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World Economy: Restrained Trend in 1985

by Günter Großer and Günter Weinert, Hamburg*

In 1984 the world economy witnessed the kind of high growth rate it had last seen eight years ago. In the industrialised countries real GNP increased by almost 5 %. The most pronounced increase was in the USA, although the initial thrust clearly tailed off during the course of the year. Against this background what are the prospects for the world economy during 1985?

The international economic upswing since early 1983 has been strongly influenced by developments in the USA. There was an almost 7 % increase in overall production there last year, the rest of the world benefitting from the subsequent demand impulses. The volume of imports in the USA, the world's largest importer, increased by over a quarter. An additional factor contributing to this development was the continuous increase in the value of the dollar, which further strengthened the international competitive position of non-American suppliers. The expansion of exports was particularly invigorating for the Japanese economy, which has much closer economic ties with the USA than the Western European economies. In addition, Japan has made considerable progress in improving its internal conditions for sustained growth during recent years.

The figures for the entire year, however, conceal a clearly changing trend during the course of the year, especially in the USA. The economic upswing there between the beginning of 1983 and mid-1984 was marked by an over 7 % annual increase in real GNP, the highest increase in the whole post-war period. However, the annual growth rate then fell abruptly to approximately 2 %. As the stimuli caused by the tax reductions and the expansionist monetary policy pursued in 1982/83 began to die down, accompanied by a clear abatement of cyclical impulses, the retardant effects of high interest rates and the strength of the dollar began to take their toll.

Even though the drop in overall demand in the USA did not hit imports with full force there was a clear weakening of demand stimuli for the rest of the world. In Japan, for example, there was a deceleration in the

expansion of the economy during the second half of 1984, albeit nowhere near the extent recorded in the USA. The consolidation of the internal stimulating forces helped Japan in this respect. In particular, the considerable improvement in the profits situation for businesses there has stimulated the propensity to invest.

Whereas the increase in Japan's real gross national product in 1984 probably reached about 5½ %, the GNP increase in Western Europe was only slightly more than 2 %. The development of production during 1984 was disrupted by industrial action in the German metal industry and the British coal-mining industry. However, up until the end of the year both demand and production were characterised by a restrained upward trend; since the middle of the year there has been a further slight improvement in the business climate. Here too, however, high interest rates had a clearly adverse effect. Although Western European currencies have clearly depreciated in value against the dollar for the fourth year running, there was only a slight "decoupling" from the level of real interest rates in the USA. This would indicate that the adjustment and, in many cases, stabilisation successes are still not able to boost confidence in a removal of obstacles to growth in the near future. Indeed, the continued policy of consolidating public finance in Western Europe has only managed to prevent any further increase in deficits.

Employment: Improvement in USA only

Only in the USA has economic recovery during the last two years been strong enough to bring about any substantial improvement in the employment situation. The noticeable increase in demand was not the only reason for this development. It would appear that the continuing restraint shown in wage settlements and the

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widespread willingness of workers to accept a differentiation of their remuneration according to the profitability of their jobs have also contributed towards the improved situation. Despite a considerable increase in the labour force potential, therefore, the rate of unemployment fell by a third within two years to just over 7 % at the end of 1984. In Western Europe, on the other hand, where the economies as a whole have expanded to a much lesser degree and wage restraint has been less pronounced than in the USA, the rate of unemployment has even increased a little during the course of 1984, now figuring at an average 11 %. This does not include the unemployment "hidden" by labour market policy measures.

There were further successes last year in the fight against inflation. In Western Europe the stability shortfall was partly made up. This was particularly the case in countries which still have high inflation rates, such as France and Italy, although the gap to the Federal Republic of Germany, Switzerland and the Netherlands, with their internationally well-below-average inflation rates of between 2 and 3 % remained considerable. Income policy measures, whose main effect was to keep increases in wage levels low, helped slow down the increase in costs and prices in many countries, for example in Italy, France, Belgium, the Netherlands and Scandinavian countries. Despite the

vigorous economic upswing in the USA, the expected cyclical reinforcement of price increases did not materialise. Japan enjoyed virtual price stability.

