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A Gloomy Outlook for the World Economy

The worsening oil crisis cast ever darker shadows over the world economy as the past year ran its course, and impaired the economic uptrend in most industrialized countries. In many of them the strong advance of production which had commenced in Western Europe and Japan in the second half of 1978 was just beginning to show signs of a self-sustained upsurge; the expansion was being maintained even though the impulses from the side of economic policy were weakening. The cyclical upswing was tapering off in the leading country of the industrialized West but the forecast recession was still outstanding.

The Western industrialized countries have for several years now come up against "limits to growth". Their existence was confirmed once more in the brief phase of synchronous expansion which lasted until early 1979. One indicator of this was the substantial quickening of the price rise at the turn of the year after in a few countries the pace of the price increases had just fallen back to the rate of the sixties. Outstanding among them were Switzerland and the Federal Republic of Germany where at the end of 1978 the consumer prices were by barely 1 and 2½ % respectively ahead of those twelve months earlier. Notable progress towards stabilization had also been made in Japan, Austria, Belgium and the Netherlands; here prices had risen by 3½ - 4 %.

At the beginning of 1979, however the uptrend of prices gained fresh strength in most countries of Western Europe, and it continued here as well as in the USA at a fast pace although the nominal wages and unit wage costs mostly kept to a moderate course. Temporary weather conditions apart, the greater buoyancy of the prices was certainly in part cyclical: it is a typical feature of periods of increasing capacity utilization. That the plant capacities had been enlarged only slowly in the preceding years when investment activity had been low played an important role.

Strong external impulses helped to drive up prices in the industrialized countries. The prices of raw

materials, for the most part imported from developing countries, underwent an exceedingly rapid increase in the course of the world-wide cyclical upswing. The world market prices of industrial raw materials excl. fuels were, according to the HWWA index, at mid-1979 on a dollar basis one-third higher than a year earlier. A great deal more aggravating was the renewed turbulence in the international mineral oil market. The disturbances in Iran and the consequent output shortfalls touched off big price increases in the free oil markets. In the light of this evidence of scope for further price advances the oil exporting countries raised their official prices repeatedly. At the end of 1979 they were twice as high as twelve months earlier.

The monetary latitude for faster price rises had been created in the precedent phase of plentiful money supply. The monetary authorities in many countries reacted now however by a swift change of course and put a curb on the money expansion. By this policy it is intended to curtail the excessive liquidity created in the preceding years and also to set a signal: seeing that the – in some countries very marked – worsening of the terms of trade is greatly reducing the area of manoeuvre for internal distribution in the industrialized world, the quickening price advances must not be allowed to lead to corresponding wage increases.

The braking power of the stabilization policy will not be limited to the prices even if its effects show only after the usual delays. Demand and production were still expanding almost everywhere during 1979. The continued advance was however subject to wide fluctuations. In the first few months of the year productive operations in many industrialized countries had been hampered by the severe winter. The uptrend was then resumed but, although the pent-up demand had some effect, at a slower pace of expansion. Production losses due to strikes again distorted the trend in Western Europe on various occasions while in the USA the often predicted recession has not yet arrived: the temporary decline of demand and

production in the second quarter had evidently more to do with fuel market shortages.

In the existing external and economic policy conditions it may be regarded as certain that the slowing trend in the industrialized countries marks the onset of a downswing. The households are however tardy in responding to the new key data. Private consumption as a whole has until now increased at a higher rate than would have corresponded to the slower expansion of disposable real incomes, for in many countries the private households have tended to cut down first on their rate of saving. In the USA it has fallen to an extremely low level, probably because of strong inflationary expectations combined with – for a long time – negative real interest rates.

It is not yet possible to judge the loss of momentum due to the retarding influences of new business investments, which make a quite considerable impact on the dynamism of the economic process, during the second half of 1979. It is however to be assumed that less favourable sales and profits expectations have gained increasing influence on the investment propensity. Greater reserve was certainly also shown in inventory dispositions.

High Unemployment

The continuing high level of unemployment presents a special problem for the present stabilization policy, more particularly in many of the West European economies. Despite the cyclical improvement the number of unemployed declined significantly in the past year only in the Federal Republic of Germany. Slightly lower figures were recorded in Great Britain, Austria, Denmark and Finland. In almost all other countries they were virtually stagnant. In France they still went up appreciably. Although more jobs were in many instances provided, the situation in the labour market remained unsatisfactory because the population trends raised the number of people available for gainful employment.

Despite the drastic rises of import prices most industrialized countries did not yet encounter problems in their foreign trade last year. This applies also to France and Italy which had recorded extremely high deficits after the first oil price explosion of 1973/74. Great Britain which had also been one of the "problem countries" covered a large part of its requirements by its own crude oil but nevertheless showed once more an – albeit moderate – deficit. The USA reduced its current account deficits drastically while the Federal Republic of Germany and Japan which were surplus countries have been in deficit since the spring of 1979.

