World Economic Outlook

As outlined in Statement 2 of the 1997-98 Budget, the world economy overall is expected to experience continuing strong economic growth and low inflation in the year ahead. This outlook depends on three key assessments.

- *The current low inflation environment will be sustained. Inflation has been reduced across most regions and is expected to remain low, including in the United States. However, if inflation in the US increases significantly, higher interest rates could adversely affect the outlook for world economic growth.*
- *Export growth in East Asia will pick up after last year's slowdown, despite underlying economic problems. If these problems are not addressed, economic prospects in the region could be adversely affected.*
- *Medium-term fiscal consolidation will continue in most of the industrialised world.*

This article briefly reviews the outlook for countries and regions of key importance to Australia in the light of developments since the Budget and considers the likely impact on the global economic outlook of the three issues listed above.

OUTLOOK FOR WORLD ECONOMIC GROWTH

The outlook for the international economy remains consistent with that outlined in the May Budget; economic growth rates in the major industrialised economies are expected to converge to between 2 and 3 per cent in 1997-98, while economic growth is expected to remain robust in East Asia.

The **United States** has entered its seventh year of sustained economic growth. Unemployment has fallen to around 5 per cent (its lowest level for 23 years) while inflation remains subdued. Economic growth surged in the last quarter of 1996 and the first quarter of 1997. However, since then activity appears to have moderated and economic growth is expected to return to broadly sustainable levels in 1997-98 (around 3 per cent); inflation is not expected to pick up significantly over this period.

The underlying strength of the **Japanese** economy remains difficult to gauge. In the first quarter of 1997 growth was very strong, but this was in part the result of spending being brought forward in anticipation of the 1 April rise in consumption tax. Economic growth is likely to moderate considerably in the second quarter of 1997, as the bring-forward of consumption is reversed. Despite continued fiscal consolidation and the recent appreciation of the Yen, growth is still expected to continue at a moderate rate of 2 to 2½ per cent per annum in 1997-98, with the private sector replacing public expenditure as the main source of growth. While there will be a small one-off increase in the price level associated with the increase in the rate of consumption tax, no sustained inflation pressures are evident.

Economic growth in **Continental Western Europe** is expected to improve to between 2 and 2½ per cent in 1997-98, but remain patchy. Significant spare capacity remains across Europe, with few signs of inflation pressures. It is difficult, however, to predict what effect the recent French election will have on momentum towards the achievement of the Maastricht fiscal targets, and more generally towards a single European currency. The risks surrounding forecasts for Continental Western Europe have increased since the Budget.

Growth in the **East Asian**[1] economies is expected to pick up slightly to around 7 per cent in 1997-98, with North East Asia[2] contributing most to the region's higher growth. Although growth is likely to be lower than in recent years, it will remain high by OECD standards. Some economies have been affected by weak export demand over the past year but overall export growth is expected to improve by the end of 1997. Inflation pressures are likely to remain relatively moderate, but could be affected by the recent currency depreciations in a number of countries.

LOWER INFLATION — WILL IT CONTINUE?

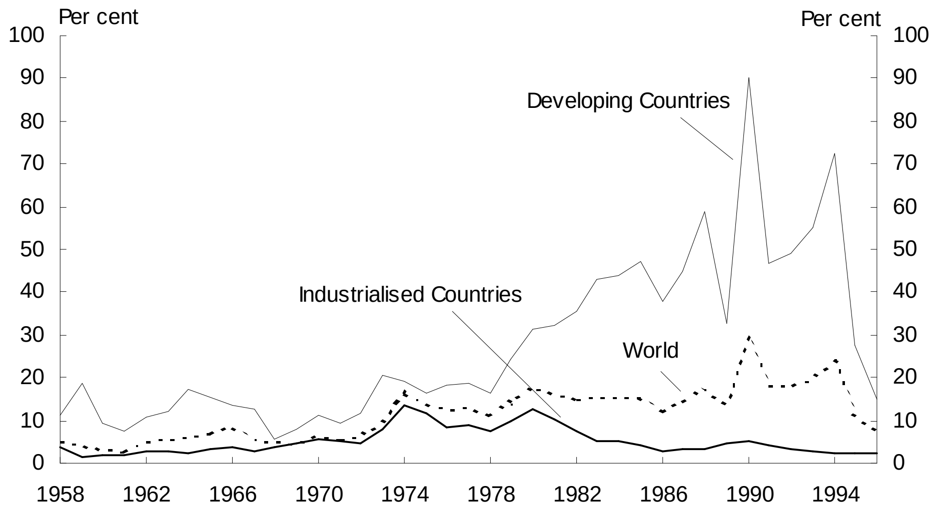
One of the most notable international economic developments of the 1990s has been the general fall in inflation experienced across the world economy. This decline has been evident both across regions and among countries at different stages of development. While it has been most apparent in developing countries, where inflation had risen to very high levels, the industrialised countries have also been successful in reducing their average inflation rate; from the double digits experienced in the mid-1970s, back to the low single digit levels experienced in the 1950s and 1960s (see Chart 1).