Last year saw a changing trend on international raw materials markets. The HWWA index of world market prices for raw materials excluding energy, calculated on a dollar basis, recorded its peak figure in March 1984 and had fallen by 13 % by December. This was only partially caused by the appreciation of the dollar. Calculated in Special Drawing Rights the decline still amounted to 6 %. The reason for this trend was a levelling-off of the cyclical increase in demand for raw materials and the growing pressure of abundant producer capacities on the supply situation. As was the case during the relatively insubstantial increase in raw materials prices in the phase of particularly pronounced expansion, the continuing containment of inflationary expectations via the stability-oriented monetary policies pursued by most industrialised countries since the early sixties has also been a major determinant factor.

Impact of Exchange Rates on Prices

The development of the costs of raw materials and the external cost stimuli in individual industrialised countries, however, were dependent to a considerable degree on the development of exchange rates. Whereas the prices of raw materials for manufacturers

Economic Indicators

	Real Gross National Product (Year-on-year change in %)				Consumer Prices (Year-on-year change in %)				Exchange Rates ¹ (Change over 12 mths in %)		Unemployment Rate ²	
	1975-82 ^a	1983	1984 ^b	1985 ^b	1975-82 ^a	1983	1984 ^c	1985 ^b	Dec. 1983	Dec. 1984	1983	1984 ^d
USA	2.1	3.7	7.0	2.5	8.8	3.2	4.5	4.5	6.3	9.8	9.6	7.5
Canada	2.2	3.3	4.5	3.0	9.7	5.9	4.5	4.0	1.0	-3.4	7.6	11.2
Japan	4.4	3.4	5.5	4.0	6.5	1.9	2.0	2.5	8.1	-0.8	2.7	2.7
Western Europe ³	1.7	1.3	2.3	2.2	10.8	7.1	6.2	5.3	9.8	10.5
Austria	2.2	2.1	2.5	3.0	5.9	3.3	6.0	3.5	-0.4	0.5	4.5 ^e	5.0 ^e
Belgium	1.6	0.4	1.5	2.0	7.6	7.7	6.5	5.5	-2.6	1.3	12.4	12.6
Denmark	1.9	2.5	4.0	3.0	10.4	6.9	6.5	5.5	-3.9	1.2	10.3	10.3
Finland	2.6	2.9	4.0	3.5	11.6	8.5	7.5	6.5	2.3	2.2	6.1	6.1
France	2.3	0.9	1.5	1.5	11.2	9.6	7.5	6.0	-7.1	-1.0	8.9	10.1
FR Germany	1.8	1.3	2.5	2.5	4.8	3.3	2.5	2.0	0.6	-0.5	8.2	8.2
Great Britain	1.0	3.0	2.0	2.5	14.5	4.6	5.0	5.5	-0.2	-8.2	11.3	11.6
Ireland	3.3	0.6	3.0	2.5	16.1	10.5	9.0	7.0	-7.5	3.0	13.1	14.7
Italy	1.9	-1.2	3.0	2.5	16.6	14.7	11.0	8.5	-4.5	-2.4	9.9	10.8
Netherlands	1.2	1.2	2.0	2.0	6.6	2.8	3.5	2.0	-1.2	-1.0	14.0	14.6
Norway	3.5	3.2	3.5	2.5	9.8	8.4	6.5	6.0	1.9	-2.5	3.1	3.3
Spain	1.5	2.1	2.5	3.0	17.3	12.1	11.5	10.0	-9.9	2.5	17.8	20.2
Sweden	1.1	2.3	3.0	1.5	10.4	9.0	8.0	7.0	2.6	2.5	3.5	3.2
Switzerland	0.1	1.0	3.0	2.0	3.8	3.0	3.0	2.5	5.4	-3.6	0.2	0.3
OECD Countries Total ³	2.3	2.7	5.0	2.5	9.3	4.6	4.8	4.5	8.3	8.0

¹ External value of currencies weighted by share in international trade 1979. ² In % of total number at or available for work. ³ Total of listed countries weighted by real gross national product or private consumption or numbers available for work respectively in 1982. ^a Average year-on-year change. ^b Estimated or forecast; figures rounded as a rule to nearest 0.5 %. ^c Partially estimated; figures rounded as a rule to nearest 0.5 %. ^d Partially estimated. ^e In % of employed persons.

in the USA already began falling in spring 1984, in line with the fall in world market prices, Western European manufacturers found themselves facing a substantial increase in prices up until the autumn as a result of the continuing depreciation of their currencies against the dollar. There was a similar development in the field of oil imports, where prices only fell on international spot markets, while OPEC's official export prices were maintained with the help of further cutbacks in the agreed production quotas. In general, the shift in the exchange-rate relations, which did not correspond to the changes in purchasing-power parities, contributed

towards keeping down the increase in prices in the USA. In most Western European countries, on the other hand, the shift tended to push prices up, thus making stability-oriented policies all the more difficult.

