Only Japan's export sector is providing some growth impetus.

The economic situation of *South Korea* was rated as more than satisfactory in January. This was also true of Thailand where private consumption increased in recent months and is expected to remain buoyant in the course of the next six months. The economic climate in *Indonesia* is still rough, however.

In *Taiwan*, assessments of the present economic situation were slightly worse, whereas more dynamic economic growth than in the recent past is seen ahead. In the *Philippines* the present economic situation remained slightly below satisfactory, but expectations for the next half year improved and are now close to the Asian average. While the economic situation of *Singapore* deteriorated in past months, it is expected to improve. *Hong Kong* again showed a considerably weak economic performance which is reflected in the low level of assessments of the present economic situation, and no significant change for the better is expected for the next six months.

Near East: Economic climate improved slightly

The overall assessment of the current economic situation in the Near East remained close to the satisfactory level. By far the best economic performance is shown by the *United Arab Emirates*, followed by *Saudi Arabia* where the outlook for the coming six months – like the average for the Near East – signals an improvement in economic activity. The economy of *Bahrain* was rated as satisfactory, though expectations for the next six months are clouded. The recent economic situation in *Iran* and *Jordan* is expected to remain at a satisfactory level. *Turkey's* current situation slightly improved, although still remaining well below satisfactory. However, the expectations for the next six months are clearly positive. *Israel* continues to suffer from political and economic crisis; WES experts don't expect a noticeable improvement in the next six months, although they see a chance for export growth.

Interest rates: Trend of falling short-term interest rates expected to slow

The phase of declining **short-term interest rates** is expected to level off in the course of the next six months. In *North America* – in the *United States* as well as in *Canada* – no further cuts are expected. Rather, short-term rates are expected to pick up slowly in the course of the next six months. A stabilisation or even a slight increase in rates appears to be also likely in *Australia* in the coming months. In Asia and particularly in *Western and Eastern Europe* the downward trend of short-term interest rates is still intact and is expected to continue in the coming months. In *Latin America* expectations of rising short-term interest rates still prevail, though the trend is not uniform: In countries like *Brazil, Peru, Bolivia, Ecuador* and *El Salvador* short-term rates, according to WES experts, are likely to decline in the coming months, whereas in most other Latin American countries, including *Argentina, Mexico* and particularly *Venezuela*, a further increase of short-term rates appears to be more likely.

Long-term interest rates are expected to remain stable or increase marginally in the course of the next six months. This picture characterises in particular the situation in Western Europe, whereas an upward trend of long-term interest rates is expected in North America and *Australia* as well as in some Latin American countries like *Argentina, Mexico* and *Venezuela* and in some Asian countries like the *Philippines* and *Vietnam*. On the other hand, a continued downward trend of long-term interest rates will prevail, according to WES experts, in most Eastern European countries and some Asian countries like *China, India, Pakistan, Taiwan* and *Thailand*.

World currencies seen relatively close to equilibrium

On average of the 90 countries polled, only the British pound sterling is still judged to be overvalued. The US dollar appears to be only slightly higher than justified on fundamental grounds. For the first time, the euro is regarded as slightly overvalued. The current level of the Japanese yen is assessed as appropriate by the vast majority of WES experts.

In Western Europe, *Canada* and *Australia* the US dollar is still seen as overvalued against own currencies, though to a lesser degree than in the previous surveys. WES experts in Eastern Europe consider the major world currencies close to "fair value" against their local currencies, except *Poland, Slovenia* and *Slovakia*, where the experts rated the US dollar and the euro as being clearly overvalued against local currencies. In Latin America, the US dollar as well as the euro and the British pound are judged as somewhat overvalued, whereas the yen is seen to be near "fair value". This trend is particularly pronounced in *Argentina* and *Brazil*. In *Mexico, Guatemala, Costa Rica* and *Peru* local currencies are still seen as overvalued in relation to the major world currencies.

In addition to the general assessment, WES experts again were asked about the likely trend of the US dollar exchange rate in the next six months. On average for all 90 countries, the US dollar is expected to remain unchanged. Views differ strongly, however. In Western Europe as well as in *Canada* and *Australia* the US dollar is expected to devalue further, whereas in the majority of *CIS* countries, *Russia* included, the US dollar is expected to gain strength. The same holds true for most countries in Latin America, the Near East and Africa.

Inflation: Expected to remain at the same level

World-wide consumer price inflation in 2003 is expected to average 3.2%, identical to last year's inflation rate. In Western Europe as a whole and specifically in the euro area, the January survey sees the 2003 inflation rate remaining at last year's level of 2.2%. However, inflation differentials are still quite large across European countries – about half of the countries within the euro area (namely *Austria, Belgium, Finland, France, Luxembourg* and *Germany*) are expected to meet or fall below the 2% mark, whereas the remaining countries *(Greece, Ireland, Italy, the Netherlands, Portugal* and *Spain)* will again exceed the ECB's target. With some exceptions, the higher inflation rate in the second group of countries is largely due to stronger productivity growth in the process of catching up to the productivity levels of the industrialized countries in the first group. As this process of relative price adjustment will go on for some time, the present ECB inflation target of below 2% appears to be too stringent. As pointed out by the latest report of the European Economic Advisory Group at CESifo, it would be preferable to raise the medium-term average inflation target to 2.5%.[1]

The 2003 inflation expectations for the *United States*, at 2.2%, are again within the range regarded as normal by the US Fed (around 2.5%), which puts equal weight on price stability and economic growth.

