

Großer, Günter; Weinert, Günter

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World Economy: Restrained Expansion in 1986

by Günter Großer and Günter Weinert, Hamburg*

The pace of economic expansion in the world economy as a whole last year was strongly influenced by the cyclical slowdown in the USA. The increase in the real GNP of the industrialised countries, for example, fell from almost 5 % in 1984 to just under 3 % in 1985. Does this mean that the phase of economic recovery is already coming to an end or is there a chance that the general upward trend will continue?

With its almost 9 % increase in real domestic demand and 24 % increase in imports the US economy in 1984 was very much a "locomotive" for the world economy as a whole. In 1985, however, the locomotive began to run out of steam. In terms of the growth of its production, the USA's lead over other industrialised countries has even been completely eroded. The roughly 2½ % increase in real GNP in the USA, for example, was no higher than in Western Europe, and considerably lower than in Japan, even though Japan's increase of 4½ % considerably exaggerated current developments there.

The change in the dollar exchange rate trend was symptomatic for the end of the American "economic miracle". Whereas the dollar was still able to scale new heights in spring, its external value fell by almost a fifth against the currencies of the other industrialised countries by the end of 1985, thus dropping to its mid-1982 level. Concerted interventions by central banks on foreign exchange markets during recent months and the deliberate raising of interest rates, especially in Japan, temporarily contributed to this trend reversal. Decisive for the downward trend, however, were economic policies pursued in the USA itself. Whereas US fiscal policy was unable to bring down the budget deficit, monetary policy kept interest rates and the exchange rate under pressure, since the central bank assessed the risk of slipping into a recession as greater than the threat to stability via the creation of an inflationary potential. High expectations regarding the dynamic growth of the US economy were apparently reduced throughout the world. This probably partly explains why the fears that the exchange rate policy arrangements made by industrialised countries in September would, due to a fundamental strength of the dollar, lead to lasting monetary problems, soon proved unfounded. However, once again it became clear that the pursuit of

exchange rate objectives restricts monetary autonomy and is thus incompatible with a policy which sets out to improve conditions for economic growth via a potential-oriented money supply.

US Locomotive Losing Its Thrust

The decline in economic growth in the USA in 1985 was to a substantial degree cyclically induced. There was a pronounced decrease in stockbuilding, for example, which in the previous year had corresponded to a quarter of the rise in production. Industrial fixed investment also increased at a much slower pace. The retardant effects of high interest rates became more apparent as the stimuli emanating from tax reductions and improved terms of depreciation died down. There was still a relatively marked expansion, on the other hand, in private consumption, with the savings ratio dropping to a new low. Because of the dollar's high exchange rate, which only fell during the course of the year, a considerable part of the increase in demand "trickled away" abroad even in the face of the slower pace of economic expansion. With capacity utilisation declining in important industries and unemployment no longer falling protectionist efforts increased to a disturbing degree.

In other industrialised countries, the impulses which resulted from the import boom in the USA had above all stimulated industrial investments. Business enterprises also benefited from the progress made in keeping down wage increases. This was particularly true in the case of Japan. Nevertheless, the economic upswing already lost momentum there last year, since the contraction of the US economy and - in its wake - of many Southeast Asian NICs and developing countries affected over half of Japan's exports. In Western Europe, on the other hand, the abatement of external stimuli did not lead to a slowdown of the development of overall production due to their much less pronounced significance. The expansionary forces which, however, right from the very start had not been as powerful as those in Japan,

* HWWA - Institut für Wirtschaftsforschung - Hamburg.

increasingly reflected the tendency towards a growing improvement in the internal conditions for economic growth.

Unemployment Remains High

Whereas the restrained increase in production in the USA and Japan meant that there was apparently no further increase in capacity utilisation there in 1985, such an increase could be registered in Western Europe, since the path of potential production there had levelled off particularly markedly as a result of the long-standing reluctance to invest. The number of employed persons, on the other hand, generally increased, even in most Western European countries. The major exception was France, where there is now a need to carry out the adjustment processes economic policy had initially tried to avoid. In many countries, however, there was also a further increase in the labour supply. The percentage share of unemployed persons in the total labour force, therefore, remained high: over 7 % in the USA and 11 % in Western Europe.