The developing countries were particularly strongly influenced by impulses from the USA last year. The USA, for example, accounted for the lion's share of the substantial increase in the export revenue of these countries during the first six months of 1984. The relief provided by this welcome development to the balance-of-payments situation of developing countries was much greater than the strain placed on them by the

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V E R L A G W E L T A R C H I V G M B H - H A M B U R G

renewed increase in the interest rates for dollar credits up until last summer. Since then, however, the waning thrust of the US economy has resulted in changing trends in both international trade and interest rates. Whereas the increase in the export earnings of developing countries has above all been adversely affected by the slowdown of expansion in demand in the USA and falling world market prices, the decline in interest rates has reduced the debt service. Although the combined deficit on current account of developing countries again fell slightly in 1984, this figure is likely to increase again in 1985 with imports increasing slightly this year. The slowdown of economic growth in the industrialised countries, therefore, will thus make it more difficult to further defuse the debt crisis.

Uncertainty over Economic Setting

The international economic setting in 1985 will again decisively depend on developments in the USA. The fact that there is still no sign of speedy success in efforts to reduce the budgetary deficit with its accompanying effect of pushing up interest rates following President Reagan's re-election makes the situation all the more problematic. The simultaneity of efforts to consolidate public finances and to restructure the tax system poses an additional difficulty. The neutrality of the effect of the reform on revenue announced earlier is now being questioned to an increasing degree, after the first draft bill had struck a rough balance between the additional financial burdens for businesses and the relief for private households. In view of the apparently substantial divergence of opinions between the government and Congress on spending cutbacks and tax changes, there is at least the danger of a longer period of uncertainty with regard to the nature and pace of consolidation efforts. Against this background, the easing of American monetary policy introduced during recent months is bound to be accompanied by caution so as not to encourage doubts about the stability orientation of the central bank. To begin with, interest rates in the USA will only drop to the extent to which the easing of the economic situation influences financial markets. A marked depreciation of the dollar is unlikely.

Under these circumstances, the economic trend in the USA will be subject to conflicting influences. On the one hand, the tax reductions during recent years and continuing wage restraint have enabled a clear recovery of profits and deregulations have extended the scope for more dynamic business activities. On the other hand, the continuing increase in the structural budget deficit has misdirected more and more monetary capital into consumption, i.e. away from private investments. On

the whole, the marked improvements in the conditions for growth recorded during recent years will allow expansionary forces to prevail in 1985. One major reason is that during the upswing period an excessive utilisation of resources was avoided and the emergence of inflationary tendencies prevented. Monetary policy has thus not been constantly obliged to effect stability policy measures. However, investor and consumer demand will probably expand very moderately to begin with under the influence of the high interest rates. Business stockbuilding will tend to produce restrictive impulses for a time. Furthermore, as a result of the further increase in the dollar rate American producers will at home and abroad again lose market shares to the more competitive non-American suppliers. The probable increase in real GNP in the USA in 1985 of just under 3 % will only just about correspond to capacity growth. Only limited progress, if any, is thus likely with regard to the reduction of unemployment.

Reduced Demand Stimuli from USA

The changing trend in the USA will also have an important effect on economic developments elsewhere in the world. Demand stimuli will be noticeably reduced due to the decrease in the import pull from the USA. This poses all the more the question, on the other hand, as to how far the retardant influences via the close monetary link with the USA, which have tended to inhibit the development of domestic demand in the other industrialised countries, will at the same time slacken off. The cyclically induced lowering of interest rates in the USA since the autumn has apparently in the rest of the world created greater room for interest rate cuts, which many countries are anxious to make use of; this is also a contributory factor towards the continuing strength of the dollar on foreign exchange markets. The loosening of the monetary reins in the USA reduces the probability that the Western European central banks, as so often during recent years, will with an eye on exchange rate developments keep the growth of money supply lower than appropriate domestically. However, it would be mistaken to place too much emphasis on the reduction of external constraints on the course of economic policy. On the one hand, the lack of clarity as to the nature and pace of public finance consolidation in the USA is likely to last until well into 1985; on the other, the improvement of the internal conditions for growth in Western Europe still lags well behind developments in the USA and Japan.

