

Hamburg Institute of International Economics (HWWA) (Ed.)

Article — Digitized Version

The world business trend at the beginning of the year

Intereconomics

Suggested Citation: Hamburg Institute of International Economics (HWWA) (Ed.) (1979) : The world business trend at the beginning of the year, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 14, Iss. 1, pp. 44-48,
<https://doi.org/10.1007/BF02924506>

This Version is available at:

<https://hdl.handle.net/10419/139590>

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ECONOMIC TRENDS

The World Business Trend at the Beginning of the Year

Although the worldwide unemployment which was the dominant topic at the economic summit in Bonn in July 1978 was still causing as much concern as ever at the beginning of the new year, it can be noted as a positive fact that the moderately optimistic predictions about the cyclical trend in the world were in great measure substantiated in the past year. What will the new year bring?

The rise of real GNP in the individual industrialized countries matched — subject to slight deviations — the anticipated rates. The increase — by better than $3\frac{1}{2}\%$ — was approximately the same as in the preceding year. The deviations from the average were much narrower than in 1977; nowhere did the real GNP decline anymore in absolute terms. (See Table.)

It is not likely that the general output expansion lagged behind the growth of the production potential in 1978. To judge from inquiries among industrial firms, a little more use was made by most firms of the available plant capacities. When modest output increases caused heavier capacity loading — as in Western Europe — this was attributable to the relatively low investment activity in recent years when capacities were enlarged at a slower rate. This also explains why hardly a single country — apart from the USA — came any nearer to the desired substantial reduction of underemployment even though production capacities were used more fully. The disproportion between job creation and job requirements was made worse by the demographic trend which was marked almost everywhere by a noticeable increase in the numbers of the working population. The unemployment ratios do not really show this. In a few cases they are actually a little lower, and in a number of countries they did not go up any further. Some relief resulted from withdrawals of more working people into the "hidden reserve", assisted in several industrial countries by the re-migration of guest workers. Continuing official measures to ease the labour market situation helped at the same time in several West European countries to keep "overt" unemployment from rising at all or by more than a small margin.

Although the factors making for a cyclical upswing were dominant in the industrial countries

during 1978, the trend was anything but steady. On the contrary, the pace of expansion fluctuated a great deal. In several West European countries production rose quite sharply at the beginning of the year but slowed down soon afterwards. After the summer the uptrend was again more pronounced. In Japan the picture was similar. In the USA the expansion in the first half of 1978 was overshadowed by severe distortions due to the weather and strikes.

The unsteadiness of the cyclical upward trend in Western Europe and Japan was reflected by the investment activity in private industry which remained generally moderate. In Western Europe the real fixed asset investments were in the aggregate barely higher than in 1977. The investment activity was, generally speaking, still too restrained to start off a self-sustained upswing.

Slight Improvement in Profitability

It is true however that in many countries the conditions now favour greater investment propensity. Profitability has probably tended to improve. The shift in the terms of trade in favour of industrial products appears to have played an important role in this respect. The world market prices of industrial products showed in 1978 two-digit rises, in dollars, while the prices in the international raw material markets rose on average hardly at all. Declining interest rates, especially from mid-1977 to mid-1978, eased costs in most countries except the USA; in several countries however interest rates have hardened since. Most important of all, the rise of unit costs appears to have slowed further in 1978 in many fields as productivity improved once more somewhat more strongly and the updrift of wages slowed further in a number of countries.

In most industrial countries the mentioned influence left room for an improvement of profitability without causing prices to rise faster. On the contrary: more progress has been made almost everywhere outside the USA in restraining the inflation. In Japan, the Netherlands, Belgium and Austria the retail price inflation receded to the annual rate of the sixties, as had happened earlier already in Switzerland and the Federal Republic of Germany; almost all the other industrial countries have at least left the phase of two-digit price increases behind. In Western Europe as a whole the price inflation fell in the annual average by 3 percentage points to about 7.5%. In Japan it receded a little more, by 4%. In the USA on the other hand prices surged in 1978 so that the fight against inflation eventually became the priority concern of economic policy.

