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## World Economy on the Down-Track

by Günter Großer, Günter Weinert, Hamburg\*

**1979 saw a pronounced cyclical downturn with mounting inflation and balance of payments problems bear upon the western industrialized countries with the long-expected recession materializing in the USA early in 1980. In Western Europe demand and production began to slide a little later. Increasing signs of a nascent downtrend were also to be seen in Japan. What are the prospects for the current year?**

The OPEC decision in Caracas at the start of 1980 to give the oil price spiral another twist set off another shock wave in the industrialized countries. They had, for the first time since the oil price explosion of 1973/74, just noticed incipient signs of an abiding "self-sustained" recovery. These were quickly blunted. At the beginning of 1980 the real gross national product was still going up in most countries thanks to precautionary buying in anticipation of oil price increases and also because of the Afghanistan crisis, but thereafter demand and production fell off. The decline which many observers had first interpreted as a reaction from the earlier trend proved persistent. The oil price-induced withdrawal effects were now clearly felt, and they were reinforced by the restrictive effects of economic policies aimed at damping the additional cost and price impulses emanating from the oil price increases.

### High Oil Prices Hit Private Consumption

After a prolonged upswing, the USA had, unlike Western Europe, already been in the grip of a stagnation since the spring of 1979. The sharp upsurge of prices gained further momentum in early 1980 and prompted the monetary authorities to impose drastic restrictions which hit in particular the building trade and private consumption. The downtrend was so

steep that the monetary brakes were eased for a while, leading to a temporary revival of demand and production in the second half of 1980.

In most industrialized countries private consumption suffered from oil price-induced withdrawal effects and in turn played a major role in slowing economic activity. Tighter inventory control – prompted by high interest rates, dwindling order books and worsening sales expectations – appears to have had a strong contractive effect. The spreading downward tendencies also damped down the export business; Japan alone – with its competitive position greatly improved by the depreciated yen and reduced unit wage costs – was at first able to resist this trend. As sales and profits declined and the horizon darkened, the investment propensity weakened generally, so far however apparently – in contrast to 1974/75 – by no more than a "normal cyclical" measure.

The recessive trend and the consequent worsening of the labour market situation touched almost all countries at a time when unemployment was in any case still at a high level. In most countries of Western Europe it had come down little in the preceding phase; there were still more people without work than before the oil crisis of 1973/74, largely because more were available for work, partly owing to demographic factors and partly because more people wanted to earn

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money. Another factor was that economic growth had been slowing since the mid-seventies, resulting in a slower increase in job opportunities.

### **Unbroken Inflation**

While the unemployment figures were once again going up in the industrialized countries, the fight against surging prices has so far shown only little success. Early last year the advance of prices had actually accelerated, in the main because of external cost increases – as already observed in the preceding year – including the latest OPEC price revision.

Later in the year the oil prices rose less quickly, while those of most other raw materials even receded. The consumer prices were now advancing a little more slowly, though still, almost all along the line, at the pace of the preceding year. A year-on-year comparison shows considerable differences from country to country but no significant slowing of the overall advance. There was only one exception: the rigorous stabilization policy initiated in Great Britain in mid-1979 has been showing results since the spring of last year.

The mistaken responses of wage and distribution policy to the upsurge of prices after the oil crisis of 1973/74 were avoided during the present downturn. The lessons of the previous recession seem to have been learnt. The governments resorted almost everywhere and at an early stage to an unequivocal stabilization policy. The trade unions on the other hand pursued for the most part – and mostly successfully – a strategy of at least maintaining the real wage levels, except where stopped by official intervention as in the Netherlands and Denmark. In the USA the real wages have also been rolled back, whereas in several other countries, especially in Italy but also in France, for example, the purchasing power of wages and salaries was kept intact through more or less automatic cost-of-living adjustments. This implied providing compensation for “imported” price increases and aggravated the stabilization problem. The wage costs per product unit went up more steeply everywhere and were bound to do so merely because the cyclical downturn lowered productivity. In a number of countries – including several in Western Europe and until the spring of 1980 Japan – the task of stabilization became more difficult because their currencies tended to depreciate against the US dollar. A factor of some weight was that shifts in the current account balances and relative interest rates affected the exchange rates more than price differentials between individual countries.

The latest oil price hoist differed from the price explosion in the mid-seventies in that it gave rise to big current account deficits in the Federal Republic of Germany and in Japan, these amounting in 1980 to about \$ 15 and 12 bn respectively. France and Italy which have had problems in the past recorded much smaller deficiencies, and Great Britain, now self-sufficient in oil, earned quite an appreciable current account surplus. The USA also moved into surplus last year.

