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The world economy in summer 1985

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ECONOMIC TRENDS

The World Economy in Summer 1985

The world economy's upward trend has lost a great deal of its momentum. Expansionary economic forces were restrained during the first few months of this year. This was particularly apparent in the case of the USA, where production only managed to increase at a relatively slow pace. Admittedly, as a result of the continuing strength of the dollar the powerful demand impulses there have clearly benefitted foreign exporters. But also in Japan and Western Europe the increase in overall demand and production has on the whole clearly tended to slow down. There has been hardly any change anywhere in the high level of unemployment. A slight acceleration of inflation in Western Europe was caused by weather-induced price increases and the renewed revaluation of the US-dollar during the first few months of the year. This was followed by a changing trend on foreign exchange markets. Nevertheless, the dollar still retains its powerful position after four-and-a-half years at a very high level.

Table 1
Production and World Trade
(Year-on-Year Change in %)

	1984	1985	1986
Real Gross National Product			
Western Europe	2.4	2.2	2.2
USA	6.8	3.0	2.5
Japan	5.8	4.5	4.0
Industrialised Countries Total	4.8	3.0	2.5
Real World Trade	9.0	5.0	4.5

The current particularly marked overlapping of cyclical and fundamental factors makes it difficult to analyse and forecast economic developments in both the USA and in other industrialised countries. The development on energy markets would indicate an improvement of the conditions for the growth of the world economy in the wake of the successful processes of adjustment during recent years. The response to the two oil-price explosions averted – in the face of the continuing Gulf War – the risk of a new oil price shock during the upswing period in the industrialised countries. This in turn was an important precondition

allowing the worldwide containment of inflation during recent years to be accompanied by a definite recovery of business profits. This development not only reflected the improved utilisation of economic capacities, but also a generally more or less clear moderation in pay settlements. The shift in the distribution of incomes in favour of businesses was bolstered in many cases by fiscal-policy taxation measures.

There are, however, signs that the necessary processes of adjustment have not yet made sufficient headway. At an average of 4½ %, the rate of inflation for private consumption shows that despite the stability policies which have been pursued for almost five years now and despite high unemployment the level of price increases in the industrialised countries is still about twice as high as the long-term average before the worldwide acceleration of inflation at the end of the sixties. This indicates both the persistence of inflationary expectations as well as the fact that there is a relatively limited scope in many industrialised countries for social consensus on the need to stimulate growth by effecting a shift in the distribution of incomes in favour of businesses.

There are still considerable differences between individual countries with regard to social and economic conditions and economic policy. This is true, on the one hand, within Western Europe, where the process of stabilisation and external economic adjustment is at an advanced stage in, for example, the Federal Republic of Germany, is still on the way in France, and is already again in question in Italy – despite the fact that this country has the greatest backlog in this respect. On the other hand, there are substantial differences between the Western European economies and the USA. The many years of adverse developments for the fundamental conditions for growth in Western Europe were accompanied by a greater expansion of the public sector, a more extensive regulation of economic activities, and greater inflexibility in wage agreements and on the labour market than in the USA. In the USA,

on the other hand, President Reagan's policy of stimulating the dynamics of free market growth via extensive tax cuts has not achieved the lasting success originally expected. The limitation of public spending has by and large failed to materialise and the continuing increase in the structural budget deficit led to high real interest rates, an overvaluation of the dollar, and an alarming deterioration of the balance on current account. The need for measures to rectify these detrimental short-term developments now seems more urgent than in the case of the longer-term fundamental problems facing Western Europe.

More recently, however, longer-term, strategic aspects have again prevailed in fiscal policy decisions in the USA. The recently announced tax reforms, which envisage a substantial decrease in the tax rates accompanied by a restriction of tax concessions, are ultimately intended drastically to reduce fiscal interventions in the market mechanism without changing the total tax burden. This intention automatically reduces any emphasis on solving consolidation problems. The signs of progress in attempts to cut back the budget deficit are now jeopardised by the uncertainties associated with these

tax reform proposals, particularly during the lengthy run-up period to their official adoption. Monetary policy in the USA, which primarily for cyclical reasons has been pursuing an expansionary course since last autumn, will have to do even more to dispel doubts about its basic stability orientation, since stability can no longer be imported via a rising dollar exchange rate.

The uncertainty of developments in the fiscal and monetary policy fields in the USA still represents a considerable risk for the world economy, particularly in view of even more serious domestic obstacles to growth in most other countries. However, since a great deal indicates the permanent nature of the changed trend in the dollar exchange rate, a major disruptive factor for the pursuit of a consistent and potential-oriented monetary policy will soon no longer exist. In view of the current expectations of interest rate reductions in the USA a process of interest rate reduction has also been able to develop in the other industrialised countries even in the absence of an expansive monetary policy. Despite a slight decline, however, real interest rates are still high.