---

1 In this article, East Asia is taken as comprising Indonesia, Malaysia, the Philippines, Singapore, Thailand, South Korea, Hong Kong, Taiwan and China.

2 In this article, North East Asia is taken as comprising South Korea, Hong Kong, Taiwan and China.

Chart 1 : Inflation[3] (annual percentage change)



Source: IMF

The general reduction in inflation over the 1990s is a significant achievement because inflation can impose significant economic and social costs. By clouding relative price signals and generating uncertainty, inflation distorts investment decisions and the allocation of resources and adversely affects economic efficiency and growth. Moreover, inflation can also have significant effects on the distribution of income and wealth.

Several factors have been associated with the general lowering in inflation in the 1990s. One has been the ongoing internationalisation of the world economy.

- Increased openness to trade through reductions in protection has helped restrain inflation. Cheaper imports have directly reduced inflation, and greater openness has increased the incentives for domestic firms to set the prices of their products competitively.
- In addition, the introduction of improved production techniques, partly through foreign investment, has led to increased productivity and lower output prices, particularly in developing countries.

The second factor has been the adoption of sustained anti-inflation policies, as governments and central banks have learnt from the experience of the high inflation decades of the 1970s and 1980s.

---

3 Developing countries refers to non-oil producing developing countries as defined by the IMF.

- Foremost among these lessons is the importance of stopping inflation before it gains momentum. The global experience of the past thirty years has been that the short-run costs in terms of unemployment and lost output of pre-emptive actions to arrest incipient rises in inflation are likely to be far smaller than the long-run costs of allowing inflation to rise to high levels.
- Expectations of future inflation are important determinants of current inflation — thus, establishing credibility in the fight against inflation is crucial. Central banks that firmly establish and maintain an anti-inflation reputation will likely garner a 'credibility bonus', which will enhance the effectiveness of monetary policy in maintaining low inflation.
- In view of their dependence on trade and the detrimental impact relatively high inflation can have on export competitiveness, the East Asian economies have been aware of the need to contain inflation.
- Structural policies can also help to restrain price pressures. For example, policies that increase labour market flexibility or domestic product market competition can have a similar impact on prices as trade liberalisation.

Global inflation appears unlikely to increase significantly in 1997-98, because:

- policy makers generally are committed to maintaining low inflation, and have learnt from the lessons of the high inflation 1970s and 1980s;
- increased global competition across all regions will continue to restrain excessive wage and price increases; and
- relatively large output gaps remain in many countries, particularly those of Continental Europe, Canada and Japan.