Stabilization Successes

There is undoubtedly a connection between the slowing of the uptrend in prices in most industrial countries since the middle of 1977 and the policy of narrowing the scope for the passing-on of price advances which preceded it. The slowdown, however impressive, was however in great measure fortuitous: it was most marked in the foods and drinks sector where it was greatly assisted by the retreat of the coffee and cocoa prices. For these and also various other products short-term

supply fluctuations played a more important role than the general price determinants.

The weakening of the price updrift has been of special importance because it evidently coincided with a subsidence of inflationary expectations. That mattered in regard to wages because it is generally the minimum aim in wage negotiations to maintain the real wage levels. In a number of countries wages therefore again rose more slowly – sometimes much more slowly. The hourly wages of industrial workers in Switzerland, Austria, the Netherlands, the Federal Republic of Germany and Japan were in the end only 3–6% higher than a year earlier. But there are still several countries in which wage rates are rising by 13 to 16% a year, namely France, Italy – where the rate of increase has however been almost halved in one year – and Great Britain. In Great Britain alone did the price uptrend accelerate appreciably after the ending of the incomes policy restraints; this happened despite a considerable slowing of the price inflation.

Some improvement in profitability and a slowdown of the updrift of wages and prices in Western Europe and Japan are essential for positive sales and profits expectations and increasing investment propensity. The basic conditions for a further cyclical recovery have improved greatly in this respect compared with the situation some

Index Figures of the World Business Trends *

	Real GNP compared with a year earlier in %				Consumer prices compared with a year earlier in %				Exchange Rates ¹ compared with a year earlier in %		Unemployment Ratios ² compared with a year earlier in %	
	1967 to 1976 ^a	1977	1978 ^b	1979 ^c	1967 to 1976 ^a	1977	1978 ^b	1979 ^c	Dec. 1977	Dec. 1978	1977	1978 ^d
USA	2,7	4,9	4,0	2,5	5,8	6,5	7,5	8,0	- 2,2	- 3,6	7,0	5,8
Canada	4,7	2,7	3,5	3,5	6,0	8,0	9,0	9,0	- 9,0	- 9,0	8,1	8,2
Japan	8,1	5,5	6,0	5,0	8,9	8,1	4,0	3,5	21,9	21,1	2,0	2,3
Western Europe ³	3,8	2,2	2,7	3,2	6,0	10,5	7,7	7,3	.	.	5,0	5,4
Belgium	4,1	1,2	2,0	3,0	6,4	7,1	4,5	4,0	2,7	3,3	6,6	7,0
F. R. of Germany	3,5	2,6	3,5	4,0	4,4	3,9	2,5	3,0	7,9	5,6	4,0	3,8
Denmark	3,4	1,8	1,5	2,5	8,1	11,1	9,5	7,0	- 4,0	5,1	7,7 ^e	8,7 ^e
Finland	4,5	0,4	2,5	3,0	9,2	12,6	7,5	7,0	- 9,3	- 5,2	6,1	7,4
France	4,7	3,0	3,0	3,0	7,3	9,4	9,5	9,0	0,1	2,0	4,8	5,4
Great Britain	2,2	1,8	3,0	2,5	10,0	15,9	8,5	9,5	9,8	0,2	5,2	5,2
Italy	4,1	1,7	2,0	3,5	8,5	18,4	12,0	12,0	- 5,5	- 5,0	7,1	7,5 ^f
Netherlands	4,7	2,4	2,0	3,0	7,0	6,4	4,0	4,5	1,2	4,2	4,9 ^e	5,0 ^e
Norway	4,7	4,1	3,0	2,0	7,2	9,2	8,5	7,0	- 1,8	- 4,8	1,5	2,3
Austria	4,5	3,5	1,5	3,0	5,8	5,5	3,5	3,0	4,1	2,1	1,8 ^e	2,1 ^e
Sweden	3,1	- 2,6	1,5	3,0	6,6	11,4	10,0	7,0	- 15,4	0,7	1,8	2,5
Switzerland	2,0	2,6	2,0	2,0	5,2	1,3	1,0	0,5	13,6	14,2	0,4	0,3 ^f
Spain	5,3	2,4	2,5	3,5	9,8	24,5	20,0	15,0	- 19,3	8,1	5,7	7,6 ^f
OECD-Countries total ³	4,0	3,8	3,7	3,2	6,3	8,4	7,5	7,5	.	.	5,1	5,0