Any forecasts on the economic trend in the world must be based on assumptions in regard to future changes in the international oil market. During 1979 the projections had to be corrected continuously because the oil exporting countries' determination to exploit their market position had been underrated. For 1980 however more favourable conditions, from the importing countries' point of view, are indicated, at least under economic aspects. The combined effect of economizing efforts, a cyclical slowdown and reduced inventory accumulation may be a quantitative decline of the demand for mineral oils. After the abortive discussions about output cutbacks it is not very likely that the supply will be curtailed immediately to an appropriate extent. It therefore does not seem unrealistic to assume at this juncture that the price of crude oil will not go up any further in the near future. The hopes for an early easing of the tight conditions in the oil market can however easily be thwarted by, for instance, a severe winter in the industrialized countries or new crises in the Middle East.

The Load Imposed by Oil Prices

Since the export prices for crude oil have been redoubled in the course of one year, the industrialized countries must expect the cost of their crude imports which probably increased by nearly US \$ 50 bn in 1979 to rise further in 1980 by an estimated US \$ 90 bn. Their combined current account surplus of

National Product and Prices

(Percentage change compared with previous year)

	Real Gross National Product					Consumer Prices				
	1967/76 ^a	1977	1978	1979 ^b	1980 ^c	1967/76 ^a	1977	1978	1979 ^b	1980 ^c
Western Europe ¹	3.7	2.2	2.9	3.2	1.5	7.0	10.3	7.6	9.0	11.0
USA	2.8	5.3	4.4	2.0	-1.5	5.8	6.5	7.7	11.5	11.5
Japan	7.9	5.4	5.6	6.0	3.5	8.9	8.1	3.8	3.5	7.0
All industrialized countries ¹	4.0	3.9	3.9	3.0	0.5	6.7	8.3	7.2	9.3	10.5

^aAverage annual change. - ^bEstimate. - ^cForecast estimate. - ¹Weighted according to gross national product and private consumption in 1977.

S o u r c e : OECD, IMF, national records and HWWA estimates.

approximately US \$ 10 bn (for the OECD countries) in 1978 has turned into a rapidly increasing deficit. In 1979 it probably amounted to about US \$ 30 bn and in 1980 it is likely to be twice as high. The additional spending of the industrialized countries on oil imports and the deterioration of their current accounts are much larger in absolute terms than during the first oil crisis in the mid-seventies; in relation to the gross national product they are of the same dimensions. Nevertheless there are now better preconditions for the avoidance of a world-wide recession.

In 1974/75 economic activity fell off as sharply as it did largely because mistaken cyclical developments of a major order had created the conditions for a stabilization crisis in most industrialized countries before the oil price explosion occurred. This time the upswing proceeded without excessive plant and inventory investments. Owing to this fact and earlier recourse to a stabilization policy in most countries the oil price impulses did not run up against as strong an internal inflationary dynamism and profit compression as they had done in 1973/74. Besides the current accounts of the industrialized countries were in much better balance before the oil price rises of 1979 than five years earlier.

International Redistribution

The trigger effect of vaulting oil prices on other prices in the industrialized countries will not be confined to what follows from a strict cost calculation. For one thing, the prices of other energy materials are rising faster. For another, the higher oil prices are giving further impulses to the internal adjustments to the international redistribution of incomes in favour of the oil exporting countries. In the early phase the burden had fallen chiefly on the real incomes of the consumers. The characteristic feature of the present phase are intensive efforts in wage negotiations to roll back the burden to the corporate sector. Most of the evidence to date suggests however that the distribution disputes in the industrialized countries will not reach the intensity of the clashes after the first oil price explosion. The smaller the twist given to the price-wage-price spiral the less restrictive will be the effect of the stabilization efforts of economic policy on demand, production and employment, and the sooner will it be possible to relax the curbs and the monetary ones in particular.

For the time being the economic development in the industrialized countries will however inevitably be dominated by the damping influences ensuing from the vaulting oil prices and the stabilization efforts of the

economic authorities. The income redistribution in favour of the oil exporters involves considerable withdrawal effects on the demand in the industrialized countries, all the more so because after the latest big price increases for crude oil the beneficiary countries are finding it even more difficult to step up their demand for imported goods in the short term to match the escalation of their export earnings. The damping effect will at first be felt chiefly by private consumption but the expansion of investment activity, moderate though it has been for the most part, will also subside. At a time when it is becoming more difficult to get outside finance, deteriorating sales and profits expectations will carry more weight than the investment stimuli provided by the need for speedy structural changes to the altered energy situation. How much and how long the investment propensity will be damped depends – given a certain trend in the oil market – in great measure on the extent to which the distribution conflicts in the industrialized countries will deepen and the profit prospects worsen as a result of the contraction of the room for decisions on internal distribution.