The increase in prices, on the other hand, has in many cases slowed down even further as a result of the stabilisation efforts made for many years by central banks and governments. In the USA the price increase remained moderate throughout the year despite the acceleration of monetary growth and the depreciation of the dollar. The process of stabilisation in the other industrialised countries was now supported and no longer slowed down by shifts in exchange rate relations. Import prices have generally fallen since spring, especially since the restrained expansion of the world economy has kept raw materials prices under pressure. At consumer level, the average rate of inflation in industrialised countries of 4 % in 1985 was no higher than at the end of the sixties. Inflation rates were even lower in the Federal Republic of Germany, Japan and the Netherlands at about 2 %. The containment of price and wage increases in Denmark and France was particularly notable.

Economic Policy and Exchange Rates

One of the main reasons for the USA's gradual departure from its "benign neglect" approach in its exchange rate policy last autumn was its concern that protectionist pressures at home would otherwise become irresistible. Bearing in mind this aspect, foreign exchange market operations and a monetary policy geared to lowering interest rates and the dollar's exchange rate worked hand in hand. A continuation of this approach over a longer period, however, is bound to trigger inflationary expectations. This will be particularly

the case if the resolutions adopted by Congress on the consolidation of public finance are not soon followed by specific measures. For continuing and excessive government budget deficits and too rapid monetary growth are the classic germ cell of an inflationary process. In view of this danger, which also casts doubt upon the planned "soft landing" for the dollar, the American central bank can be expected to opt for a less expansionary course in 1986. This need not be accompanied by a renewed increase in interest rate levels, if at the same time credible efforts to reduce the budget deficit would justify expectations of a lowering of interest rates. The pressures to opt for such an economic strategy are constantly growing; the forthcoming mid-term elections in the USA at the end of the year, however, seem to have a paralysing effect on fiscal policy decision-makers.

With the dollar probably tending to become weaker, exchange rate considerations are likely to become less important for the central banks of the other industrialised countries. The prevailing objectives indicate that a course of steady, stability- and potential-oriented monetary growth will generally be pursued. A reorientation in this direction is particularly urgent in Japan, where the exchange-rate-oriented raising of interest rates during the last few months has curbed domestic demand at a time in which the increase in exports has already come to a standstill. Although monetary policy in the Western European economies will occasionally be subject to greater external influences during the run-up period to adjustments of central rates within the framework of the European Monetary System, a basic tendency towards an adequate money supply and slightly falling interest rates can be expected. Fiscal policies will generally support this development via consolidation efforts, even though budget deficits will often remain high, especially in Italy. On the other hand, even allowing for the adherence to the consolidation objective, there may be scope in a number of major countries for improving supply conditions via tax cuts.

Moderate Rise in Production in USA

Despite the previous expansionary monetary and fiscal policies in the USA demand and production there will only increase at a moderate pace during 1986. The main reason for this is probably the still unusually high real interest rate level, which, for example, was well over 6 % at the end of 1985 in the case of long-term government bonds. It now looks as if the government, which is much less sensitive to the level of interest rates, is crowding out private investors. Stagnation, at any

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rate, has become apparent in the field of fixed industrial investment, and the housing sector is also unlikely to recover to any noticeable degree despite the drop in interest rates hitherto. The savings ratio is unlikely to decrease any further and private consumption will probably increase at a slower pace than it has done so far. On the whole, the increase in domestic demand will probably be less pronounced. The improved competitive strength of American producers as a result of the depreciation of the dollar, however, will stimulate exports and curb the increase in imports. All in all, therefore, the increase in real GNP in the USA in 1986 will probably lie between 2½ and 3 %, slightly higher than last year.