* Decimal notations marked by commas.

^a Average annual change. ^b Estimate in round figures; stated by countries. ^c Advance estimate. ^d September or October, respectively; adjusted for seasonal variation. ^e Unemployment ratio in % of persons employed. ^f adjusted for seasonal variation. ¹ Weighted by foreign trade shares in 1974. ² In % of employed persons. ³ Weighted by GNP or private consumption or persons employed, respectively, 1976; sum of countries mentioned.

two years ago for instance, and as this holds good for most countries, it disposes of another obstacle in the way of a cyclical upswing: in the West European countries with their extensive external trade ramifications in particular the prospects for the success of stimulatory efforts were rather limited as long as the outlook in important partner countries was unpropitious.

Payments Balances Generally Better

The expectation of better things to come was buoyed by the balance of payments improvement in the countries which had been beset by problems. Great Britain's current account was for the second year running more or less in balance. France and Italy did even better — they recorded substantial current account surpluses; the Italian surplus was probably only relatively little smaller than that of the Federal Republic of Germany. However, the largest surplus on current account by far was again shown by Japan.

The combined current account of the Western industrial countries — which in 1977 still showed a deficit similar to that recorded in 1974, following the oil price explosion — was in approximate balance last year, not least because the terms of trade moved against the raw material countries. The international currency situation however remained troubled. The current account deficit of the US economy, by far the most important one in the world, widened still further, and by a wide margin, compared with 1977. Moreover, the dollar was under massive pressure last year because the domestic inflation was expected to accelerate. The central banks intervened in the foreign exchange markets several times on an extensive scale in support of the US currency but checked the fall only temporarily. Only when the US Administration was given some credence for its announced intention of giving priority to the check-

ing of the price updrift did the dollar recover slightly. In the meantime it has come under fresh pressure owing to the recent announcement of more oil price increases.

The decline of the dollar and the turbulence in its wake have tended to retard the investment propensity in the rest of the world as the US currency still holds the stage in the international monetary system both for business transactions and for intervention purposes. This was evident in the countries which "suffered" from exchange rate rises substantially in excess of their inflation differential from other countries — and thus from a real currency appreciation — so that their international competitiveness declined, but elsewhere too. The frailty of the dollar added to the general uncertainty about the viability of the international monetary system. This, it was feared in some quarters, would fuel the mounting protectionist tendencies in international trade.

Change of Course in the USA

While the pace of expansion in the world during 1978 was marked by a convergent trend in the industrial countries, new differences emerged between them in regard to their economic policies. In Western Europe and especially in Japan the domestic demand continued to be stimulated whereas the USA after long hesitation embarked on a restrictive course in order to counter inflation and the drop of the dollar rate. The monetary expansion was checked in the last few months, and the public announcements which have been made suggest that this policy is being continued. A start was made at the same time on the reorientation of the financial policy: the tax cuts foreshadowed long ago have been revised downwards, and it has been stated that the budget deficit will be reduced in the next fiscal year.

WELTKONJUNKTUR DIENST

Annual subscription rate
DM 60.—
ISSN 0342-6335

This quarterly report — compiled by the Department on Business Cycles and Statistics of the Hamburg Institute for International Economics — analyses and forecasts the economic development of the most important Western industrial nations and on the international raw material markets.

