

gas prices. Wellhead prices have increased over 60 percent this year. As a result, home heating costs in the Midwest, where gas is the fuel of choice, will be much higher this winter.

The economy appears to be at a crossroads. It is currently performing at a record pace. The outlook for the immediate future is reasonably good, but significant problems are building. Any significant changes in consumer saving behavior, in the value of the dollar, or in international energy markets could significantly alter the outlook in a negative way.

Endnotes

¹Output is measured by real gross domestic product. The inflation measure used is the GDP deflator. The data shown are averages of annualized quarterly rates of change for the four quarters of the year. The data for 2000 are for the first three quarters only.

²Job creation is the increase in total nonfarm payroll employment measured from fourth quarter to fourth quarter. The value for 2000 is third quarter to third quarter.

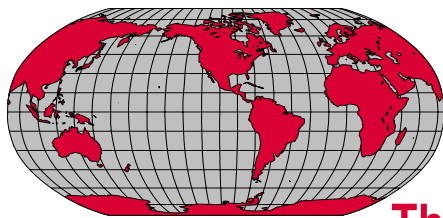
advanced and developing economies are contributing to this performance, with the former marching at 4.7 percent and the latter at 5.6 percent. Clearly, booms are becoming increasingly synchronized; and with this synchronization comes the fear that rising inflation may prompt monetary authorities to reduce money growth and raise short-term interest rates. To complicate matters, the world is suffering from an oil price shock similar in size to the one that took place at the end of the seventies. The convergence of business cycles and the oil price shock represent the most significant risk to this year's forecast.

Consensus Forecast

The International Monetary Fund projects that the world in 2001 will be growing at 4.2 percent, down a half percentage point from 2000 growth. The advanced economies are forecasted to grow at 3.2 percent—down one percentage point from 2000—and the developing countries at 5.7 percent—virtually unchanged from last year—. *The Economist's* poll of forecasts (see **Table 1**) suggests that the world has now many growth locomotives, in contrast to last year when the United States and the 11 countries that have formed the European Monetary Union (France, Germany, Italy, Spain, Portugal, Belgium, Luxembourg, Netherlands, Austria, Finland, and Ireland) were pulling the world train of economic growth.

The United States is still going strong. For 2001 the percentage increase in real GDP is projected to fall towards trend values. Stock market and consumption developments are signaling a landing of sorts. The Euro-11 continues its expansion phase, with virtually all of the eleven economies registering declines in unemployment. Good news at the moment is overshadowed by a weak euro, a subject of significant controversy. The depreciation of the euro relative to the dollar is boosting the competitiveness of euro-based export companies. On the other hand, a weak euro is threatening inflation via the import channel. In particular, a depreciating euro is magnifying the local effects of the higher dollar price of oil. Furthermore, the depreciating euro and the inflation threat has led the European Central Bank to keep its guard up and raise short-term interest rates, thus keeping the expansion in check.

Japan is doing better, but growth there is still anemic. Japanese policy makers have applied and continue to apply archetypal Keynesian pump-priming stimulus. Government debt as a proportion of GDP



The International Economy

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Economic growth around the world in 1999 rose above trend, as the effects of the 1997 Asian crisis were unwinding. The year 2000 looks even better. The International Monetary Fund forecasts world economic growth at 4.7 percent, one and half percentage point above 1999 growth. Both the

has now surpassed that of Italy, with the important difference that Italian debt is declining whereas Japanese debt is rising. With a current government budget deficit of 7 percent of GDP and a glut of government-financed investment projects, fiscal policy stimulus appears to have reached its limit. Monetary policy as well seems to have reached its limit in light of the fact that short-term interest rates are close to zero. There is no strong evidence that private consumption is ready to step in and replace government spending as the engine of growth.

The outlook for Asia is positive on the whole. China is doing very well. Accession to the World Trade Organization will force drastic restructuring at home. One big question is whether the political leaders are up to the challenge. India's performance is quite satisfactory. The South East economies, which were swept by the currency and banking crisis of 1997, have bounced back. Structural problems persist, however. Indonesia is the most vulnerable of the group. At the moment, high oil prices are hiding the weak spots in the economy. South Korea as well has failed to implement serious reforms and is at risk by high oil prices.

Performance in Latin America is more uneven than in Europe. Brazil, Chile and Mexico have the best prospects of the group. Argentina is struggling and the currency board prevents any depreciation of the domestic currency in the exchange markets. High oil prices are covering Venezuela's deep problems, most of all centered around a populist and popular president. Columbia is torn by civil war; the extremely risky environment is causing capital to leave the country. Peru is in the midst of a political transition that has raised the risk of doing business.

The Russian economy is finally growing: 3.2 percent in 1999, 6.2 percent in 2000 and 4.7 percent forecasted for 2001. High oil prices are certainly helping, but credit should be given to Putin's economic policies that are delivering declining inflation. The West and the Russians have yet to figure out whether Putin is a throw back to the past or a reformer.

