PROSPECTS FOR THE WORLD ECONOMY : RECOVERY AND FRAGILITIES

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Recently, at an international meeting, Central Bank officials were more optimistic than representatives of the private sector. This is perhaps because, at a time when economic cycles bottom out, some manifestations of the past shock are still apparent (rising unemployment, balance sheet problems, bankrupties, falling profits….). The private sector is obviously particularly sensitive to those manifestations.

But one could also ask whether those differences of views might be the reflection of a fundamentally more pessimistic diagnosis of the economic situation as observed from the standpoint of private institutions.

Let us try to answer this question under two headings :

1. the economic recovery is stronger, and could be more ensured than most observers thought at the end of 2001 ;
2. remaining imbalances are nonetheless a source of vulnerability which could alter the picture.

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I. The economic upswing is stronger and perhaps more durable than had been foreseen after the September events :

1. The United States economy, after a relatively short slowing down, is rebounding :

The US "recession" has been most unusual :

- Negative growth has been limited to one quarter (the 3d of 2001). One could thus argue that there has been no "recession", in the technical sense of the word ;

- The upswing observed in the fourth quarter of 2001 is particularly vigorous (1,4 % annualized growth of GDP) which is all the more remarkable that the running down of inventories has been massive (its contribution to growth has been - 2.5 % during that quarter) ;

- This is because consumption has been a strong pillar of the US economy all along the cycle. The US household has steadily confirmed its appetite for credit in 2001. This can be explained by high levels of income and low interest rates ;

- Two factors usually present in past recessions in the United States : i.e. lower incomes and falling real estate prices, have been absent in the recent slowing down phase of the US economy.

Prospects for the US economy in 2002/2003 are seen as favorable by many observers. Their view is based, in particular, on :

- continued weak inflation ;
- the inevitable increase in production in the aftermath of a very strong inventory correction;
- the resilience of productivity gains (5 % annualized in the 4th quarter) which reflects expectations of increased profits ;
- the belief in a moderate monetary policy ;
- an active budgetary policy that will support the economy.

On the whole, those observers are forecasting a GDP growth (year on year) in the United States of :
+ 1,7 % in 2002
+ 3,5 % in 2003.

2. <u>Europe would follow with some lag and somewhat less strength :</u>

The Euro zone has done slightly better than the United States in terms of economic growth in 2001 (+ 1.5 % growth against 1.2 % in the US).

In spite of the negative growth observed in the Euro zone in the 4th quarter (- 0,2 % annualized) and the weakness of investment for the last five quarters, there are encouraging signs :

- market sentiment reviews are now positive,
- the absence of major imbalances should favor a steady recovery.

All in all, most observers forecast a GDP growth (year on year) for the Euro zone of :
+ 0,9 % in 2002
+ 2,8 % in 2003

3. <u>The prospects for Japanese economy remain dim :</u>

One of the basic problems of Japan, i.e. the cleaning up of financial institutions' balance sheets, has yet to be really tackled. The amount of non performing loans is of the order of 10 % of GDP. Given the very significant unfinished structural reforms and the particularly weak productivity rates of the economy, it is difficult to imagine for 2002 a better performance than - 0,5 %. For 2003, much will depend on confidence, politics and policies.

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II. <u>But significant vulnerabilities could alter that picture :</u>

Four sources of weakness can be analyzed :

1. <u>Higher oil prices :</u>

There has been a recent tendency towards higher oil prices. They are now at 26 dollars per barrel. The situation in the Middle East is tense. A further deterioration of the political climate could significantly change inflation and growth prospects.

2. Financial imbalances in the United States :

- The existence of a highly indebted corporate sector at a time when overcapacity is significant (the rate of capacity utilization is historically low) could lead to a lengthier adjustment ; in particular the overcapacity of the communication bubble could take more time to reduce. This could delay the upswing in investment ;
- A slowdown in consumption could be triggered by households desire to reduce their indebtedness ;
- The return of the United States to "twin deficits" implies, lest the dollar were to depreciate, that the US expansion continues to be spontaneously financed by growing external inflows of capital. This is itself dependent on the performance of the US economy which could be affected by a "double dip" in the coming months.

3. Financial markets are still upbeat in spite of those vulnerabilities :

Financial markets have been, overall, good advanced indicators of past recoveries.

But, profit expectations -as they are, for example, reflected in the 12 months forward price earning ratios for the S&P 500- are higher than previous averages in similar phases of the economy (PER of more than 20 in the US against 15 in recent stages). This means that if the economy was not as continuously vigorous as foreseen by many, a stock exchange correction could not be discarded. But this time, the FED would have no margins to counteract.

4. Emerging market economies will be heavily dependent on external financing :

A modest recovery is foreseen for 2002, of 3,1 % instead of the 2,7 % in 2001 for the emerging economies. This will depend, however, on the strength of economic growth of the advanced countries, especially the United States.

If emerging economies are to grow at a rate of more than 3 %, this will contribute to the deterioration of their current account balances. Estimates indicate that the combined deficit of all emerging countries could reach 22 billion dollars in 2002 against a 17 billion dollar surplus in 2001. This implies a strong performance of foreign direct investment which is, by no means, assured. In this regard, the consequences on FDI of the situation in Argentina could be more severe than many observers seem to believe.

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In sum, the imbalances I have touched upon are not susceptible, by themselves, to stifle the world recovery ; but a strong cyclical upswing based on such imbalances -with lesser margins of maneuver- is always fragile.