V E R L A G W E L T A R C H I V G M B H - H A M B U R G

As for the other industrial countries, Japan is pursuing a definitely stimulatory policy with the intention of compensating for the retardation of economic growth by the decline of exports which is however indispensable if the excessive current account surpluses are to be reduced. In Western Europe the Federal Republic of Germany is making especially energetic efforts to stimulate the demand. Other countries are generally practising more cautious policies of demand reinforcement but their monetary and financial policies are for the most part generating unmistakably expansionary impulses — even in a country like Italy where inflation is still very strong.

The divergences between the economic policies will be reflected by the cyclical trend in 1979. The USA, which has been the "expansion leader" for a number of years, will probably slip to the bottom of the international scale of cyclical progress. In question is only whether it will go down into a proper recession. A restrictive policy to combat inflation at the end of a long upswing would almost certainly lead to one in normal circumstances. There are two reasons why this will not necessarily happen this time: one is that the preceding upswing was unhurried and firms and consumers are therefore feeling little need for "corrective action"; the other reason is that the US Administration is evidently striving to avoid too abrupt a change of course in its economic policy which would upset the time schedule for the stabilization process. Bearing the strength of the inflationary forces in mind, it must nevertheless be assumed that the restrictions and the consequent damping of commercial and consumer expectations will have a definite brake effect on the expansion of real demand and production in the USA during 1979 and at times even bring it to a standstill. It is only because of the heavy "overhang" at the beginning of the year that the real national gross product may still be counted upon to increase by about 2½ % in the annual average. It is assumed here that a marked recession will be avoided, a condition the fulfilment of which depends on a solution of the conflicts which a restrictive policy entails in incomes distribution.

Uptrend to Continue in Japan and Western Europe

It follows that other economies cannot look forward to significant demand impulses from the USA in 1979. This applies to Japan in particular; over a quarter of its exports goes to North America. Japan already experienced a substantial export decline in 1978 in response to a sharp revaluation-induced rise of the world market prices of its products combined with protectionist obstructions including "voluntary" self-restraint arrangements,

but Japan's exports will probably increase slightly in 1979. Assisted by economic policy efforts, the country should therefore again be able to achieve a by and large satisfactory measure of economic growth. Substantial structural problems have however arisen in consequence of the very big yen appreciation; in the two years to end-1978 the yen rate has gone up by about 50 %.

The cyclical expansion in Western Europe will continue to be determined by internal stimulatory forces. The economic climate improved right through 1978 on a wide front despite the currency unrest which spread from the dollar and the marked worsening of the competitive position vis-à-vis the USA. The improvement of the conditions for growth as a result of unexpectedly great advances towards stability and mostly increased profitability will continue to make itself felt. This will make for greater efficiency of economic policy stimuli including the cyclical impulses from the Federal Republic of Germany on its partner countries. The differences between individual countries which in the past showed up chiefly in the lagging of the smaller economies are likely to prove less and less important. Most Western economies will have real GNP growth rates of 3–3½ %. This will in general make only a small impact on the high unemployment. More importantly, there is no sign yet of the economies passing over to a self-sustaining upswing which would be invigorated by company investments. The stabilization efforts in important countries have not yet gone far enough for this to happen.

Moderate Expansion of World Trade

The economic prospects of the industrial countries suggest a continuation of the expansion of international trade during the current year at a moderate and not greatly altered pace, held back by the developments in the USA even if a proper recession is avoided there. The developments in the West European economies will carry much more weight; they account for as much as half the world trade turnover and show signs of a faster rise of imports. In Japan the measures for the promotion of imports, the sharp appreciation of the yen over the last two years and the cyclical expansion of demand point to a significant increase of purchases from other countries.