The Risks

One risk in the forecast stems from a slowdown in the U.S. economy. The slowdown can either be "hard" or "soft." The hard version could be triggered by a spike in inflation sparked, among other things, by a further and sustained increase in oil prices. The Fed would be compelled to tighten the money stock and bring about a substantial rise in short-term interest rates. Stock prices would decline substantially, say 20 or more percent from present levels and net capital flows would change direction. The dollar would depreciate against both the euro and the yen. Exporters in Euro-11 and Japan would lose competitiveness, but imported inflation in those two areas would lessen. The European Central Bank could offset the impact of the decline in the foreign impulse by loosening monetary policy. The Bank of Japan could in principle do the same, but it would have much less room because short-term interest rates in Japan are already

Table 1
The Economist's Poll of International Economic Forecasts

	GDP		Consumer Prices		Current Account Balance	
	2001	2000	Percent of GDP		2001	2000
			2001	2000		
U.S.	+5.2	+3.5	+3.3	+2.9	-4.3	-4.2
Japan	+1.9	+2.1	-0.6	0.0	2.6	2.4
Euro 11	+3.5	+3.1	+2.2	+1.9	0.2	0.4
Canada	+4.8	+3.4	+2.6	+2.4	0.9	1.1
U.K.	+3.0	+2.7	+2.4	+2.5	-1.6	-1.8
China	8.0	7.6	n.a.	n.a.	1.6	1.1
India	6.4	6.4	n.a.	n.a.	-1.3	-1.3
Indonesia	4.1	4.2	n.a.	n.a.	5.8	4.5
Malaysia	8.4	5.6	n.a.	n.a.	11.6	7.7
South Korea	8.7	5.9	n.a.	n.a.	1.6	0.8
Argentina	1.5	2.9	n.a.	n.a.	-4.0	-4.2
Brazil	3.8	4.1	n.a.	n.a.	-3.9	-3.6
Mexico	6.6	4.4	n.a.	n.a.	-3.4	-3.9
Russia	6.2	4.7	n.a.	n.a.	17.8	11.1

Source: the *Economist*, 14 October 2000

close to zero. Latin American economies would feel the brunt of the U.S. slowdown and dollar depreciation through a flattening of their exports. Monetary and fiscal policies could come into play but initial conditions are not favorable for a big expansion. In sum, a hard landing of the United States would impact most negatively Japan and Latin America and less Euro-11. World growth would clearly take a dive. One small consolation would be the much-awaited appreciation of the euro against the dollar.

The chance of a soft landing depends on the Fed and the oil price shock. If the Fed were to believe that higher oil prices would not last beyond six months and actually oil prices were to follow the Fed's prediction, monetary policy would change course and expand. Short-term interest rates would fall to compensate the adverse effects on the economy of a declining stock market and higher oil prices. Net capital inflows would slow down and the dollar would depreciate, but much less so than in the hard landing scenario. Globally, a soft landing of the U.S. economy would be relatively benign.

As to oil prices, these are bound to remain high throughout the winter. The short-term supply of oil is very inelastic to prices; the demand is also very inelastic to prices. Consequently, if the demand for heating oil were to rise in response to a harsh winter, oil prices would be bound to rise before falling. Over the medium run, the supply of oil is responsive to oil prices. Oil producers will find it profitable to extract more oil from existing wells and bring to production new wells. Experts indicate that it takes approximately six months for the supply of oil to adjust to the higher oil prices. Until then oil supply will remain relatively rigid.

Another risk of the forecast arises from the possibility that the United States may not be able to borrow approximately \$400 billion a year to finance its current-account deficit. While this state of affairs cannot go on forever, it can last for quite a few years. There is no way to tell when foreign capital will turn sour on the United States. The day it will happen a hard budget constraint will be enforced on the U.S. current account, meaning that either exports will rise or imports will decline or there will be a combination of more exports and fewer imports. For exports to rise substantially, the dollar would have to depreciate significantly in the exchange markets with the obvious consequences on domestic price inflation. For imports to fall sharply, the U.S. would have to suffer a cut in income. This is what usually happens in countries that

have to correct a current account deficit: unpleasant but necessary consequences. The United States is fortunate to have the largest economy and the most widely used currency in the world.

In sum, the soft landing scenario may appear a good bet should oil prices stay high or rise for a limited number of months.

Financial Market Forecast for 2001

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It is time for us to take out the crystal ball once again. 2000 being a presidential election year we must repeat one salient truth: the 2001 forecast is not dependent upon who is in the White House.

There are three major factors in forecasting the financial markets: interest rates, earnings and the risk premiums. First, interest rates are lying on a yield curve that declines by 60 basis points in the first 15 months and is then essentially flat. This appears to indicate that the markets are looking for a slight decline in interest rates. But beneath this there is a major struggle between the forces of light and darkness.

The forces of light believe that the Fed is done tightening and the next move in interest rates, if any in the next few months, will be downward. While the forces of darkness see rising interest rates necessary to combat inflationary pressures due to the rise in the price of oil. By the way, there are two schools of thought regarding oil prices and interest rates. One is that the rising costs of crude diverts dollars out of the domestic economy and, although some may come back via the financial system, that this may actually reduce inflationary pressures in the general economy. The counter argument is the classic cost-push argument that high crude prices raise costs and