In Japan the prospects for a marked increase in domestic demand, sustained by a much increased investment propensity, are good despite the distinctly

reduced stimuli from exports. The economy, therefore, will continue to expand at a notable pace; GNP in real terms will probably grow by about 4 % in 1985. In most Western European economies, on the other hand, there will only be moderate increases in overall demand and production. However, here too the structure of the expansive forces will improve together with the general increase in the propensity to invest. First successes are thus visible of the many years of efforts to improve the conditions for economic growth. This obviously provides sufficient support to the upward trend to dispel fears of another immediate downswing, despite the waning impulses from economic policy and the flagging demand stimuli from the USA. However, the obstacles to a self-sustaining economic upswing are still substantial; apart from the effects of the cyclical improvement in 1983/84 there has only been a slight recovery of business profits following a long period of erosion. The unavoidable processes of adjustment, in particular in connection with continuing consolidation efforts, also have, for the time being, a distinctly detrimental effect on private consumption and public demand. In view of all these factors, real GNP in the Western European economies will probably increase on average by little more than 2 % in 1985.

Economic growth for the industrialised countries as a whole will probably figure at about 2½ % in 1985, half the figure recorded in the previous year. The slowdown of economic expansion, however, which primarily reflects developments in the USA, already set in towards the end of 1984. The same applies to the increase in real terms of world trade, which at roughly 9 % surpassed all expectations in 1984 and is likely to fall by half in 1985. The major factor for this development is the subsiding import boom in the USA; but Western Europe's foreign trade will also expand at a slower pace due to the diminishing importance of stockbuilding. The imports of developing countries will probably increase

slowly. Following the painful process of adjustment in recent years, these countries will endeavour to take advantage of their increased scope in international trade; however, this scope will be restricted by the slowing-down of economic expansion in the USA, especially since in this situation the prices of raw materials will be under pressure. In view of the generally falling oil prices the foreign trade position of many OPEC countries will remain strained.

Conclusions

The state of the world economy has improved during two years of increasing production. Capacity utilisation has increased almost everywhere and in most countries the increase in unemployment has, at least, almost come to a standstill. Inflation has been checked to a substantial degree, and it has been possible to prevent the acute international debt problems from reaching boiling-point. Although these developments reflect considerable successes of economic policies, they are only first steps along the path towards sustained economic growth and a satisfactory employment situation. The powerful upswing in the USA helped offset the retardant effects of the stabilisation and adjustment process in the rest of the world. However, the high budget deficit in the USA reflects a still unsolved and serious adjustment problem in the world's leading economy and the degree of progress made with regard to the improvement of conditions for growth in other countries is still relatively limited, as shown by the weak position of their currencies. The tasks facing economic policy in the industrialised countries in 1985 will thus be no easier than in previous years, above all because the slowing-down of economic expansion in the USA and the accompanying weakening of the dynamics of the world economy will make it difficult to maintain strategies which can only be successful in the longer run.

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

Raw Materials and Groups of Materials	1983		1984				1985	
	AA ²	December	AA	October	November	December	Jan. 4th	Jan. 18th
Total index	209.3	205.7	205.0	202.8	202.6	201.1	200.4	200.8
Total, excl. energy raw materials . . .	122.8	127.4	125.1	119.5	118.6	115.0	113.2	114.4
Food, tropical beverages	116.8	126.7	122.7	116.2	116.0	111.9	111.1	112.9
Industrial raw materials	127.4	127.9	126.9	122.0	120.6	117.4	114.8	115.6
Agricultural raw materials	125.5	130.0	128.6	125.8	119.6	115.9	112.1	111.7
Non-ferrous metals	145.0	139.8	135.8	125.8	131.7	127.8	128.0	131.6
Energy raw materials	259.8	251.4	251.7	251.5	251.6	251.4	251.3	251.3

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