The cyclical slowdown will at first be especially evident in the USA where the majority of indicators suggest that demand and production will fall away during the greater part of 1980. The potency of the mostly "home-made" inflation compels the US Administration to adhere for the time being to its restrictive economic policy although elections are due in the autumn. There is nevertheless still a chance that the recession will turn out to be mild since the earlier long upswing was not attended by excessive investment activity and corporate profits remained relatively satisfactory. In Japan and most of the West European economies the slowdown in 1980 will be less marked than in the USA. The decisive reason for this is the fact that the retarding influences of the oil price explosion were first felt in a cyclical phase when the internal stimulatory forces were about to burst into activity and the upsurge of prices and wages was not yet very dynamic. Nevertheless the expansion of demand and production will be reined in also in Western Europe and Japan. In a few countries it will probably come to more or less of a stop, at least for a while. The labour market situation will deteriorate again or further, as the case may be, in most of the industrialized countries.

Uncertain Prognosis

The crucial question in this situation is whether economic activity in the industrialized countries may be

expected to recover when the oil price-induced withdrawal effects abate or whether the cyclical slowdown will last longer in consequence of internal adjustment difficulties. We shall probably have to wait until later this year for a reasonably well-founded answer. Especially great uncertainties hamper an economic forecast covering the whole world at the present, not only because of external influences issuing from the international oil market but because the reaction of businessmen and trade unions to such a severe external shock as the doubling of oil prices within twelve months is equally incalculable.

The oil price hoist is hitting many non-oil producing developing countries even harder than the industrialized countries. Their current accounts have been showing huge deficits ever since the first oil price explosion and these are likely to increase so much that, as their credit-worthiness will tend to decline at the same time, growing difficulties will be met in financing them. Without substantially greater assistance by the OPEC countries there is little prospect of a solution which does not force the developing countries to cut down their imports.

The foreseeable slowdown in the industrialized countries and the balance of payments difficulties of the non-oil exporting developing countries will throttle back the world trade in 1980, and the expected steep rise of the import demand of the OPEC countries will offset these factors only in part. In these circumstances it is certainly not unduly pessimistic to expect the real expansion of world trade – by about 6 % in 1979 – to be halved. A prognosis of import dispositions and thus of the course of world trade involves in any case much greater uncertainties than a forecast of the total demand and production in the industrialized countries, the more so as mounting employment and balance of

payments problems accentuate the hazard of a further spreading of protectionist measures.

Consensus on Distribution the Key Problem

The chance of avoiding a world-wide recession such as occurred in 1974/75 depends in the main on the satisfaction of two conditions. The first of these is that the oil exporting countries will in the future act with some measure of rationality and for the sake of a tolerably steady development of the world economy show themselves willing to heed the limited adaptability of the oil importing countries to oil price increases in the short term. A precondition of their willingness to export more oil than needed to cover their foreign exchange requirements is an adequate assurance of opportunities for the investment of surpluses, and this means confidence in the continuing viability of the international payments system. This is in turn closely connected with the satisfaction of the second condition which is the successful solution without major frictions of the adjustment problems in the most important industrialized countries. An effective social consensus on the spreading of the unavoidable real income cutbacks is of cardinal importance in this context. The inflationary forces at work in the industrialized countries cannot be expected to weaken without such a consensus but would if anything quicken. Even a relaxed economic policy would in that case prove inadequate to avoid a severe economic setback. That substantial progress in curbing inflationary expectations is indispensable for a lasting improvement of the growth conditions in the world economy was already evident after the first oil crisis.

Compiled by the Department on World Business Trends of HWWA-Institut für Wirtschaftsforschung-Hamburg.

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

Index and commodity group	1978	1979				1980	
	YA ¹	YA ¹	June	September	December	Jan. 4	Jan. 18
HWWA-Index*(1952-1956=100) . . .	320.2	392.5	382.6	428.6	451.6	479.4	493.8
Fuels	250.6	276.5	279.9	295.9	310.8	300.3	311.0
Raw materials for consumer goods . .	353.8	448.1	432.2	492.6	519.4	565.8	582.0
Fuels	561.8	713.7	661.3	820.5	866.5	983.7	999.4
Raw materials for consumer goods . .	193.2	233.4	242.4	236.8	251.4	254.7	262.9
Raw materials for capital goods . . .	253.8	327.7	330.5	336.4	352.4	356.6	378.9
Reuter's Index (18. 9. 1931 = 100) . .	1461.1	1593.9	1620.4	1611.9	1702.0	1702.7	1739.9
Moody's Index (31. 12. 1931 = 100) . .	929.9	1093.0	1092.0	1132.5	1226.4	1383.3	1490.0

*Index compiled by HWWA-Institut für Wirtschaftsforschung-Hamburg. On dollar-basis. ¹Yearly Average.