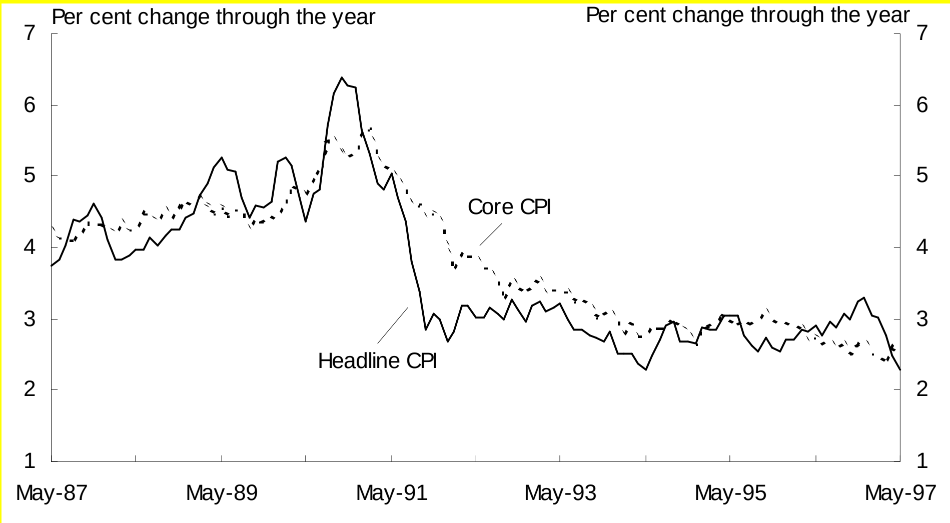
The main risk to inflation is in the United States, where the economic upswing is mature, and where little spare capacity exists. As discussed in Box 1, several factors have helped restrain inflation in the US over recent years and some are expected to continue during 1997-98. Economic growth is expected to moderate to more sustainable levels through 1997 and the Federal Reserve Board appears ready to apply pre-emptive monetary policy if there are indications of a pick up in inflation pressures. Nevertheless, past experience has shown that a failure to halt emerging inflation pressures can quickly result in an increase in inflation expectations, which in turn can require a sustained period of tighter monetary policy to correct.

If inflation in the US were to pick up significantly in 1997-98, higher long-term and short-term interest rates would result, lowering the outlook for activity in the US and in the world economy more broadly. In particular, this would have adverse consequences for the recovery currently underway in Japan and the pick up in growth expected in Continental Western Europe, as lower growth in the US would reduce demand for imports and world-wide long-term interest rates would rise in response to expectations of higher inflation in the US. In addition, higher interest rates in the United States could reduce the flow of capital to some developing countries.

Box 1: The US Inflation Experience over the 1990s

Over the past 18 months, the US economy has been operating at levels that many have considered to be above its output potential. During this period, growth has accelerated, employment growth has remained strong and the unemployment rate has fallen to a 23 year low, around 5 per cent. At the same time, core inflation has trended down (see Chart B1) and there have been no unambiguous signs of a strong upturn in labour costs.

Chart B1: US Inflation



Over the 1990s, several factors have helped restrain inflation, including:

- the consistency of the (moderate) rate of economic growth since 1991 — as the United States economy has generally grown at rates broadly consistent with its growth potential, marginal resources (particularly unemployed labour) have been engaged more smoothly and with less impact on prices than would have been the case if economic growth had been more volatile;
- reduced job security — major restructuring of work arrangements in the 1980s and early 1990s appears to have contributed, amongst other factors, to labour attaching lower priority to wage increases relative to job security;

Box 1: continued

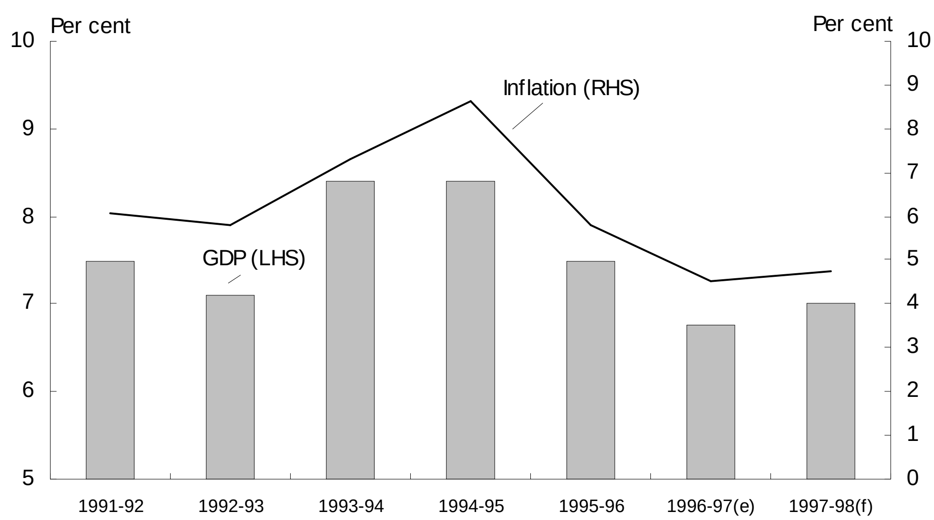
- lower growth in health care costs — as health care costs are a significant part of overall wages and benefits paid to workers, the reduction in their rate of growth, evident since the late 1980s, has helped restrain growth in employment costs;
- the increased competition in US product markets due to increasing import penetration and contestability of markets; and
- falling import prices due to the appreciation of the US dollar and benign energy prices resulting from weak demand in other industrialised economies.

