

Hamburg Institute of International Economics (HWWA) (Ed.)

Article — Digitized Version

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Intereconomics

Suggested Citation: Hamburg Institute of International Economics (HWWA) (Ed.) (1984) : The economic situation in Western Europe, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 19, Iss. 5, pp. 250-252,
<https://doi.org/10.1007/BF02928346>

This Version is available at:

<https://hdl.handle.net/10419/139939>

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The Economic Situation in Western Europe

After economic expansion in Western Europe had gathered considerable momentum during the autumn of last year, retardant factors again made their presence felt during the first half of 1984. This applied in particular to Britain and the Federal Republic of Germany, which up to this point in time had spearheaded the improvement in economic activity in Western Europe. However, the fact that production even fell at times in both countries was due to the impact of strikes. Italy and France also revealed renewed levelling-off tendencies. In most of the smaller economies, on the other hand, the upward economic trend would appear to have progressed at a relatively rapid pace. During the first half of 1984, GNP in real terms in Western Europe was 2 % up on the figure recorded one year previously, industrial production having increased by about 3 %. Even assuming a substantially slower expansion of capacities during recent years, these growth rates would indicate that there has only been a slight increase in capacity utilisation during this period.

The more restrained development of production has left the employment situation, for which there were at least signs of improvement in some countries last autumn, looking even more bleak. The jobless figure in Western Europe increased yet again and by mid-1984 corresponded to 11 % of the working population. On the other hand, restrained economic expansion led to a further containment of inflation. As a result, the increase in consumer prices has in most cases slowed down during the course of the year; the average rate of price increase compared to the previous year's figure fell to a level of just under 6 % by late summer.

Continuing Stabilisation Efforts

The further reduction in wage and price increases continued to be supported in a number of countries by income policy measures. A major prerequisite, however, was a stability orientated monetary policy. The emphasis placed by most Western European countries on such a policy has tended to increase; in Italy and France, too, the monetary scope for passing on costs

has now been reduced. A major part in all of this was played by efforts to limit the extent of the depreciation of European currencies against the US dollar because of the associated increases in import prices. For this reason, shortly after the middle of the year Britain's central bank dropped its rather expansionary monetary policy, after strikes had weakened confidence in the pound Sterling, by drastically increasing key interest rates. Apart from this move, however, the first half of 1984 witnessed a trend towards a slight reduction in interest rates in most Western European economies. Even though real interest rates – due to the parallel steadying of prices – did not fall, this development is worthy of note since it has resulted in a considerably wider interest rate gap between Western Europe and the USA, where the interest rate has continued its rising trend.

With reference to the change in the overall level of prices, the real interest rates for long-term capital in Western Europe remained unusually high, in most cases between 5 and 7 %. At the same time, however, they were appreciably below those in the USA, which had a mid-year level of between 9 and 10 %. This difference explains the continuing strength of the dollar on foreign exchange markets. The gradual increase in the gap during the course of the year has tended to tally with the cyclical differential between Western Europe and the USA. However, economic policy moves have also probably played a part.

Improved Propensity to Invest

According to the regular surveys in the industries of the European Community, there was another increase in the level of planned investments during the period between autumn 1983 and spring 1984 (March/April). This would result in an increase of about 7 % in real terms for 1984, following a decrease of 2 % in 1983. There is, therefore, an unmistakable tendency towards an improved propensity to invest. This undoubtedly reflects improved business profits, resulting not least from the wage restraint shown in all countries, even

though in varying degrees. The backlog with regard to process and product innovations was presumably another major factor. On the other hand, an investment dynamic which clearly goes beyond that, which is also directed towards the extension of plant capacities, does not yet appear to be evolving. Investments in non-industrial fixed assets in Western Europe continue to be subdued during the course of 1984. Residential building, for example, is adversely affected by high interest rates and the unfavourable income and employment prospects of private households. Public-sector investments are also increasing only slightly or in fact falling in the face of greater efforts to cut government budget deficits.

Weak Increase in Private Consumption

In view of predominantly restrained wage agreements, stagnating employment levels and fiscal consolidation measures, the increase in disposable incomes in Western Europe has continued to slow down, even though the entrepreneurial income of private households has again begun to increase more rapidly. Despite the slowdown in price increases, incomes will only expand slightly in real terms. The propensity to consume will not, in all probability, increase to any mentionable degree. Altogether, therefore, there will only be a marginal increase in private consumption in Western Europe this year.

Exports Slowing Down

Exports in Western European economies continued to be stimulated by the expansion of each other's demand, trading links intensifying markedly during the course of the general economic improvement. There was also a pronounced increase in exports to regions outside of Europe during the first few months of 1984. However, the stimuli from this source appear to have died down after this initial period.

Since the restrained economic improvement resulted in a slower growth in real terms of imports than exports, the seasonally adjusted foreign trade deficits fell again markedly at the beginning of 1984. Rather than continuing during the second quarter of 1984, there has apparently been a reversal of this trend.

The combined balances on current account of the Western European economies in 1983 showed a slight surplus for the first time in five years. This surplus probably increased during the first half of 1984. Favourably influenced by the cyclical differential, in particular with regard to the USA, external adjustment in Western Europe is thus so far advanced that currently

hardly any one country is faced by an urgent need to take economic policy action in this respect.