All in all, general economic conditions in both the USA and in most other industrialised countries seem to be

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GOLD, PLATINMETALLE UND DIAMANTEN IN DER SOWJETISCHEN HANDELSPOLITIK

- Produktion, Export, Eigenverbrauch, Reserven -

(GOLD, PLATINUM METALS AND DIAMONDS IN SOVIET TRADE POLICY)

- Production, Exports, Consumption, Reserves -

This study centres on the question as to the importance of the production, export and stock-building of gold, platinum metals and diamonds for Soviet trade policy's financial room for manoeuvre. The data on mining output, sales, consumption and stocks in the USSR is probably unique, as the Soviet Union has not published official figures for several decades. Soviet activities on Western gold, platinum metals and diamond markets are described in detail and appraised. The general demand and supply relationships on these markets are also carefully depicted.

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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

such that expansionary forces, which have been strengthened in recent years, will be able to sustain a further upward tendency in demand and production. This is reflected, albeit to a differing degree in various countries, in the continuing growing propensity to invest. The future trend of industrial investments is not easily quantifiable. The still high real interest rates and the still considerable overall economic risks will probably mean that growth will remain relatively restrained in this field. Public sector demand will continue to increase rapidly in the USA, in particular in the military sector, whereas there will only be a slow increase in most other industrialised countries. Real disposable incomes and private consumption will probably increase at a moderate pace in the USA and Japan, but only a slow pace in the remaining countries.

Domestic demand in Western Europe will generally continue to expand much more slowly than in the USA. Even allowing for a trend towards a gradually falling dollar exchange rate, however, the competitive position of American suppliers will remain unfavourable. The shift in the international flow of goods and services at the expense of the USA will continue. The increase in real GNP in the USA at mid-1985 of almost 3 % will probably not be much higher than the expected average of 2 to 2½ % for Western European economies, and lower than Japan's 4½ %. The forecast of no more than a moderate increase in production in the industrialised countries is primarily based on the still cautious assessment of the true expansionary forces. No noticeable change in the pace of world economic expansion is to be expected in 1986 either, thus implying that there will also be no improvement in the – especially in Western Europe – high unemployment level.

The flagging of the cyclical upswing in the USA means that a major impulse for the improvement of the foreign

trade situation of developing countries has also weakened. This is not only due to the slower increase in the American demand for imports from these countries, but also due to the impact on raw materials prices. Although the falling interest rates in the USA will reduce the interest burden of developing countries, these countries will hardly be able to improve their generally weak economic growth in the near future. Their imports, therefore, will only increase at a moderate pace. In view of the continuing pressure on export prices and quantities in OPEC countries there may in fact be a further reduction of imports in these countries.

The smouldering debt crisis in a number of major developing countries still places a burden on the international financial system, making it even more difficult to reduce interest rates on a worldwide basis. A more serious risk, however, since it emanates from the world's leading economy, is the still precarious "balance" between the interest-rate-raising effect of the budget deficit and the confidence-building stability orientation of the central bank in the USA. The exaggerated strength of the dollar would in the long run lead to structural misdevelopments of the economy in both the USA and partner countries. On the other hand, sudden rectifications of the dollar's exchange rate could subject the world economy to a new shock. The happy medium of continuous adjustment, however, is difficult to find in the field of economic policy. All in all, therefore, despite the strengthening of the underlying expansionary forces of growth in the industrialised countries the instability of the world economy, resulting from inadequate and misguided economic policy decisions, has not appreciably improved.

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	AA ²	1985						
		February	March	April	May	June	5. 7.	19. 7.
Total index	205.0	197.7	197.0	198.1	197.6	196.8	196.4	197.2
Total, excl. energy raw materials	125.1	114.1	112.6	115.0	113.8	111.4	110.7	112.2
Food, tropical beverages	122.7	111.4	111.3	110.7	107.3	105.9	103.1	102.6
Industrial raw materials	126.9	116.1	113.5	118.4	118.7	115.6	116.4	119.6
Agricultural raw materials	128.6	112.0	106.9	109.8	111.5	109.5	111.1	114.2
Non-ferrous metals	135.8	131.6	131.2	137.9	138.6	133.0	132.2	135.3
Energy raw materials	251.7	246.6	246.2	246.6	246.5	246.6	246.5	246.8

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