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Restrained Expansion of the US Economy

The development of the US economy is marked by the tailing-off of the rise in production. During the first six months of 1985 GNP in real terms only increased at an annual rate of 1 %, as opposed to 3 % in the second half and almost 9 % in the first half of 1984. The reduction in stockbuilding further contributed to the slowdown. Final demand managed to increase at an annual rate of a good 2 % between the final quarter of 1984 and the first quarter of 1985, and domestic final demand even increased at twice this rate. In view of the only slight increase in production the number of employed persons has grown only slowly since spring; the rate of unemployment remained at 7 %. Consumer prices have so far risen at a current annual rate of between 3½ % and 4 %.

The increase in domestic final demand was sustained by both private consumption and business fixed investment. Private consumption increased during the first six months of 1985 at an annual rate of approximately 5 %. This substantial increase is all the more surprising in view of the fact that there was a clear downturn in the expansion of disposable incomes, primarily caused by the slowdown of the increase in the number of employed persons. Private households revealed a greater propensity to consume; the savings ratio fell during the first six months of 1985 to just under 5 % (1984: 6 %). The increase in industrial fixed investment had already begun to tail off during the second half of 1984; since then it has been increasing at a current annual rate of between 6 and 7 %. Although the drop in interest rates has continued, demand for residential buildings has hardly increased in recent months. Expectations of even lower financing costs together with the less favourable income expectations of private households are two probable explanatory factors here.

The increase in exports in real terms, which amounted to 6.4 % on an annual average in 1984, did not continue into 1985. In fact, there was a marked decrease in seasonally adjusted terms, reflecting the substantial drop in agricultural exports. Although there was a continuing slowdown of the increase in overall demand,

commodity imports in real terms continued to expand at a brisk, albeit more recently slower pace. During the first half of 1985 they were roughly 10 % up on the previous year's figure. The balance of trade deficit has again increased, although the terms of trade improved notably at the beginning of the year and hardly responded initially to the changing exchange-rate trends. The import surplus reached a seasonally adjusted figure of US \$ 71.7 billion (fas values) during the first seven months of 1985, compared with US \$ 108 billion for the whole of 1984.

Following a much more pronounced increase of the money supply M1 than originally intended in the announced target range of 4 to 7 % during the first six months of the year, the central bank revised its target figures. It not only extended the range for the rest of the year to 3 to 8 %, but also raised the reference base from the level of the fourth quarter of 1984 to that of the second quarter of 1985, thus sanctioning the considerable increase recorded during the first six months of 1985. However, by the end of August M1 had again overshot the new target range. This clearly shows that, in view of the unstable economy, the central bank shys away from restrictive measures to achieve its monetary objectives. As at the same time substantial unused capacities and supply pressure, in particular on food, energy and raw materials markets, counteracted the emergence of new inflationary fears, the fall in interest rates – and with it the depreciation in the value of the dollar – has continued.

The combination of "cyclical" and "structural" factors implies a considerably larger budgetary deficit for the current fiscal year. According to the latest official forecast of US \$ 211 billion, it will account for 5½ % of GNP in nominal terms. Consolidation efforts, however, are making little headway. Although the Senate and the House of Representatives agreed on a joint draft for the next budget envisaging a number of cuts, even the attainment of such targets – very unlikely in the case of some cuts, e. g. in the agricultural budget – would only represent an initial consolidatory move in the right direction. A reduction of the deficit by half during the

coming years, as assumed by intermediate budgetary planning, presupposes a rapid upward economic trend and a further drop in interest rates as well as more substantial cutbacks.

The clear tailing-off of the rise in production is partly a cyclical phenomenon. In addition, however, there are apparently continuing obstacles to growth primarily resulting from the still high level of real interest rates and the accompanying high valuation of the dollar on foreign exchange markets. These developments are mainly due to the fact that for some years now domestic savings have been excessively taken up by government financing deficits. The neglect of consolidation is even more serious against the background of the uncertainties surrounding the current discussion on tax reforms. Despite the precarious fiscal policy situation the central bank has opted to try and lower interest rates and subsequently the dollar's exchange rate via a substantial increase in the money supply in an effort to stimulate demand and production. The continuation of rapid monetary expansion, however, would inevitably boost inflationary potential and jeopardise the arduously regained confidence in the central bank's stability orientation. This would ultimately cast doubts upon the planned reduction of interest rates and at the same time enhance the risk of an uncontrollable depreciation of the dollar. It is therefore assumed here that the central bank will attempt to again slow down monetary expansion in the near future. In view of the moderate inflationary expectations and the restrained overall economic situation this would probably be possible without a setback in the interest rate field.

The stimulating effects on demand and production of the fall up to now in interest rates will probably continue to remain limited. Demand for residential buildings will not increase to any noticeable degree in view of the undoubtedly subdued income expectations. The still high level of real interest rates is particularly important in

this respect. This factor will probably also impede a renewed improvement in the propensity to invest. Private consumption will probably not increase as rapidly as it has done, particularly since the propensity to save had already declined to an unusually low level by the middle of the year. At the same time, however, the contractive stimuli which have been emanating for about a year from the reduction in stockbuilding will decline. The considerably retarding influence exerted for a longer period by the external flow of goods and services on production in the USA will become weaker. However, the depreciation in the value of the dollar will lead to a deterioration of the terms of trade, thus burdening the balance on current account.

The decline in the dampening stock-cyclical effects and the slightly more favourable development of the external flow of goods and services will probably allow the increase in production to accelerate again. The pace of this development, however, will remain moderate due to the continuing obstacles to growth; on an annual average, GNP in real terms will probably be only 2½ % higher in 1985 than in 1984. In view of the expected less expansionary economic policy this growth rate will hardly be higher in 1986. Employment will probably increase somewhat, whereas unemployment will probably continue to more or less stagnate. Following the expansion of the money supply and the increase in the price of import goods as a result of the dollar depreciation, inflation will probably accelerate, although the competitive pressures on most markets will exert a restraining influence. All in all, consumer prices will increase by an average 3½ to 4 % during 1985 and at a somewhat higher rate next year.

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	1984	1985						
	AA ²	April	May	June	July	August	30. 8.	13. 9.
Total index	205.0	198.1	197.6	196.8	196.9	196.1	196.0	194.9
Total, excl. energy raw materials	125.1	115.0	113.8	111.4	111.6	110.4	110.2	108.3
Food, tropical beverages	122.7	110.7	107.3	105.9	102.4	99.8	99.8	99.0
Industrial raw materials	126.9	118.4	118.7	115.6	118.6	118.5	118.2	115.5
Agricultural raw materials	128.6	109.8	111.5	109.5	113.3	113.5	113.3	112.8
Non-ferrous metals	135.8	137.9	138.6	133.0	134.5	132.1	132.1	128.0
Energy raw materials	251.7	246.6	246.5	246.6	246.8	246.2	246.1	245.4

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