### **High Current Account Deficits**

The current account deficits of the industrialized countries doubled in the aggregate to about \$ 75 bn in 1980. This was entirely due to the strong adverse effect of the oil prices on their terms of trade. The worsening trend abated in the course of the year when oil prices rose less steeply, and the current account deficits of the industrialized countries then apparently began to go down. The turn-round was however in the main confined to the USA, Japan and Great Britain; most of the continental countries of Europe recorded as large or even larger shortfalls than before. A notable feature was the swift subsidence of Japan's current account deficit in 1980 as the result of an – only partly cyclical – contraction of imports coupled with a far more favourable experience in the export field than observed in other industrialized countries; Japanese firms had greatly improved their international competitiveness in 1979. An opposite trend set in before the middle of 1980 when the yen rate and the unit wage costs rose appreciably.

The internal and external developments in the industrialized countries during 1980 have shown that the adjustment to an external shock like the latest oil price increase is bound to involve considerable temporary production and employment shortfalls. Going on the indicators available, the recessive movement seems destined to continue in the next few months. There is, however, another more important question: Are there as yet any pointers to a likely improvement of the economic situation in the latter part of this year? The experience of the last two years suggests that the tendencies in the oil markets will play a major role in this respect. The supply shortfalls caused by the war between Iraq and Iran are forcing the industrialized countries to draw on stocks to cover their requirements. The supply situation need not be expected to grow tighter, however, although it will certainly remain tight for a while. The demand for oil will fall off further as the result of a cyclical and – thanks to stringent energy economies – structural

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decline of consumption. Notwithstanding the recent OPEC increases, the world market price of oil is thus unlikely to rise more than the prices of industrial products – in the annual average, and in US dollars, by 15-20 %.

### Little Room for Countercyclical Policies

Even bearing in mind how the inflation expectations in the industrialized countries have been constantly fuelled by oil price increases since the spring of 1979, it may be expected that the efforts now being made over a broad front to scale down the price advances will gradually show clearer evidence of success. Stabilization will nevertheless remain a high-priority target in most countries. Another matter of concern, in the European economies in particular, will be how to finance the current account deficits without running into trouble. By strictly limiting the expansion of the money supply and by providing attractive interest rates, it is intended to pull in enough capital to avoid a fall of exchange rates which would make stabilization an even more difficult task. The monetary developments in the USA will be a major factor in this

respect through the intermedium of international interest rates. The “excesses” witnessed in recent months are, however, likely to pass away shortly, if the US demand for money falls and interest rates recede, as they may do in view of the renewed easing of economic expectations.

Despite the recession, no more thought seems to be given to financial than to monetary stimulants. The scope for such moves is indeed limited because the budgets were in deficit even during the cyclical upturn, and the recession will in any case cause the shortfalls to snowball. Under these circumstances it is doubtful whether adding to the deficits by increased spending and/or tax cuts would generate any expansionary impulses, the more so as they are known to stand in the way of monetary policies consistent with the aim of stabilization. This is why additional public spending in industrialized countries at present often goes hand in hand with tax increases, as in Japan, while tax cuts are matched by dents in expenditure, as foreshadowed for the USA. It is difficult to estimate the short-term overall effect of such strategies. The only assumption to be made with certainty is that the “built-in stabilizers” of