Outlook

Any forecast of the future development of the Western European economy is at present particularly hampered by the fact that the analysis of developments so far this year has failed to reveal any clear trends. The problems – primarily caused by strike action – associated with assessing economic trends in Britain and West Germany are significant in this context, since these two countries led the economic improvement last year. The resultant stimuli were of key importance to the rest of Western Europe. Were they to subside, the other two major economies, France and Italy, would not – at least not yet – seem able to assume the role of economic motor, in accordance with the “cyclical seesaw” pattern recorded during the sixties. The smaller countries for their part, whose economies have registered a marked expansion in the wake of the stimuli they have received, lack the economic power to take on such a function.

Western Europe's economic instability, therefore, which in the early phase of economic recovery during the last winter six months seemed to be disappearing as a result of the mutual reinforcement of expansionary stimuli, has once more increased. This finds its expression in the overall business climate, as reflected in the regular opinion polls in which enterprises are questioned as to the situation and prospects in their branch of industry. Since here too the influence of transitionally effective factors – such as strikes and their consequences – cannot be fully eliminated, the current forecast is obliged to rely to an even greater extent on an assessment of major internal and external economic parameters.

The development of the US economy undoubtedly ranks as a major factor among the external stimuli influencing the course of economic events in Western Europe. At the same time, however, it is worth bearing in mind that Western Europe's exports to the USA only account for a quarter of total exports to regions outside Europe. This puts in perspective both the boom in exports to the USA during the past as well as the expected levelling off, particularly considering that supplies to developing countries and state-trading countries have again been increasing slightly for some time. Economic policy aspects, and especially the monetary links with the USA, are more significant than direct demand links anyway. Although the development during the course of 1984 has up to now shown that successes with regard to the containment of inflation and the consolidation of public finances have reduced

the intensity of interrelations in this field, the developments of interest and exchange rates in the USA continue to represent an element of lasting uncertainty for economic policies pursued in other countries. However, it is assumed that the expected steadying of economic developments in the USA will, at the latest next year, result in a changing trend for interest and exchange rates. The extent of this change, however, will depend to a substantial degree on the clarity of consolidation efforts shown by American fiscal policies.

Under these circumstances, the importing capacity of developing countries is unlikely to benefit in the near future from noticeably reduced interest rates. On the contrary, it is once again adversely affected by the fall in raw materials prices since last spring. There will also hardly be any noticeable improvement in the balance-of-payments situation of the oil exporting countries. Under these circumstances, exports by Western Europe to overseas markets other than the USA are only likely to increase slowly during the coming year too.

The general economic policy setting in the Western European economies will probably continue to be marked by economic policy efforts to sustain a gradual improvement of conditions for growth via stabilisation and consolidation. On the one hand, this means that hardly any economic policy measures can be expected which are designed to stimulate demand. On the other hand, the clear successes in curbing inflation will strengthen the effects of the policies oriented towards steady growth.

Restrained Increase in Production

Above all, the improved profit situation, which is not solely due to cyclical factors, would suggest that

business investments in plant and equipment will continue to increase, particularly in view of the urgency of numerous projects following many years of slack investment. However, the pace of this increase will remain restrained, a major reason being the continuingly adverse effects of high real interest rates on the propensity to invest. These effects will be most markedly felt in the field of residential building, especially since a rapid improvement in income and employment prospects cannot be expected. Private consumption in Western Europe, therefore, will initially only continue to rise slowly; indeed, in some countries it will decrease, particularly since probable further rectifications of income distribution with the effect of promoting growth will, to begin with, automatically be effected to the detriment of private households.

On the whole, there are at present hardly any signs in Western Europe of an acceleration of the economic upswing in the near future. However, there are also no indications of any new misdevelopments likely to trigger a relapse into stagnation and recession. GNP in real terms in 1984 will probably increase by an average of 2 to 2.5 %, rising at a similar rate in 1985. Although the individual economies can claim varying degrees of progress so far with regard to the improvement of growth conditions, the growth rates of production will be quite similar, a major reason being the compensatory effects produced within this region by the close economic links. This forecast of the development of demand and production in Western Europe shows hardly any signs of improved employment prospects; in fact, unemployment is likely to reveal a further slight increase.

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

HWWA Index of World Market Prices of Raw Materials¹ (1975=100)

Raw Materials and Groups of Materials	1983	1984						
	AA ²	April	May	June	July	August	August 31	Sept. 14
Total index	209.3	207.6	207.4	206.1	204.7	204.0	204.2	203.3
Total, excl. energy raw materials . . .	122.8	131.2	130.9	127.6	124.2	122.1	122.7	120.7
Food, tropical beverages	116.8	129.2	132.8	125.6	120.0	117.0	117.8	117.0
Industrial raw materials	127.4	132.8	129.5	129.2	127.3	125.9	126.4	123.5
Agricultural raw materials	125.5	131.6	129.9	134.2	132.5	131.5	131.8	128.9
Non-ferrous metals	145.0	146.8	140.4	135.7	132.9	131.8	132.3	126.6
Energy raw materials	259.8	252.2	252.0	251.9	251.7	251.8	251.8	251.6

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