With growth expected to return to moderate levels through the remainder of 1997 and 1998, there does not seem to be strong evidence to suggest that US inflation will pick up over this period. Nevertheless, with the economy operating at around capacity, the risks are predominantly on the upside.

EAST ASIA: STRONGER EXPORT GROWTH, BUT FINANCIAL MARKET INSTABILITY HIGHLIGHTS RISKS

The East Asian economies averaged nearly 8 per cent annual growth in the four years to 1994-95 (see Chart 2) fuelled, in part, by strong growth in exports. Since then growth has moderated and is expected to average around 7 per cent in 1997-98. While policy makers in some countries took restraining action to help counter inflation and rising current account deficits, a marked slowing in export growth was also a key factor in the region's lower rate of growth (see Box 2).

Chart 2: East Asia, GDP Growth and Inflation (through-the-year, percentage change)



e = estimate and f = forecast

By the end of 1997, most economies in East Asia are expected to experience a general pick up in economic growth, underpinned by stronger exports, as a result of stronger demand from industrialised economies, including improved semiconductor sales. The recent depreciation of several East Asian currencies will help to improve export competitiveness and should lead to stronger exports provided the boost to competitiveness is not lost through higher ongoing inflation.

The weakness in exports and economic growth in 1995-96 and 1996-97 revealed economic problems in some economies which had previously been masked by high growth rates, strong investment and high corporate profitability. While activity in the region is expected to pick up in 1997-98, these problems, which are outlined below, suggest that there are significant downside risks surrounding the forecast improvement.

First, the need for reform of the financial sector and for appropriate prudential and regulatory arrangements in many of the countries has been highlighted. The slowdown in economic growth and falling asset prices has increased the number of non-performing loans in some economies. Underpinning the forecast pick up in exports and GDP growth in 1997-98 is the expectation that this issue will be resolved in the period ahead, including through the use of supportive policies. To the extent that this does not happen, the capacity of affected financial institutions to lend for new investment would be impaired, adversely affecting the outlook for economic activity.

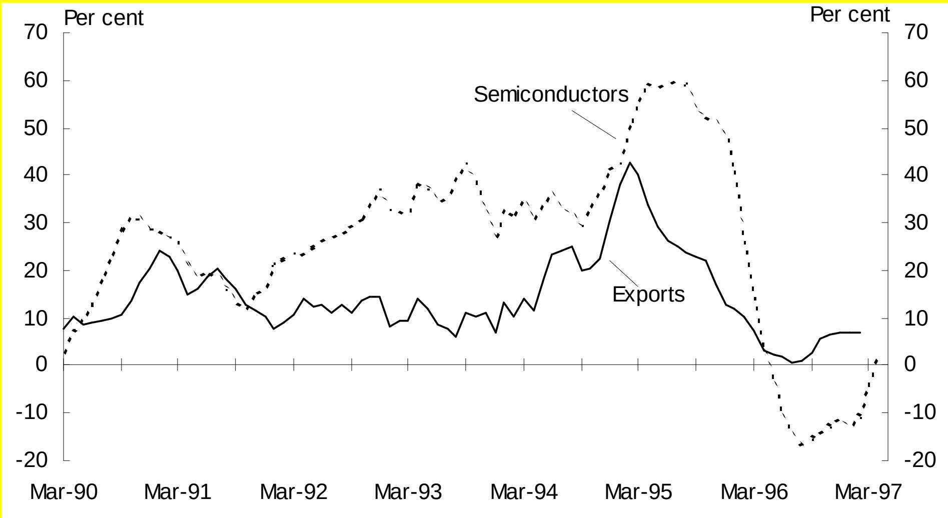
Secondly, the weakness in exports and economic growth has focussed attention on the need for sound macroeconomic policies and the difficulties associated with setting macroeconomic policies in the face of capital flow surges. Several countries have recently increased interest rates significantly in an attempt to support their external position. If maintained, these higher rates could weaken their growth outlook. Action to tackle underlying problems, including in respect of financial sectors, would help to allow lower interest rates. There are reasonable prospects that this will occur.