## Economic Indicators

	Real Gross National Product (Year-on-year change in %)				Consumer Prices (Year-on-year change in %)				Exchange Rates <sup>1</sup> (Change over 12 mths in %)		Unemployment Rate <sup>2</sup>	
	1970-78 <sup>a</sup>	1979	1980 <sup>b</sup>	1981 <sup>b</sup>	1970-78 <sup>a</sup>	1979	1980 <sup>b</sup>	1981 <sup>b</sup>	Dec. 1979	Dec. 1980	1979	1980 <sup>c</sup>
USA	+2.9	+2.3	-1.0	-0.5	+ 6.6	+11.3	+13.5	+10.0	+ 0.9	+ 1.6	5.8	7.6
Canada	+4.4	+2.7	-0.5	0.0	+ 7.2	+ 9.1	+10.0	+ 9.5	+ 1.1	- 2.2	7.5	7.6
Japan	+6.0	+5.9	+5.0	+2.0	+ 9.6	+ 3.6	+ 8.0	+ 6.0	-20.1	+17.9	2.1	2.0
Western Europe <sup>3</sup>	+3.2	+3.4	+1.2	-0.7	+ 8.7	+ 8.6	+11.7	+ 9.2	.	.	5.4	6.5
Austria	+4.2	+5.1	+2.5	+0.5	+ 6.4	+ 3.7	+ 6.5	+ 5.0	+ 4.0	- 1.0	2.0 <sup>d</sup>	1.9 <sup>d</sup>
Belgium	+3.7	+2.1	+1.0	-1.0	+ 7.4	+ 4.5	+ 6.5	+ 6.5	- 0.6	- 2.7	7.4	8.7
Denmark	+2.7	+3.5	-1.0	-0.5	+ 9.1	+ 9.6	+12.0	+ 9.0	- 7.7	- 5.8	6.0	7.3
Finland	+3.3	+7.2	+5.0	+1.0	+10.6	+ 7.5	+11.5	+11.0	+ 2.4	+ 2.1	6.2	5.0
France	+4.1	+3.2	+1.5	-0.5	+ 8.6	+10.8	+13.5	+11.5	+ 0.9	- 2.8	6.1	6.5
FR Germany	+3.0	+4.5	+2.0	-0.5	+ 5.0	+ 4.1	+ 5.5	+ 4.5	+ 3.7	- 4.8	3.3	3.6
Great Britain	+2.3	+1.4	-2.5	-2.0	+12.4	+13.4	+18.0	+10.0	+ 6.7	+16.0	4.9	7.1
Italy	+3.1	+5.0	+3.0	-2.0	+12.1	+14.8	+21.0	+18.0	- 2.0	- 5.4	7.7	8.2
Netherlands	+3.7	+2.6	+1.0	-0.5	+ 7.3	+ 4.2	+ 6.5	+ 5.0	+ 0.3	- 2.2	4.1	5.5
Norway	+4.3	+3.2	+3.0	+2.0	+ 8.8	+ 4.8	+11.0	+10.0	- 3.2	- 0.1	1.3	1.1
Sweden	+1.8	+3.8	+2.0	0.0	+ 8.7	+ 7.0	+14.0	+12.0	+ 0.2	+ 0.8	2.1	2.2
Switzerland	+1.3	+2.5	+1.5	-0.5	+ 5.1	+ 3.6	+ 4.0	+ 4.0	- 0.6	- 2.5	0.4	0.2
Spain	+4.4	+1.5	+1.5	+1.0	+14.1	+15.7	+15.0	+13.0	+ 2.5	- 9.9	9.2	12.6
OECD Countries Total <sup>3</sup>	+3.6	+3.4	+1.0	0.0	+ 7.9	+ 9.2	+11.8	+ 9.0	.	.	5.0	6.0

<sup>1</sup>External value of currencies weighted by share in international trade 1979. – <sup>2</sup>In % of total number at or available for work.

<sup>3</sup>Total of listed countries weighted by real gross national product, private consumption and numbers available for work respectively. –

<sup>a</sup>Average year-on-year change. – <sup>b</sup>Estimated or forecast; figures rounded to nearest 0.5 %. – <sup>c</sup>September or October, seasonally adjusted. – <sup>d</sup>Ratio of unemployed to total number of wage- and salary-earners.

public sector finance will this year in general have a demand-sustaining effect.

### **Upward Tendencies**

The current inflationary and recessionary trends are at present world-wide, though nevertheless raising different problems in different countries. In the USA, external considerations play a subordinate role in economic policy as the current account is back in surplus. With retail prices rising at an annual 13 % in recent months, the Federal Bank is forced by the unbroken inflation to keep to its stabilization strategy. A further decline of demand, production and employment looms in the coming months. It will, however, probably again be attended by a fall of interest rates, the more so as the inflation expectations may ease, and this will eventually improve the conditions for a recovery so that the level of business activity – supported by cyclical inventory changes – will probably rise in the second half of 1981. The strength and duration of the coming upturn will depend in large measure on the success of the new President's efforts to engender confidence in his proclaimed economic policy of combining stabilization with growth.

The monetary policies of the West European countries will follow in the wake of the monetary developments in the USA, the more so as it is likely that little progress will in general be made this year yet as regards rolling back the high current account deficits. While the foreseeable interest rate reductions in the USA will permit similar moves in Western Europe, a more important antidote to a protracted downtrend in Western Europe is at hand in the form of wage agreements which take account of the unfavourable trend of productivity and the lessened scope for passing-on of increased costs; these would encourage industrialists to step up their investment activity. The situation in the labour market and the exigencies of economic policy suggest moderation in wage demands. If the cutback of business investments continues to be limited to a "normal cyclical" measure, the expansive forces in the West European economies may be expected to gain the upper hand later this year.

Japan's economic expansion was sustained for a long time by a strong increase of exports although the domestic demand stagnated. Under the impact of the world-wide slowdown and the manifest self-restraint of Japanese exporters exports will, however, probably be lower in the six months ending in March 1981. Economic activity is therefore also likely to slacken in Japan. The conditions for a recovery later in the year are, however, much more favourable than in the other

industrialized countries. The current account deficit has been reduced so much that little attention need be given to external constraints on economic policy, and there are good prospects that the updrift of prices will subside also at the retail level and that the next round of wage increases will again be moderate. The investment propensity is under these circumstances likely to hold up well during the slack period. The Japanese economy will therefore probably soon change gear and enter another expansionary phase, but the upward thrust will remain moderate, simply because – Japan's great competitive strength notwithstanding – the export trade will revive only slowly this year in line with the subdued economic trend in the world.

