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## World Economy Lacks Momentum

by Günter Großer and Günter Weinert, Hamburg\*

**After the price of oil began falling sharply during the first few months of 1986 the prospects for a more pronounced and long-lasting economic upswing in the industrialised countries were generally regarded as having improved. The increase in demand and production in 1986, however, was more restrained than expected. Against this background, what are the prospects for expansionary forces in 1987?**

One of the main reasons why the positive impact of the collapse of the price of oil on the development of the economy was overestimated last year was that the increasing depreciation of the dollar meant that a second key international economic parameter changed substantially. Although this was also basically an adjustment to a preceding immoderate upward revaluation, the continuing depreciation of the American currency also meant that a growing number of trading partners had reached their "pain threshold". The effects of the oil price reduction on the one hand, and the shift in exchange rate relations on the other, overlapped to a varying degree in individual branches, and the growing uncertainty about the course of adjustment processes put a discernible strain on the business climate in the industrialised countries.

Contrary to expectations, the annual increase in production in the OECD countries in 1986 was slightly lower than during the previous year. It was now more or less the same everywhere, real GNP increasing by approx. 2.5 % in the USA, Japan and Western Europe. The respective growth rates of domestic final demand, roughly one percentage point higher than those of real GNP, also converged to a considerable degree, since the corresponding growth rate slowed down in the USA but accelerated substantially in Western Europe. This reflected particularly the boost given to private consumption by the transfer of real income resulting from the slump in the price of oil and the appreciation of most Western European currencies against the dollar. In Japan, on the other hand, these stimuli only reached private households to a slight extent, since the considerable reduction in import prices was only slowly passed on to consumers. Although this led to correspondingly higher profits in the favoured sectors of the economy there was a concomitant drastic deterioration in the profit prospects of export industries,

which had a considerably adverse effect on the propensity to invest.

The fact that the increase in production in the industrialised countries lagged behind the increase in domestic demand was due to processes of external economic adjustment, primarily triggered off by the slump in the price of oil and the depreciation of the dollar. Oil-exporting countries, for example, were obliged to curb imports substantially due to the drastic reduction in their export earnings. However, imports were also reduced in many other developing countries whose terms of trade had deteriorated due to the pressure on prices on raw materials markets and the effects of the weakness of the dollar, in an effort to prevent the serious debt problems from getting even worse. The industrialised countries' imports, on the other hand, picked up, mainly because stocks of oil and oil derivatives were replenished following the marked drop in prices, but also, for example, because there was a further improvement in the competitive strength of the so-called newly industrialising countries, whose currencies are closely pegged to the dollar. In contrast to this, the considerable depreciation of the dollar only had a gradual effect on the exchange of goods between the USA on the one hand and Western Europe and Japan on the other, since non-American suppliers initially defended their market positions even although this meant a substantial loss of profits.

Although the considerable shifts in the terms of trade between industrialised and developing countries were soon accompanied by substantial quantitative reactions, there was a substantial shift in current account balances, primarily to the detriment of the oil-exporting countries. The imbalances in trade relations between the industrialised countries themselves have also become more pronounced. Whereas Japan's current account surplus in 1986 increased to over US \$ 80 billion and Western Europe's to almost US \$ 60

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billion, the deficit in the USA increased again, to roughly US \$ 140 billion, even though the terms of trade improved considerably despite the dollar depreciation.

### Price Stabilisation

With the upswing remaining restrained, economic policies in the industrialised countries in 1986 were also hardly able to move any closer to achieving their most important objective: the improvement of the employment situation. The increase in the number of employed persons was only able to prevent an increase in the rate of unemployment, which still averaged 8 % of gainfully employed persons in OECD countries. The lower price of oil, on the other hand, was a major factor which helped by and large to contain the increase in prices. The annual rate of inflation at consumer level, which still averaged 4 % in the industrialised countries in 1985, fell to little more than 2 % in 1986.

Although the steadying of prices last year was unmistakably exaggerated by special factors, economic policies, above all in the USA, saw scope for intensifying the expansionary course. With the government budget deficit still rising, the US central bank stepped up efforts to reduce interest rates and accepted the associated very substantial growth in the money supply. Other industrialised countries were unable to steer clear of the wake of American monetary policy due to the very fact that they were intent on preventing the appreciation of their currencies against the dollar from becoming even greater. Despite the expansionary monetary policy worldwide, however, the process of interest rate reduction, which had been rapid up to that point, already began to flag again in the early summer of 1986.

The continuing weakness of the dollar was probably also an expression of the fact that the "Reagan bonus", which was an effective factor for a long time, had disappeared in the face of growing uncertainty over American economic policies. In this situation there is a greater risk that the monetary inflation potential – also under the influence of higher import prices caused by depreciation – might eventually become virulent. Monetary policy in the USA during 1987, therefore, will probably turn to a less expansionary course. A shift in American fiscal policy has also become more probable. Although the deficit is hardly likely to be cut to the extent envisaged in the Gramm-Rudman law, a marked reduction definitely seems probable. One of the contributory factors in this respect are transitional tax reform arrangements which will temporarily lead to greater government revenue in 1987. A marked reduction in the budget deficit would improve the

prerequisites for the slowing down of monetary expansion without considerable interest rate increases. At the same time, greater confidence in an again more pronouncedly stability-oriented policy by the USA would probably moderate the decline of the dollar.

