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## The prospects for the international economy

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## WORLD ECONOMY

# The Prospects for the International Economy

by Hans-Jürgen Schmahl, Hamburg\*

**Although the international economy seems to be well on the road to recovery, the question remains as to how much of this recovery is of a short-term cyclical nature and how much an expression of a renewed longer-term trend towards economic growth. Are we merely witnessing an increased utilisation of existing production capacities without a parallel expansion of production capacities themselves? What conditions have to be fulfilled to ensure the latter?**

At the start of the 1980s the international economy has been hit by its most serious post-war setback yet. It is undisputed that this setback cannot be solely blamed on the second oil-price crisis of 1979/1980, but that the latter was just the major triggering factor. What is even more important, the worldwide recession cannot be simply interpreted in the light of business cycle phenomena. However, cyclical factors, accounting for the fluctuations in the degree of production capacity utilisation, must also share responsibility for recent developments.

Today, it is fair to claim that the international economy is well on the road to recovery. In some countries, especially the USA, this process of economic revival is, indeed, already at quite an advanced stage. In others, particularly France, an improvement is only just beginning to set in. The extent of international economic recovery is reflected in a remarkable increase in world trade. Nevertheless, the question must be raised as to how much of this recovery is of a short-term cyclical nature and how much an expression of a renewed longer-term trend towards economic growth. In other words: are we merely witnessing an increased utilisation of existing production capacities without a parallel expansion of production capacities themselves? Talk of a new phase of economic growth is only then justified if there is a renewed marked increase in production capacities and subsequently in the number of jobs.

The topic dealt with by this report relates to both the short-term, primarily business cycle, aspect, as well as to the longer-term prospects for a "revitalisation" in the form of a renewed boost to the growth potential of productive capacities. I shall only briefly touch upon the

short-term aspect, concluding this particular section with a quantitative forecast of probable developments. The second section of my appraisal requires a more detailed exposition, and my conclusions here will not adopt the form of a quantitative prognosis. Here, I shall concentrate on the conditions which must be met in order to avoid longer-term international economic stagnation. These are conditions which must be respected by individual national economies, at an international level, and in the form of an interaction of both.

### The Current Situation

Beginning by taking a look at the current situation in the international economy, it can be seen that since 1983 the international economy, has been going through a period of economic recovery.<sup>1</sup> With demand and production increasing markedly also in Western Europe, this recovery has now become more broadly-based. The pronounced economic upturn in the USA influenced developments in other parts of the world. In Western Europe, where recovery took off in Britain and in the Federal Republic of Germany, there was a process of mutual stimulation. Other countries, namely France and Belgium, which lagged behind in the field of stabilising costs and prices, were obliged to take even further steps towards stabilisation. However, external stimuli managed to prevent a recessionary development in these countries. During the early stages, recovery of demand in major industrialised countries was only supported by private consumption, stock-cyclical movements and, occasionally, by residential construction activities. More recently, however, business investments have also gathered momentum in a growing number of countries.

\* HWWA-Institut für Wirtschaftsforschung-Hamburg. Lecture held at the 4th Annual Convention of the European Federation of Associations of Business Economists (slightly abridged version) in Rome, 16th May 1984.

<sup>1</sup> Partly based on the joint analysis of the five German Institutes of Economic Research "Die Lage der Weltwirtschaft und der westdeutschen Wirtschaft im Frühjahr 1984".

Last year's economic uptrend was encouraged by monetary and, in individual cases, fiscal policy impulses. In some countries, however, an improvement in supply conditions also led to an enhanced propensity to invest. This particularly applies to the USA, where the relief provided for businesses in the form of reduced taxation burdens and the moderation in negotiated wage settlements were much more pronounced, and to a certain extent to the Federal Republic of Germany. Growth conditions have also improved in a number of other countries in the wake of successful stabilisation and structural adjustment efforts.

In summer 1983 the central banks in a number of important countries began to curb the previously substantial monetary expansion. It is unclear whether they will now pursue a steady potential-oriented path of monetary growth. The reins of monetary policy in the USA, for example, may be tightened if the rate of inflation again increases during the course of the year, a development which, together with the high deficits on current account, would put pressure on the dollar.

There is considerable uncertainty with regard to American fiscal policy. Up to now, it has been extremely expansive in nature, and the federal budget deficit has not decreased despite economic improvement. For some time, however, there has been mounting political pressure to introduce consolidation measures. Any decision on this point is made even more difficult by the current election campaign. Nevertheless, there are strong indications that measures designed to bring down the deficit level will be passed before the election. If these measures take the strain off the financial markets, such a move can be expected to counteract the upward trend in interest rates, which results from the sustained upswing of the US economy.