In particular, recent developments have shown the difficulties that can be encountered in trying to maintain a fixed nominal exchange rate that is not supported by economic fundamentals. Recent decisions by some countries in East Asia to allow greater exchange rate flexibility are, overall, positive developments that are likely to help underpin a pick up in export growth. However, simply allowing greater exchange rate flexibility is rarely a panacea and the forecasts are based on the expectation that introducing greater exchange rate flexibility will not be used as a replacement for addressing fundamental economic policy problems. Greater exchange rate flexibility can help policymakers to address those fundamental issues by removing the sense of crisis that can surround a fixed exchange rate when it is under pressure.

Box 2: Developments in East Asian Exports

After recording strong export-led growth during the first half of the 1990s, economic growth in East Asia slowed in 1995-96 and 1996-97. This was, in part, the result of a region-wide easing in nominal export growth[4] (see Chart B2). While the decline in nominal export growth was widespread, the depth and length of the slowdown varied across the region.

Chart B2 : Growth in East Asian Export Earnings and in the Value of Semiconductor Sales (through-the-year, 3 month moving average)



Source: Datastream

The region-wide decline in nominal export growth reflected a number of factors, including:

- a loss of price competitiveness by the East Asian economies, following real appreciation of exchange rates and greater competition from cheaper producers of the East Asian economies' traditional exports such as textiles and food products;
- slower growth in global demand and a fall in Asian import penetration to the US;
- significant intra-regional trade links, with Hong Kong and Taiwan being particularly affected by China's slowing during early 1996; and

4 Nominal exports rather than real exports are used because region-wide data on export volumes are unavailable.

Box 2: continued

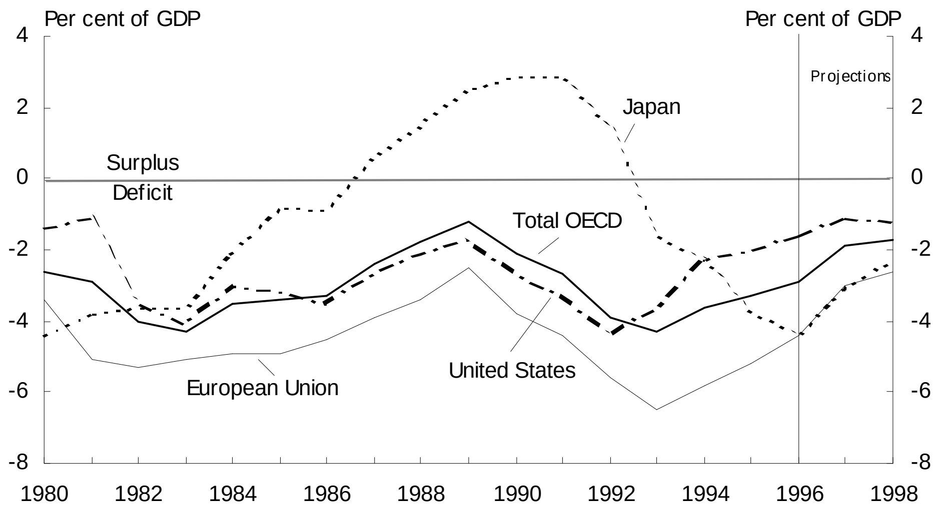
- a global oversupply in some goods, notably semiconductors. Singapore and South Korea's large semiconductor industries, in particular, were adversely affected in 1996 when unexpected weaker demand and over production resulted in DRAM (Dynamic Random Access Memory) chip prices falling by over 80 per cent. Semiconductor producers responded to the price reductions by reducing production. As a result, the value of East Asian semiconductor sales contracted for much of 1996 and through the first two months of 1997. It is expected that a run down in inventories, combined with the transition to new computer products, should help the recovery in the East Asian semiconductor industry during the year ahead.

So far in 1997 most East Asian economies have recorded some recovery in export growth, albeit to varying degrees. China and the Philippines have recorded strong export growth, while in economies which rely significantly on the electronics sector — such as Singapore and South Korea — the pick up has been slower.