Considerable uncertainty with regard to fiscal, monetary and foreign trade policies in the USA surrounds this forecast. However, even though the smouldering problems are unlikely to come to a head this year, the rest of the world can only expect weak demand stimuli from the USA. As a result, there has already been a noticeably reduced propensity to invest in Japan. The measures adopted to boost investments, on the other hand, will take time to become effective. The levelling-off of exports, therefore, will probably coincide with a somewhat waning expansion of domestic demand. The probable 3 to 3½ %

increase in real GNP in 1986 will only be slightly higher than in the other industrialised countries.

More Investments in Western Europe

The reduction of external stimuli will not be so noticeably felt by Western Europe, which did not benefit to the same extent as Japan from the economic upswing in the USA. Against this background, the tendency towards greater domestic demand will suffice to reduce the slowdown in the restrained economic expansion. The consolidation of the investment propensity as a result of an improved profits situation for businesses is of decisive importance in this respect. Activities in the housing and public building sectors are also, at least generally, unlikely to decline any further, and private consumption will increase at an accelerated pace under the influence of cyclical income stimuli, the steadying of prices and in some cases fiscal stimuli. On the whole, real GNP in Western Europe will, as in the two previous years, probably increase by about 2½ % in 1986.

Production in the major industrialised countries, therefore, will increase at a similar pace in 1986. As in 1985, the growth rate of the combined GNP will probably reach just under 3 % this year. 1986, therefore, promises to be the fourth year running to witness a

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	
	1976-83 ^a	1984	1985 ^b	1986 ^b	1976-83 ^a	1984	1985 ^c	1986 ^b	Dec. 1984	Dec. 1985	1984	1985 ^d
USA	2.3	6.6	2.5	3.0	8.0	4.3	3.5	4.0	10.2	-13.1	7.5	7.2
Canada	2.4	5.0	4.0	3.0	9.1	4.3	4.0	3.5	-2.9	-9.8	11.3	10.5
Japan	4.4	5.1	4.5	3.5	5.2	2.2	2.0	2.0	1.8	10.8	2.7	2.6
Western Europe ³	2.0	2.4	2.3	2.5	10.0	6.2	5.4	4.0	.	.	10.5	10.8
Austria	2.5	2.2	3.0	2.5	5.2	5.6	3.0	2.5	-0.2	2.9	4.5 ¹	4.7 ¹
Belgium	1.8	2.2	1.5	2.0	7.0	6.3	5.0	3.5	0.5	2.0	12.4	11.6
Denmark	2.2	4.0	2.5	3.0	10.1	6.3	4.5	2.5	0.1	2.8	10.0	9.0
Finland	2.9	2.9	3.5	2.5	10.4	7.1	6.0	5.0	-2.5	3.6 ^e	6.2	6.4
France	2.4	1.6	1.0	2.0	10.9	7.3	6.0	4.0	-1.8	5.5	9.9	10.3
FR Germany	2.2	2.7	2.5	3.0	4.4	2.4	2.0	2.0	-1.4	5.4	8.1	8.2
Great Britain	1.5	2.4	3.5	2.5	12.1	5.0	6.0	4.0	-9.3	5.0	11.4	11.9
Ireland	3.5	4.4	2.5	2.5	14.8	8.6	5.5	5.0	1.4	3.1	16.0	17.2
Italy	2.2	2.6	2.0	2.5	16.3	10.8	9.0	7.5	-3.2	-6.3	10.4	10.6
Netherlands	1.4	1.7	2.0	2.0	5.7	3.3	2.5	1.5	-1.6	4.3	14.4	13.4
Norway	3.6	3.8	4.0	4.0	9.4	6.2	5.5	5.0	-4.4	-0.7	3.3	2.7
Spain	1.7	2.3	2.0	2.5	16.7	11.3	8.5	6.0	0.0	-1.9 ^e	20.1	21.4
Sweden	1.2	3.0	2.0	2.0	10.3	8.0	7.5	5.5	1.6	-2.3	3.1	2.8
Switzerland	1.2	2.0	3.5	3.0	3.3	2.9	3.5	2.0	-4.2	3.0	1.1	1.0
OECD Countries Total ³	2.5	4.6	2.8	3.0	8.4	4.7	4.0	3.7	.	.	8.1	8.1

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 October. ^f In % of employed persons.

