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Article — Digitized Version

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Intereconomics

Suggested Citation: Schröder, Wolfgang (1982) : Inescapable vicious circle?, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 17, Iss. 6, pp. 261-262, <https://doi.org/10.1007/BF02930168>

This Version is available at:

<https://hdl.handle.net/10419/139828>

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Inescapable Vicious Circle?

The world economy seems to be caught in a vicious circle: the weakness of growth accompanied by international payments crises is causing a world-wide increase in unemployment. An attempt is being made to combat the crisis with domestic instruments and a more or less well disguised beggar-thy-neighbour policy, including protectionist practices. Followed on a world-wide scale, this policy is doomed to failure. It leads to a reduction of world trade and of the international division of labour. This only weakens the growth of real income even further and the vicious circle is complete. However, the world today – in contrast to the world of the thirties – possesses a degree of freedom in economic policy which makes it possible to escape this vicious circle.

Nevertheless, a dramatic worsening of the situation, possibly emanating from the sensitive financial markets, cannot be completely ruled out at the present time. The bad news from that quarter knows no end. The number of negotiations on debt-rescheduling has doubled from year to year since 1980. The sum of the credits to be rescheduled has jumped even faster. Banks are collapsing and insolvencies of single countries call forth international “fire-brigade manoeuvres”, involving the International Monetary Fund, the Bank for International Settlements and important central banks, in order to prevent destructive chain reactions.

The parallel crisis of world finance and world trade appears superficially to be due to the recession in the industrialised countries, which for its part – and here lies the deeper, *common* cause of the disaster – has a great deal to do with the restrictive monetary policy of recent years. Of course this does not mean that the weakness of the world economy is due to restrictive monetary policy alone, but it does mean that the monetary deceleration in important industrialised countries, in particular the USA but also Britain, the Federal Republic of Germany, Japan and France, made an appreciable contribution to the downswing. It cannot be denied that a monetary cause is among those underlying the real vicious circle described above. And the thought is of little comfort that the change-over to monetary restriction simply served to correct the exaggerated expansion of the money supply of recent years, which had bestowed a new pinnacle of inflation on the western industrialised countries in 1980.

Both the inflation and the struggle against it have resulted in losses of growth. Nominal interest rates rose already in 1979 and 1980 due to inflation. Because of the restrictive phase’s tightening of liquidity which began in 1979, the rise in interest rates continued to mid-1981. Thus, on the one hand, interest costs rose considerably, especially for debtors who had taken up long-term credits with floating interest rates. On the other hand, investments in financial capital thus became more profitable than many investments in real capital, which were therefore postponed. Whereas in the mid-seventies investors in US dollars were still being fleeced by negative real interest rates from which investors in credit-financed real capital profited, this relationship has been completely reversed in the last few years. Unexpectedly high real interest rates dampened consumption and investments in real capital.

Under the dominant influence of restrictive US monetary policy, the other central banks had only the choice between a considerable devaluation in relation to the dollar – and the consequence of imported inflationary impulses – or a corresponding monetary deceleration at home. This alternative was posed particularly acutely for the Deutsche Bundesbank, since the D-Mark – although still far behind the US dollar – has become the second most important

reserve and investment currency. The Bundesbank, and with it the other important central banks, decided in favour of a restrictive monetary policy.

Considering the world-wide leaping interest rates, the highly indebted newly industrialising countries and east bloc countries could only have avoided payments difficulties if they had been able to increase their receipts of foreign exchange sufficiently. The necessary increase in exports to financially strong industrialised countries foundered, however, mainly for the same reason as that which was decisive for the exorbitant burden of interest: restrictive monetary policy. The latter dampened economic activity; the industrialised countries' production and imports stagnated and unemployment rose at a frightening rate. But an increase in imports was hindered not only by the general weakness of the economy; it was further depressed by protectionist measures. Even efficiently producing industrialised countries insulate large sectors of the economy from foreign competition. Others devalue their currency in order to increase their competitiveness or give additional subsidies to domestic industry and support exports in other ways, for example by credits on easy terms.

There is a disquieting lack of symmetry in the foreign trade policy of the industrialised countries here: a liberal credit policy is incompatible with trade barriers. If the two are combined in spite of this then the crisis is pre-programmed. Since world trade and the international financial system are directly linked to one another, the present financial crisis cannot be solved by banks and monetary authorities alone. "Fire-brigade manoeuvres" on the financial plane can only serve to create a breathing-space long enough for efforts towards a permanent solution to the problems to be made. Only when the latterly introduced import barriers have been removed and the liberalisation of international trade has ceased to be just a catchword for Sunday speeches and become the maxim of economic policy, shall we be closer to a permanent solution to the financial crisis.

Monetary policy in the industrialised countries is freeing itself more and more from its restrictive course, so that the monetary cause of the vicious circle is disappearing. The chances of overcoming the weakness of the economy and the financial crisis are thus increasing. Interest rates have sunk world-wide and the monetary aggregates, which reflect the impact of monetary policy, are already growing faster again. There is therefore hope that monetary policy will cease to put a brake on growth, as it has been doing until now, and will make growth possible again. The vicious circle can be broken with the help of monetary policy. This must certainly not be understood as a plea for an expansionist course, which would simply lead to a renewed alternation between monetary acceleration and unavoidable deceleration. It is a question of adopting precisely that course of monetary expansion which neither hinders real growth nor drives prices upwards. To determine this course, the possible growth of real income in the medium term must be estimated. The unavoidable rate of price increases in the same period must be included in the calculation.

Even with such a monetary policy, many countries will have difficulties in regaining their trust in a policy conforming to the requirements of stability and growth. The rates of inflation have fallen and are still falling but the continuing very high real interest rates – i.e. returns minus the current rate of price increase – are a sign both of inflexible inflationary expectations and of a continuing uncertainty regarding the future level of nominal interest rates and thus, also, regarding future monetary policy. This is particularly true of the USA. If it should not prove possible there to reduce uncertainty, then interest rates will continue to include a high inflation and risk premium. Every move by the US Federal Reserve System (Fed) is registered, interpreted and transformed into decisions on the financial markets by the "Fedwatchers". If the restrictive course of monetary policy is relaxed even just a little, many observers immediately suspect a change to an inflationary expansionist policy. The central banks must make it appear credible that this conclusion is false. The suspicion contained in it is a decisive reason for the hesitancy of the central banks in their return to appropriate monetary growth. This must be overcome if we are to escape at last from the vicious circle of restrictive monetary policy, increasing real interest rates, declining economic growth, growing unemployment, increasing budget deficits leading to further increases in interest rates, and protectionist measures. The first steps have been taken and they give us hope.

Wolfgang Schröder