In most Western European economies and Japan, on the other hand, fiscal policies have been consolidation-oriented for quite some time now. This policy course has been effected both via taxation increases and the withholding of "hidden" tax increases – in an interaction between progression and inflation – as well as via greater restraint in government spending. However, many governments are also trying to urge businesses to invest by providing tax reliefs.

The risks facing international financial markets and the international economy in the form of the debt crises troubling many developing countries have also been reduced somewhat by the overall economic recovery. The average current account deficit for this group of countries fell substantially during 1983, due primarily to rising export earnings rather than reduced imports. Against this background, the difficulties associated with

vital rescheduling operations and renewed borrowing are gradually decreasing. However, the situation does vary considerably from one country to the next.

### Short-term Prospects

In view of the general economic policy setting, the upward economic trend in industrialised countries can be expected to continue during the course of 1984. However, the US economy will not be able to maintain its vigorous expansion. As the stimulating effects of economic policy measures recede, the retardant effects of the persistently high real interest rate levels will probably exert a greater influence on the behaviour of investors and consumers than has previously been the case. The waning import pull in the USA will tend to slow down expansion in Japan, where domestic demand will only recover gradually. In Western Europe recovery will probably continue at its hitherto restrained pace. There will continue to be substantial differences in the development of individual countries, some of them placing an even greater emphasis on austerity policies this year. On the whole, the increase in real terms of the gross national product of industrialised countries will figure at about 4 % in 1984, the highest growth rate for six years. However, the overall picture is a varied one. In Western Europe, for example, the growth rate will only reach 2 %. In the USA and Japan, on the other hand, the figure will climb to 5 to 6 % and 4 to 5 % respectively.

In 1985 the international economy can also be expected to continue its upward trend. However, the pattern of development will change. Expansion in the USA will undoubtedly slow down, the pace of expansion next year being at least clearly slower than the 1984 performance. This is only natural considering the fact that during the first quarter of 1984 GNP in the USA rose by a seasonally adjusted annual rate of 8 %, and that the economic upturn will in 1985 already be in its third year. (At this stage, it should be pointed out that there is no indication that economic development does not still pass through cycles, that an upswing is not followed by a downswing. The question is, however, whether such a downswing means a lower increase in production or a recession.)

How pronounced the slowdown in the USA will in fact be depends, among other things, on monetary and fiscal policies; the uncertainty of developments in this field has already been emphasised. In Europe, on the other hand, GNP can, at least on the whole, be expected to continue its upward movement. Even if it should already start to slow down in individual countries – as may, for example, be the case for the Federal Republic of Germany – other countries, for example the relatively

late starter, France, will experience an increase. The International Monetary Fund expects these varying developments to result in a increase in the GNP of industrialised countries as a whole of slightly over 3 % in 1985. This can be regarded as a plausible figure. It reflects an international economic development which also gives developing countries the opportunity to further improve their own economic situation.

### **The Longer-term Trend**

As already stated, the subject should not be merely approached from a short-term view. The crucial question is whether a process of fundamental economic growth is possible beyond the inevitable fluctuations of the business cycle. As has already been stressed at the outset the global recession at the start of the eighties cannot be explained by merely referring to the second oil-price crisis. Although this was undoubtedly one major cause, the duration and intensity of the subsequent setback demands additional explanations. In seeking them, however, the approach cannot confine itself to a consideration of this latest recession alone. The development during the seventies, for example, already revealed marked differences to previous developments. After the first oil-price crisis in 1973 it became clear that the trend of economic growth had begun to level off strongly, whereas unemployment disturbingly revealed a steeply rising trend. The look at major problems, therefore, not only covers the past few years but stretches back just over a decade.

### **Increasing Saturation of Needs?**

Before proceeding any further, a hypothesis shall be taken up which is frequently put forward in connection with the deterioration in the welfare of the international economy. It is the claim that economic difficulties more or less result from an increasing saturation of needs. This theory has re-emerged ever since modern economies have existed. One needs only call to mind the theory of secular stagnation expounded during the 1930s. In a quotation which dates back even further, to 1815 to be precise, the French economist and philosopher, Simonde de Sismondi, sceptically poses the question: "What are we possibly expected to do with even more production, now that we have already satisfied man's essential needs?"

