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The world economy in the summer of 1980

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The World Economy in the Summer of 1980

While in the USA the recessionary forces were gaining the upper hand after the turn of the year, production in most other industrialized countries was still moving ahead at a good pace. Businessmen and consumers in Western Europe and Japan were however also scaling down their expectations – a pointer to an incipient world-wide recession. With inflation rates still rising, the efforts to narrow the monetary scope for passing on cost increases certainly also carried weight. But that the stabilization problems have become so acute throughout the world and the expansion of demand is flagging, is to a crucial extent due to the oil price policy of OPEC. Ever since the Caracas conference in late 1979 it has been brought home to oil consumers what an appallingly heavy burden the cartel of the oil exporting countries feels able to impose on the oil importing countries. The phased increase of the oil price – at the end of 1978 still at \$ 13 a bbl. – to an average of more than \$ 31 in June 1980 has created a continually growing risk that the combination of direct withdrawal effects and general adjustment frictions will result in a world-wide recession.

Production and World Trade

(Year on Year Change in %)

	1978	1979	1980
Real gross national product			
Western Europe	2.9	3.4	1.7
USA	4.4	2.3	-1.5
Japan	6.0	6.0	4.5
Industrialized countries: total	4.0	3.4	0.8
Real world trade	5.2	6.0	2.5

The quickening price increases in the industrialized countries – the year on year rise of the cost of living went up from 7½ % at the end of 1978 to nearly 13 % in April 1980 – reflects in great measure the heavier oil price burden, to which other energy producers have added by exploiting the larger scope for price increases, while many other raw materials have also become dearer. Besides, the inflationary expectations were apparently fed by the passing-on of the resulting burdens which led to additional stimuli to the upward price tendency. The impact of this factor varied from country to country according to economic policies and social and institutional circumstances. In general –

Italy and Great Britain are among the exceptions – the updrift of wages quickened only relatively little or not at all. A serious aggravation of the internal distribution struggle and a compression of profits which would have impaired the conditions for growth in a similar way as after the first oil price explosion in 1973/74 was thus by and large avoided. It cannot be regarded as certain however that the conditions for successful adjustment processes will remain so favourable on the distribution side. How wage policy will react to the further and faster upsurge of prices in the early part of this year is in most countries as yet undecided. This makes it all the more important to keep economic policy pointed towards an abatement of inflationary expectations.

The consequences of the oil price-related shifts in international income distribution are reflected more and more clearly by the international trade and payments flows. The OPEC countries' spending on imports is not rising nearly as fast as their revenues from exports – with notable adverse effects on the current accounts of the industrialized countries. This has created few problems as yet because hardest hit were at first two "strong-currency" countries – Japan and the Federal Republic of Germany – and next two countries which found themselves until last autumn in a surplus position – Italy and France. Even countries with chronic deficits have so far been spared serious financial difficulties. Several of them had however to resort to a balance of payments-induced high-interest policy.

Because of their deflationary effects the current account surpluses of the OPEC countries are a heavy handicap for the world economy. Coincidentally they provide however a source of capital for the industrialized countries which can make it easier to finance the extensive investments needed for the adjustment of their economic structures to scarcer and dearer energy supplies. This being so, there is certainly no cause for forceful measures to get rid of the current account deficits by curbing domestic demand, promoting exports and checking imports. As the absorptive capacity of the oil exporting countries is limited, such an approach could at best only solve a few countries' problems, and that at the expense of others.

If a significant number of countries were to react in this way, the aggregate production and employment in the industrialized countries would come under even greater pressure. It is true that the success of a strategy which relies on capital inflows from OPEC countries for the financing of the investments required for adjustment and incidentally of the current account deficits also depends on a confidence-creating stabilization policy. A potential-oriented monetary policy with this aim in view would ultimately lessen the inflationary expectations and by this very fact gradually lose its restrictive effects. It would allow financial policies to be aimed at reducing frictional losses in the economic and social spheres, but it has to be added that the large – and during a downturn normally growing – budget deficits leave in most industrialized countries little financial leeway for such action.

With this kind of background the downward tendencies must be expected to strengthen perceptibly later this year, not only in the USA, but in the other industrialized countries. They will be most marked in private consumption because it is unlikely that the impact of the reduced real incomes will in general be further delayed by an increased propensity to consume. With sales prospects worsening, business firms will show greater reserve in their inventory policies, the more so as the commodity boom is over. True, exports to oil exporting countries will rise strongly, but they carry relatively little weight; in the industrialized countries they average not much more than one per cent of gross national product. That corporate plant investments will at first in many cases rise further and thus act as a "slowdown brake" is rather more important. While this may in part be the result of the usual delayed-action effects, the propensity to invest seems to be sustained by a mostly relatively favourable profits situation and by incentives to save energy and replace oil.

The influence of changes in consumer attitudes and inventory policies on future developments creates great uncertainties for forecasts about the start of a cyclical downturn in the West European economies and Japan. Whatever happens however, the overall rise of demand and production must be expected to come to a halt later this year – in some countries there may even be a decline – while the USA will experience a marked recession. The real gross national product will probably show an average rise over the preceding year of $1\frac{1}{2}$ – 2 % in Western Europe and close on 5 % still in Japan, due mainly to the cyclical expansion which continued into the first half of 1980; in the USA

an average decline of production by 1 – 2 % will mask a much faster contraction in the later part of this year. Under these conditions the world trade cannot be expected to expand further. While imports into the industrialized countries will if anything decline, those into oil exporting countries are very likely to increase substantially. On an annual average world trade will, in real terms, probably be 2 – 3 % higher than in 1979, but only because it was still growing in the early months of the year.

Bearing in mind that the slowdown will be felt by almost all industrialized countries at the same time this year, it must be anticipated that the factors making for a downturn will be fuelled by each other; this may lead to a world-wide recession in 1980 and 1981. Such a development seems indeed certain if the oil exporting countries persist in their aggressive price policy. But even if the decline of oil consumption – which is to a significant extent due to cyclical causes – "neutralizes" the OPEC constraints on the supply side, as is assumed here, and if the world market price of oil does not rise any further in relation to industrial products, there will still be a not inconsiderable recession hazard. For it is almost impossible to say to what extent the damping effects on demand and production of the oil crisis have so far been obscured by the dynamism of the cyclical upturn in Western Europe and Japan. Besides, the balance of payments problems will not reach their full explosive force in the industrialized and developing countries for some time yet, merely because the existing institutions and instruments for coping with balance of payments disequilibria are still providing a respite.

The need for expediting the medium-term process of adjustment to changed conditions created by the oil price explosion, on the one hand, and the inevitable increase of unemployment in the short term, on the other, pose a grave dilemma for the economic authorities in the industrialized countries. Some countries will certainly again incline, in spite of the previous unsatisfactory experience, to acquiescence in long-term disadvantages for the sake of a short-time fillip to demand and production and fail to curb inflation. One of the reasons why such measures are problematic is that they threaten in present conditions to lead very quickly to balance of payments crises which in view of the gravity of the employment problems give rise to a heightened danger of protectionist intervention in foreign trade relations. This would not make for greater job security but create an additional hazard from escalating trade restrictions.