FISCAL POLICY

Along with the general decline in inflation over recent years, there has been a major shift toward fiscal consolidation in most OECD countries. Nearly all OECD countries are undertaking consolidation and many have made significant progress. Fiscal positions deteriorated in most industrialised economies in the early 1990s, unwinding the substantial reduction in fiscal deficits achieved over the period 1983 to 1989 (see Chart 3).

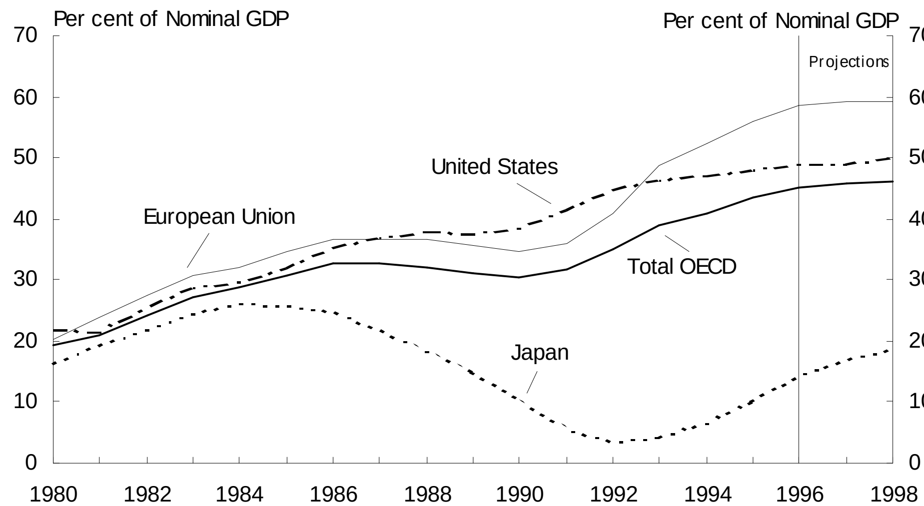
Chart 3: General Government Financial Balances



Source: *OECD Economic Outlook*, June 1997.

Since the early 1990s, fiscal positions across the OECD have generally improved, largely reflecting specific fiscal consolidation measures. The latest OECD Economic Outlook projects a continued improvement in the fiscal positions of most member countries in 1997 and 1998, which, as can been seen in Chart 4, is expected to result in general government net financial liabilities for the OECD region broadly stabilising relative to GDP.

Chart 4: General Government Net Financial Liabilities



Source: *OECD Economic Outlook*, June 1997.

Fiscal Policy Outlook

In view of the risks associated with debt accumulation and the growing pressure that most industrialised countries will face from their ageing populations, there is now widespread commitment across the OECD area to take further action to improve fiscal positions over the medium term.

Many countries have established plans to implement substantial fiscal consolidation programs over the coming years.

- Within Europe, many countries have announced plans for further fiscal consolidation to underpin their participation in the European Monetary Union (EMU).
- Japan introduced significant fiscal stimulus in the early to mid 1990s to assist recovery from recession. In 1996, the Japanese Government announced that this stimulus would be wound back, and that the combined deficit of the central and local governments would be more than halved as a proportion of GDP by early next century.
- The US has outlined a medium-term objective of balancing the Unified Federal Budget by 2002. In order to achieve this, considerable focus will need to be brought on welfare entitlement programmes.

Over the medium term, implementation of the announced fiscal consolidation plans will help to raise sustainable rates of economic growth and living standards.

In the short term, the impact on economic growth of fiscal consolidation is less clear. In some countries where economic growth has been relatively weak, such as Japan and many countries in Europe, some have argued that the degree of fiscal consolidation being undertaken may adversely affect their growth prospects.

However, international experience[5] suggests that fiscal consolidation can have positive effects on economic growth. This is because the direct impact on activity from lower government expenditure may be offset by higher private expenditure generated by lower interest rates, possibly reflecting lower risk premia and less demand for funds from the public sector. In addition, transfers of functions from the public to the private sector should not reduce total activity and may increase demand by increasing efficiency and reducing prices. On the other hand, the benefits of consolidation may be smaller in economies with other structural rigidities which impede growth of the private sector.

In that context, the benefits of fiscal consolidation in Europe may be reduced to the extent that consolidation is not accompanied by structural reform and to the extent that consolidation reflects revenue rather than expenditure measures.

---

5 *World Economic Outlook*, May 1996 and *OECD Economic Outlook*, June 1996.