A glance at the situation in the Third World suffices to show that, at least on a global scale, this saturation theory is incorrect. Yet even in industrialised countries it does not hold true. The savings ratio in most industrialised countries is no higher today than it was a decade ago; in fact, in some cases it is lower. If the

saturation-of-needs claim were correct, the savings ratios should have risen universally. However, the fact that the saturation argument is repeatedly used would seem to be a case of mistaking a partial for a total saturation of needs. Assuming steadily rising incomes there is, of course, a partial saturation with regard to the supply of certain goods. However, these are replaced by new goods which provide opportunities for sales expansion. The economic development of modern societies is characterised, on the one hand, by a succession of partial saturations of needs, and on the other, by the introduction of new products.

### **Inadequate Structural Adjustment**

The new and unfavourable trend of economic development since the start of the seventies does not reflect a state of saturation, but is a manifestation of something entirely different, namely of the inadequate degree of adjustment to massive structural changes. The OECD aptly describes this situation as follows:

"The most visible and important factor that brought about a break in the underlying long-term trends was the oil price shock of 1973 . . . However, it is difficult to believe that the oil shock of 1973, the wage-price spiral thereafter and the subsequent energy price increase in 1979 can entirely explain the persistence of poor overall economic performance. Even if other factors bringing about structural adjustment pressures such as shifts in demand, changes in the size and composition of the labour force, introduction of new technologies, more stringent environment standards and new patterns in international trade and capital flows are also taken into account, it appears that a well functioning market economy should normally be able to cope with such challenges. . . The presumption is, therefore, that it is not only the adjustment requirements which have been too great or which came too abruptly, but also a diminished capacity and/or willingness of the economy and society in the industrialised countries to respond positively to them, which makes present economic difficulties so troublesome to resolve."<sup>2</sup>

The statement that a well functioning market economy will normally be able to cope with the challenges of structural adjustment perhaps sounds like a little too much trust in the abilities of the market mechanism, something which Germans are often reputed to possess. However, the statement quoted was made by an international organisation and for quite some time it has been shown to be correct. In many

<sup>2</sup> OECD: Positive Adjustment Policy – Managing Structural Change, Paris 1983, p. 7.

countries we now come across a kind of rediscovery of the fact that guidance by market forces – with individual businesses and private households responding to the signals emitted by the market – is as simple as it is effective. To quote the OECD once again: “The competitive system is a mechanism to convey complex information about social preferences and technological possibilities to economic agents in factor and product markets through the indirect means of profits and losses.”<sup>3</sup>

However, it must be added that the marketplace cannot cater for everything. Even in market economies economic policies have a role to play, and a significant one at that. However, the decisive question is how policymakers view and perform their task. What is needed are policies which set up a framework, lay down certain regulations and make sure that these regulations are respected and implemented. Such policies must also be able to ensure that the economy functions smoothly and efficiently by fostering economic stabilisation and economic growth. In addition, the part of governmental activity dealing with the provision of public goods and the associated reallocation of

resources is, of course, also essential. However, all these considerations by no means justify a form of interventionism, the nature and extent of which cripples market forces. All too often this is practised under the label of “structural policy”.

### **Mutual Reinforcement of Adverse Factors**

Reducing our findings to a single formula, “increased need for structural change plus reduced flexibility = weak economic growth and unemployment”. The major reasons for the increased need for structural change have already been outlined. So as to preclude any misunderstandings on this point, however, a few words are to be said about the problem of “increased need for structural change”. Very often, research into structural change has come to the conclusion that the speed at which such change occurs is no different today than in earlier periods; in fact, in some cases it has slowed down. This is the essential crux of the problem. The inducement and the need to effect structural change are greater than the actual change itself. Structural change is subject to considerable frictional losses, reflected in the increased sluggishness of economic growth and in unemployment. Once economic growth begins to slow down, structural change becomes even more difficult,

<sup>3</sup> Ibid., p. 8.

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confronted by the opposition of those adversely affected by this change.

It seems, therefore, that once events have taken a turn for the worse, the result is a process in which there is mutual reinforcement of weak growth and opposition against structural change. This vicious circle can be all too clearly observed in a number of countries. Calls for increased protection against foreign imports and against the effects of rationalisation confirm this trend.

The second part of the formula referred to the reduced ability and/or willingness to push through structural change. What are the reasons for this? In an attempt to discover these reasons one should concentrate on four problem complexes, which, although they do not claim to relate to all conceivable reasons, do perhaps cover those which are most relevant. These are

- ☐ the role of inflation,
- ☐ the role of governmental activities,
- ☐ the role of labour costs and labour regulations and
- ☐ the role of international conditions.