The imports of the raw material countries on the other hand will probably advance more slowly than last year since their current account position has worsened a great deal, mainly because of the shift of the terms of trade to the detriment of primary materials. The notified crude oil price increases will neutralize the effect only in part for the OPEC countries but the balance of payments problems of the non-oil developing countries will

be aggravated further by these price increases. Their current account deficits may well be pushed up to the oil price explosion level of 1975. The retarding effect of this on their import policies will probably be slow in making itself felt because it still seems to be fairly easy to finance deficits by further borrowing. In view of the subdued cyclical trend in the industrial countries it seems rather unlikely that the terms of trade will change in favour of the developing countries during 1979 and help to improve their external economic position significantly. The industrialized countries would be greatly amiss, economically and politically, if they ignored this explosive problem through preoccupation with their own inflation and employment worries.

The balance of payments disequilibria between industrial countries seem to be abating, especially at the two flash-points — the exceptionally high current account surplus of Japan and the almost equally large deficit of the USA. More important in the short term — and this means at least for the current year — than the shifting exchange rates are the trend variations between different countries brought about by the running-out of the long upswing in the USA. If the USA stands by the declared aim of greater stability orientation, the dollar will tend to strengthen in the foreign exchange markets even though little progress may at first be made in curbing the excessive energy consumption which is an important structural cause of the US current account deficit. Signs of an improvement of the external situation of the US economy would strengthen rather than weaken the cyclical impulses in the rest of the world, despite the associated slowing of the US import trade, as it would remove a major cause of uncertainty, especially about the future of the liberal world trade and currency system.

To put more stress on the objective of stability, as the USA did last year, does not mean that the growth and employment targets are lowered, even if the restrictions will at first depress demand and production. The economic authorities in the USA had to recognize the fact that the quickening price surge had impaired the sustainability of the cyclical expansion and that an improvement of the medium-term growth chances was contingent on the curbing of inflationary expectations. The USA has thus taken to a rethinking process about possible boosts for an economy which has spread through many other industrial countries in recent years. Apart from its token effect, this change of mind in the predominant industrial country eases the situation for the countries which put stability first before the USA did so. These countries have had to choose between a significant real and therefore economically depressant appreciation of their currencies and countervailing intervention in the foreign exchange markets undermining their stabilization policies.

It should be easier for most countries, and the West European economies in particular, to overcome gradually the stabilization crisis which hit the industrialized countries in the seventies in as much as the prerequisites for it in the field of economic policy have obviously improved. This applies particularly to the West European economies. But success depends upon a crucial precondition: there must be no fresh acerbation of the struggles about incomes distribution. In view of their repercussions on demand, production and employment they still present a major element of uncertainty regarding the cyclical trend in 1979 and beyond.

Compiled by the Department on Business Cycles and Statistics of HWWA-Institut für Wirtschaftsforschung-Hamburg.

Index Numbers of World Market Prices of Foodstuffs and Industrial Raw Materials

Index and commodity group	1977	1978				1979	
	December	March	June	September	December	Jan. 1	Jan. 19
HWWA-Index * (1952–1956 = 100)	314.9	315.3	314.8	324.0	332.0	340.3	339.4
Fuels	265.3	256.3	249.3	248.3	246.2	248.4	245.9
Raw materials for consumer goods ..	338.8	343.7	346.4	360.6	373.4	384.6	384.6
Fuels	554.1	563.4	557.0	562.7	567.9	585.6	585.7
Raw materials for consumer goods ..	178.6	184.1	187.1	196.8	212.7	217.8	211.8
Raw materials for capital goods	231.1	231.2	242.8	268.5	286.9	295.7	299.5
Reuter's Index (18. 9. 1931 = 100)	1,443.5	1,400.2	1,503.2	1,481.2	1,507.7	1,495.8	1,499.6
Moody's Index (31. 12. 1931 = 100)	874.2	901.7	922.9	944.2	978.6	977.2	996.7

* Index compiled by HWWA-Institut für Wirtschaftsforschung-Hamburg. On Dollar-basis.