Sources: OECD, IMF, Deutsche Bundesbank, various national statistics, own estimates and forecasts.

marked increase in production. In view of this it is all the more remarkable that the increase in prices will probably remain relatively moderate. The average rate of inflation of 4 % for private consumption in the Western European economies this year will no longer exceed that of the US economy. On the other hand, economic growth in the industrialised countries is still too weak to enable employment to increase faster than the labour supply. Unemployment, therefore, is unlikely to decrease to any noticeable degree.

Developing Countries: Dismal Prospects

In view of the moderate increase in demand in industrialised countries world trade will only expand slowly. In real terms the increase will probably be just as low as in 1985, i.e. approximately 3 %. The stimuli, which primarily emanate from Western Europe, will be offset by a further reduction of imports by oil-exporting countries, since the procurements of the latter group will probably have to be realigned to the renewed reduction in export earnings. Allowing for considerable differences between individual countries, the imports of the other developing countries will, on the whole, probably only increase slightly. Their ability to import will also be adversely affected by the fact that due to the restrained growth of the world economy demand for their major export products, especially raw materials, will hardly increase. In addition, within the existing structure of exports and imports the decreasing value of the dollar is initially reflected in the case of these countries in a deterioration in the terms of trade. On the whole, as in 1985 the current account deficits of the developing countries will increase somewhat in 1986, even with imports increasing only slightly. Despite the decrease in interest rates on international financial markets the containment of the debt crisis will thus remain a difficult problem, particularly in view of the fact that opposition to the imposition of further stabilisation

and adjustment measures is growing as the "hardship period" continues.

The continually low level of oil and raw materials prices undoubtedly provides relief for the industrialised countries in terms of their stability efforts. As regards the Western European economies and Japan, whose currencies are appreciating in value against the dollar, this development is accompanied by a substantial improvement in the terms of trade, i.e. by an increase in real income. However, regardless of how welcome these effects may seem to individual countries, they do not buttress the world economy, since these effects are counteracted by the income losses and additional current account deficits of oil-exporting and developing countries. In contrast to previous years, the strained balance of payments situation in many of these countries means that this affects their imports, and subsequently the development of production and incomes in industrialised countries, at an earlier stage.

World Economy Remains Unstable

All in all, the world economy remains unstable, and the sustained improvement of the conditions for growth remains a primary economic policy objective. One of the main reasons for the high real interest rate levels, which clearly stand particularly in the way of a more dynamic economic development and also aggravate the debt crisis, is that in many industrialised and developing countries a considerable share of savings is not available for productive use because of the financing of government consumption and transfer spending. Here, too, the USA plays an extremely important part on account of its economic weight. The obstacles on the path towards consolidation, however, are merely a striking example of the fact that adverse developments which have taken place throughout the world over a longer period of time can only be rectified within the framework of an arduous and lengthy process.

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

Raw Materials and Groups of Materials	1984		1985				1986	
	AA ²	December	AA ²	October	November	December	3. 1.	17. 1.
Total index	205.0	201.1	197.3	195.6	196.7	198.5	200.6	199.1
Total, excl. energy raw materials	125.1	115.0	112.5	109.3	112.0	116.6	121.9	119.5
Food, tropical beverages	122.7	111.9	106.9	100.8	105.7	114.2	125.2	119.2
Industrial raw materials	126.9	117.4	116.8	115.8	116.7	118.4	119.3	119.6
Agricultural raw materials	128.6	115.9	112.4	114.3	114.6	117.8	119.8	119.9
Non-ferrous metals	135.8	127.8	131.5	127.2	125.5	128.4	127.1	129.0
Energy raw materials	251.7	251.4	246.7	246.0	246.2	246.4	246.5	246.5

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