### **The Role of Inflation**

The rise in prices in industrialised countries over the past 10 to 12 years has been much more pronounced than at the time before this period. The effect of inflation on the market's set of signals can be compared to that of a jamming transmitter on radio reception. Businesses are unable to clearly distinguish between that part of the price increase caused by "general inflation" and that caused by the "special change in price relationships", which in effect is a call for structural adjustment. The greater the general inflation rate, the more difficult it becomes to differentiate between these two components. Furthermore, inflation makes it difficult to tell which are real profits and which are fictitious profits. A great number of businesses have collapsed because of confusing the two. And, finally, inflation leads to the anticipation of even further inflation. The more perfectly this occurs, the smaller the chances that the impulses of economic policy will produce effects on the quantity of production and employment. Inflation is a major reason why Keynesian economic policies have become less and less successful.

### **Governmental Activities**

The importance of governmental activities when seeking an explanation for undesirable developments in the economy is obvious. A few facts and figures underline the point. Between 1960 and 1983 the average percentage share of government expenditure

in the GDP of all OECD countries increased from less than 30 % to a figure of about 50 %. Social expenditures account for approximately 60 % of this figure. To cover the spending governments have been obliged to step up their borrowing, with the result that in 1983 the government deficit in OECD countries averaged 4 % of GDP, with levels of up to 12 % in some countries. At the beginning of the seventies the corresponding figure was only half a percent. In other words: there has been a huge reallocation of resources by governments, primarily channelling them into the consumptive sphere. In a report just published, the OECD describes the implications of this trend for economic development as follows:

"The scale of these developments has raised sharp questions about feasible limits to the size of the public sector and the transfer burden, beyond which overall economic performance is seriously impaired. Worries include detrimental effects on individual and entrepreneurial initiative; disincentive effects of higher cash benefits and subsidies; distortions due to the level and pattern of taxation; and the inflationary and 'crowding-out' effects of public sector borrowing. In a number of countries voters are increasingly saying that existing tax burdens are too great and are asking for reductions in the size and scope of government activities."<sup>4</sup>

What is more, other forms of governmental influence on the economic process have increased. These "off-budget activities" include tax exemptions, tariffs and import quotas, credit practices, governmental regulation including that of prices and interest rates, and expenditures by non-budget agencies.

### **Labour Costs and Regulations**

The importance of labour costs and labour conditions for the confirmed adversity of economic development is clear, particularly in the majority of European countries. Labour costs, i.e. wages and salaries plus the marked increase in additional costs, increased more than producer prices and productivity together in probably all countries during the course of the seventies. This has been a major cause of the observed profit squeeze, which in its turn is one of the reasons for slack investment activities and thus for the decline in the level of employment. However, a different causal network is probably more significant in this context: there has been a rise in the costs of labour compared with the costs of

<sup>4</sup> OECD: The Longer-Term Performance of OECD-Economies: Challenges facing Governments, Paris 1984, p. 7.

capital, this shift in relative factor prices leading to the increased substitution of capital for labour. "Increased" in this context means to a greater extent than would have been induced by technological progress alone.

### International Conditions

This process of displacement has been particularly pronounced in areas in which the productivity of labour could only be raised to a limited degree on account of technological reasons – or administrative or other artificial barriers. For wages and salaries increased in a rather undifferentiated manner, the increase in labour costs per unit of output being particularly large in areas with below-average productivity. In order to do justice to the requirements of structural change, a more differentiated development pattern is needed for wages and salaries – according to regions, branches of economic activity and manpower qualification levels. On the whole, the displacement effect would have undoubtedly been less severe had the relationship of labour to capital costs not changed to the detriment of the former.

The detrimental effects of those labour regulations difficult to quantify in terms of money have also been substantial. This applies to both statutory regulations and regulations negotiated between employers and employees. These include dismissal protection regulations if these go so far as to make a reduction in the number of employees virtually impossible. Particularly worth mentioning in this respect are also those regulations designed to protect employees from the adverse consequences of rationalisation, not only from dismissal but also from loss of income and even labour reallocation measures. The latter case is nothing less than a clear barrier to any form of flexible response to the need for structural change. It is obvious that such regulations represent a serious disregard of the requirements of a functioning market economy. Their long-term adverse effects on employment are definitely much greater than their positive short-term effects on job preservation.

In view of the manifold problems and difficulties facing industrialised countries, with their accompanying adverse implications for developing countries, it is hardly surprising that the international framework is also in a bad way. To begin with, each individual country suffers from the fact that a growing number of countries try to "export" a part of their problems by erecting import barriers. The OECD confirmed that the number of restrictive trade agreements on manufactured imports introduced by the US, the EEC, Japan and Canada has quadrupled since 1975. The product categories currently subject to discriminatory and non-conventional forms of protection comprise at least 15 per cent of world trade in manufactures and a quarter of OECD manufactured consumption.<sup>5</sup> There is therefore a clear mutually detrimental interplay between the economic performance of individual countries and international conditions as a whole.