### **Contraction of International Trade**

International trade has already fallen back considerably since the spring of 1980 and is, according to our forecast for the industrialized countries, due to contract further at first. The oil exporting countries are this time responding much more tardily to the extraordinary rise of their export earnings than in the mid-seventies, following the first oil price explosion. Increased imports by them will provide only partial compensation for the contractive influences. The non-oil developing countries will in the meantime face even greater balance of payments problems. Neither they nor the state trading countries are likely to raise their imports more than marginally. While the upturn in the industrialized countries' forecast for the second half of 1981 will help to revive world trade, its volume in the annual average is estimated to remain 2 % below the 1980 level.

The annual figures reveal neither the strength nor the time-pattern of the current recessive trend. This applies even more to the industrialized countries' aggregate real GNP than to international trade. The marked slowdown of economic activity from the spring of 1980 until well into the year 1981 was reflected by an annual average growth rate down to about 1 % in 1980, and a stagnant real GNP rate is forecast for 1981. The figures do not differ significantly from those for 1974 and 1975, the years following the first oil price explosion. Such a production standstill entails reduced capacity loading, but this effect is at present not as manifest as during the previous recession because the production capacities have apparently not been expanded so fast. On the other hand, unemployment started its climb this time from a higher basis line. It is therefore all the more serious that, even assuming that economic activity improves as forecast and taking the

usual delayed-action effects into account, unemployment is liable to rise further, probably right through 1981.

### **Outlook Blurred**

Our forecast for the world economy rests, like all forecasts, on certain assumptions which may prove to be either unduly optimistic or pessimistic. Cyclical changes almost inevitably take time to work through, and the adaptability of the national economies is perhaps underestimated at the present time. The factors making for an upturn – such as changes in inventories and consumer attitudes – may come into play sooner than assumed. This would produce distinctly better growth rates in the current year. On the other hand, there are a number of hazards which could prolong the demand and production slide. The world may be in for another oil shock if the supplies are disrupted further, or internal difficulties may have to be coped with: the investors may be less resilient than expected, the inflation expectations may be too deeply ingrained, wage-earners may – perhaps for this reason – show a lack of moderation. The psychological factors at play here can hardly be traced back to past experiences, deriving as they do from an acute need to adjust to high oil prices superimposed on mistaken endogenous developments over many years.

Uncertainties exist not only about the attitude of businessmen, consumers and trade unions but about the economic policy parameters and in particular the portended impulses from the USA, the most important

of all industrialized countries. How swiftly and consistently the new President will carry out the heralded shift in economic policy towards extension of private choice and contraction of the public sector and whether all his plans can be put into effect without a struggle remains to be seen. The difficulties of the other industrialized countries in coping with the present adjustment problems and overcoming the recession would be aggravated by an acute stabilization crisis of the British type and likewise by a continuing failure to damp inflation expectations as witnessed in the USA in the past.

### **Trade Protectionism a Danger**

The longer the world-wide downturn lasts, the less certain is it that all the governments will resist the pressure for protectionist measures against mounting unemployment and high current account deficits, as their freedom of action in the field of monetary and fiscal policy is limited. It is all too easy to overlook the fact that short-term support for incomes and employment in the protected industries is in all experience more than offset by shortfalls in other areas, in part because of the inroads of bigger price increases into the consumers' real incomes and in part through loss of exports due to counter-measures of other countries. More protectionism would not make the adjustment to wide shifts in national and international cost and price relations any easier. It would only draw out the process, with higher economic and social costs to boot.

### **HWWA-Index of World Market Prices of Raw Materials<sup>1</sup>**

(1975 = 100)

Raw Materials and Groups of Materials	1979		1980				1981	
	AA <sup>2</sup>	December	AA <sup>2</sup>	October	November	December	Jan. 2nd	Jan. 16th
Total index . . . . .	152.7	194.0	226.0	237.8	236.8	236.9	247.0	246.2
Total, excl. energy raw materials . . .	138.5	148.4	157.5	162.5	160.2	152.7	153.5	152.8
Food, tropical beverages . . . . .	130.3	140.6	150.4	164.1	162.6	150.1	151.9	151.1
Industrial raw materials . . . . .	144.7	154.4	162.9	161.3	158.3	154.7	154.7	154.1
Agricultural raw materials . . . . .	142.8	149.4	164.3	167.4	166.3	164.8	163.9	163.1
Non-ferrous metals . . . . .	169.6	187.6	185.5	179.0	173.9	164.7	164.7	164.2
Energy raw materials . . . . .	161.1	220.6	265.9	281.7	281.5	286.0	301.6	300.7

<sup>1</sup> On dollar basis. - <sup>2</sup> Annual Average. For the method of computation of the HWWA Index cf. INTERECONOMICS No. 5, 1980, p. 261 ff.