Asia continues to show by far the highest degree of price stability, though this year's expected inflation rate is moving up a bit (1.5% compared to 1.1% in October 2002). Deflationary trends still prevail in *Japan* (– 0.6% in 2003 compared with – 0.8% in 2002) and *Hong Kong* (– 0.7% in 2003 compared with – 2.1% in 2002). In *China* and *Taiwan*, inflation is expected to pick up marginally (from 0.7 in 2002 to

[1] European Economic Advisory Group at CESifo (EEAG), Report on the European Economy 2003, published by the Ifo Institute for Economic Research, 2003, p. 4.

presumably 1.1% in 2003), though there is still some danger of getting into a deflationary spiral.

The inflation outlook for Central and Eastern Europe has decreased from 5.3% in 2002 to 4.7% in 2003. The only countries in this bloc still having very high inflation rates are *Yugoslavia* (9.3% expected this year compared with 17.3% last year) and *Romania* (14.3% compared with 21.2% last year).

Inflation rates are also expected to decline further in Central and South America (from 12.5% in 2002 to 9.6% in 2003), although some countries are moving against this trend and expect rates to rise. The greatest changes have been recorded in *Venezuela* (from 34.5% in 2002 to 45.0% in 2003); whereas in other countries the expected acceleration of inflation is more modest: in *Brazil* (from 8.6% in 2002 to 10.1% in 2003), in *Paraguay* (from 15.0% to 17.0% in 2003) and in *Uruguay* (from 26.6% to 29.7% in 2003). Some success in fighting inflation is reported from *Argentina*, where the inflation rate of 62.3% in 2002 is expected to slow to about 26% in 2003.

Special question: How big is the threat of worldwide deflation?

The special question asked this time focused on the "D" word, the threat of deflation, meaning sustained decreases in prices across the entire economy. The question was split into two parts: The first part dealt with the threat of global, i.e. worldwide recession. The second part focused on the specific country or region the WES expert is reporting from.

An obvious example of country-specific deflation is *Japan* in the 1990s when the economy moved into a phase of sustained deflation which was caused by the collapse of the stock market and the burst of the real-estate bubble at the end of the 1980s. It was aggravated by the lack of appropriate monetary and fiscal policies and by the postponement of necessary structural reforms.[2]

Is the *Japanese* case of deflation only an isolated "accident" or do we also have to face problems of this type in other regions or even worldwide? This was the reason for asking the "D" question in this survey.

About one quarter of approximately 1,100 WES experts in 90 countries assess the threat of a local deflation in their particular region as very realistic. Amongst them, 14% report that deflation is already a problem in the country they cover and another 11% see a strong possibility of the outbreak of deflation. The worldwide average is strongly influenced by the answers from Asia, where about half of the respondents assess deflation as an imminent threat. In other parts of the world, the share of respondents fearing deflation in their region lies between 3% and 22%, with the CIS and Africa marking the lower end and the Near East the upper end of this range. In Western Europe this percentage is only 13% and thus lower than in North America (20%) and the world average (25%). Within Western Europe the share is particularly high in *Germany* (about 30%). The share in the Near East (22%) is mainly influenced by responses from Israel. On the other hand, as the economies in Latin America and Africa are more frequently struggling with high inflation, the risk of deflation is not seen as very great (8% and 9% respectively).

Economic experience shows that the behaviour of entrepreneurs and consumers is not only influenced by the assessment of risks in their own countries and regions but increasingly also by the assessment of global risks. And here deflation appears to be a major threat to the global economy, with 45% of all WES experts surveyed worldwide thinking that global deflation is possible, though only 5% speak of a "strong" possibility. A breakdown by region shows that WES experts in Asia (68%) and the Near East (67%) are much more worried about the spread of deflation worldwide than the others. Particularly in Asia, this can be explained by deflationary experience in the region; in the Near East the pronounced economic problems in *Israel* and *Turkey* obviously have influenced the rather pessimistic view of likely developments in the world economy.

Which conclusions may be drawn from this? The widespread fear of deflation at the global level but also the more isolated problems in specific countries or regions should be taken seriously by economic policymakers. Self-fulfilling prophecies can become a problem. The Fed study on what went

[2] See e.g., Alan Ahearne et al.,"Preventing Deflation: Lessons from Japan's Experience in the 1990s", International Finance Discussion Papers, Number 729, June 2002, Board of Governors of the Federal Reserve System, USA.

wrong in *Japan* gives advice on how the spread of the Japanese disease may be avoided.

The Japanese case shows that deflation can be very difficult to predict. For that reason monetary policy must provide sufficient insurance against downside risks through a precautionary easing of monetary policy. The costs of excessive monetary easing appear to be relatively low compared to the costs of entering into deflation. Should monetary policy prove to have been overly expansionary, a correction will cause much fewer problems than the move from excessive restriction to more expansion should a deflationary process already have started. In an advanced stage of deflation, consumers and entrepreneurs come to expect price declines and thus will postpone purchases in order to benefit from the expected price reduction. On a global level, widespread postponement of purchases aggravates the weakness of the economy and the increase of unemployment. The result would be a deflationary spiral. Fortunately we are far from this point. As the recent WES results have shown, relatively few experts assess deflation as a strong possibility for a specific country, with the exception of Asia and Japan in particular. However, in the assessment of the worldwide risk of deflation on a more general level, the respective share of experts is significantly larger. In order to avoid self-fulfilling expectations, monetary policy is well advised to display an easing bias. Only after the Iraq crisis will have been resolved, after investor and consumer confidence will have strengthened and world economic growth will have gathered more steam should central banks cautiously absorb any excess liquidity.