The debt crises facing many developing countries are also embedded in this framework of interaction. The second oil crisis and the subsequent unfavourable economic developments in industrialised countries have led to both quantitative export losses and a deterioration in the terms of trade for developing countries. These adverse effects were accompanied by the worldwide increase in interest rates caused to a large extent by the huge government deficits in the USA. All these factors accumulated to produce serious debt crises, even though their intensity often reflects misdevelopments in the developing countries themselves. In many cases, imported capital was not invested in such a way as to help meet debt-servicing obligations. Spreading debt crises subsequently, for their part, became a new element of uncertainty for the economic development of industrialised countries.

Finally, mention must be made of the sorry state of the international monetary system. Severe exchange-rate fluctuations, particularly against the dollar, are a common occurrence. This primarily reflects failings

<sup>5</sup> Ibid., p. 19.

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caused by economic policies pursued by individual countries. The significance of American fiscal and monetary policies in this context has already been mentioned. From time to time, reference is made to the relatively smooth development of the European Monetary System, particularly during the past 12 months, to support the suggestion that a worldwide system of fixed exchange rates should be re-established. However, the development of the EMS itself confirms that the decisive factor for stability in international monetary relations is not the type of system involved – i.e. fixed or floating exchange rates – but rathermore the policies pursued by the individual member countries. Without a certain degree of harmonisation between national policies there can be no stability in international monetary relations.

### Conclusions

What conclusions can now be drawn from this analysis? The main problem was shown to be how to improve the economy's ability to adjust to the inescapable need for structural change. Success in this endeavour will enable sustained economic growth and a decline in unemployment. In line with the four problem complexes addressed above, the following can be regarded as requirements essential to achieving this objective:

□ The stability of prices and costs – or to be more realistic: inflation rates which are kept as low as possible – are an important prerequisite for economic activities leading to economic growth. The basic requirement for such a path is a monetary policy which more or less follows the monetarist rule of money supply. The economy's supply of money should only expand so far as to enable the financing of the growth in real terms of productive capacity and a falling, in the short run inevitable, rate of inflation. This can only be effected smoothly if public sector borrowing and negotiated pay settlements stay within the limits of this monetary framework. If all these conditions are respected there will be a corresponding improvement in conditions for falling nominal and real interest rates.

□ Governments must create a framework of provisions and conditions which regulate, yet do not strangle, the economic process. Tax burdens must be dispensed with caution so as not to undermine the achievement motivation or weaken the willingness to invest. The governments should try to reduce the redistribution of resources rather than increase it even further. What is more, their policies ought not to go towards preserving existing structures in the economy but must confine themselves to facilitating structural adjustment.

Subsidies, therefore, must be degressive and of a temporary nature.

□ Labour must become cheaper in relation to capital. In expanding economies this does not require an absolute reduction in real wage levels but only a relative one, i.e. the increase in real wages must be lower than that of productivity. Pay increases must again be more strongly differentiated according to the various branches of economic activity, regions and qualification levels. Protective regulations, particularly far-reaching protection against the effects of rationalisation, must be reduced. Only then can the task of structural change be tackled without excessive frictional losses. Governments can support this task by pursuing a reasonable labour market policy to help retrain, upgrade and increase the mobility of employees.

□ The more consistently these principles are pursued in individual countries, the lower the risk of a lasting deterioration in the functioning of the international trade and monetary system. On the contrary, this may lead to an improvement in international conditions. Increased international coordination of national economic policies would undoubtedly be useful. However, priority must be given to the national efforts of individual countries.

Are there, finally, prospects for a sustained growth of the international economy? In principle they do exist. The slow growth since the start of the seventies cannot be explained by referring to the insurmountable barrier of an assumed general saturation of needs in industrialised countries. The main reason for the poor performance was the serious and widespread failure to restructure the economy. What is needed above all is a rectification of policy misdevelopments in the broader sense, i.e. what is termed a supply-side policy. Certainly often there will be an accompanying need for Keynesian-type demand management. Yet in the current situation this seems to be of secondary importance.

Have governments and the relevant social groups learnt their lesson? In many countries there are indications that they have. However, no one country can currently claim to have taken all the steps necessary to improve the situation. Admittedly, there is no denying that economic policy is a policy like any other, and that the discarding of a well-worn policy course should not be too abrupt. Most changes take a long time, usually longer than initially expected. Bearing this in mind, one can hope that during the next few years progress will be made in establishing the conditions needed to guarantee economic growth and prevent a stagnation of the international economy.