Such a "smooth landing" by American economic policy would be an important step towards improving the prospects for economic development in the rest of the world. In Western European countries and Japan the central banks would then be more likely to be able to pursue a potential-oriented course which would not allow new inflationary expectations to develop. This is all the more important in view of the fact that the end of the oil price decline and of the dollar depreciation means an end to imported stability. In most countries fiscal policy will probably tend to be geared to enlarging the scope for a more dynamic development of market forces by reducing the ratio of public sector spending to GNP as well as national budget deficits. This also applies to Japan, since the additional investments announced for the current and the next financial year in the economic policy programme of autumn 1986 will be offset by corresponding spending cuts in other fields.

### World Economy Still Restrained

Actual economic relationships are currently being concealed worldwide to an unusual extent by the adjustments to the abrupt shifts in relative prices, and this at a time when there are in many instances still serious imbalances caused by adverse developments in the past. This is one of the reasons why the forecast for the USA, in particular, is marked by greater uncertainty than usual. Working on the basis of the afore-mentioned assumptions, especially regarding economic policy parameters, domestic demand in the USA will probably increase at an even lower pace in 1987. Above all, a renewed increase in the – previously extremely low – propensity to save can be expected to put a brake on the expansion of private consumption. Following the depreciation-induced strengthening of the competitive position of American suppliers, on the other hand, exports will probably pick up, whereas imports will increasingly be subdued. Altogether, the US economy will probably continue to be characterised by a slight upward trend; the increase in real GNP in 1987 will probably resemble the corresponding figure for 1986, i.e. between 2½ and 3 %.

The shift in trade flows in real terms brought about by the dollar depreciation will occur at the expense of those countries whose currencies have noticeably appreciated. The deterioration in the competitive position of these countries will stimulate a reduction in

exports and an increase in imports. The retardant effects are most pronounced in Japan, since Japanese firms compete to a particularly large extent with suppliers from the dollar area – which de facto also includes South Korea, Taiwan and Hong Kong. The deterioration of the sales and, above all, the profit prospects in the international sector of the Japanese economy will lead to a considerable reduction of investments in this sector. Therefore, despite the effects of the transfer of real income which resulted in particular from the lower price of oil, the dynamic thrust of domestic demand in Japan will in 1987 probably once more fail to increase substantially and GNP can only be expected to increase at a moderate pace.

In the Western European economies the retardant effects of the appreciation of currencies against the dollar will be less significant than in Japan. On the other hand, the marked stimuli to real incomes and domestic demand, which primarily emanated from the reduction in the price of oil will lose momentum during the course of 1987. This particularly applies to private consumption, but probably also to a certain extent to business investments, even though there will probably be a very differentiated development here due to the juxtaposition of expansionary and contractive adjustments to the slump in the price of oil and the currency appreciations.

At the same time the decline in exports to the rest of the world will probably become less pronounced, especially since the substantially reduced demand by oil-exporting countries can be expected to gradually become more stable. Altogether, there are signs of a rather restrained economic upswing. The increase in real GNP in Western European countries in 1987 will probably again average roughly 2½%, although the pace of this increase will tend to slow down during the course of the year.

### Developing Countries: Persistent Problems

The only moderate increase in real GNP in the industrialised countries continues to understate the associated demand stimuli, since the continuing adjustment to shifts in price and exchange rate relations benefits the rest of the world. Nevertheless, the external conditions for an improvement of the economic situation in the developing countries remain unfavourable. The demand for raw materials, which still account for the lion's share of their exports, will only increase slightly in view of the slow growth of the world economy. An easing of their external economic problems is all the more dependent on their ability to penetrate new markets for manufactures in industrialised countries; here, however, they are still facing a growing number of protectionist barriers.

What is more, there is no indication of an improvement

### Economic Indicators

	Real Gross National Product (Year-on-year change in %)				Consumer Prices (Year-on-year change in %)				Exchange Rates <sup>1</sup> (Change over 12 mths in %)		Unemployment Rate <sup>2</sup>	
	1976-84 <sup>a</sup>	1985	1986 <sup>b</sup>	1987 <sup>b</sup>	1976-84 <sup>a</sup>	1985	1986 <sup>c</sup>	1987 <sup>b</sup>	Dec. 1985	Dec. 1986	1985	1986 <sup>c</sup>
USA	2.9	2.7	2.5	3.0	7.6	3.6	2.0	3.5	-13.1	-13.6	7.2	7.0
Canada	2.7	4.0	3.5	3.0	8.5	4.0	4.0	5.0	-9.8	-3.2	10.4	9.6
Japan	4.5	4.7	2.5	2.5	4.9	2.1	0.5	0.5	10.8	14.4	2.6	2.8
Western Europe <sup>3</sup>	2.0	2.4	2.5	2.5	9.6	5.4	3.0	3.3	.	.	10.7	10.7
Austria	2.5	3.0	2.0	2.0	5.3	3.2	1.7	2.0	2.9	4.3	4.8 <sup>e</sup>	5.1 <sup>e</sup>
Belgium	1.8	1.3	2.0	1.5	6.9	4.9	1.3	1.5	2.0	5.2	11.6	10.7
Denmark	2.3	3.8	3.0	1.0	9.7	4.7	3.7	2.5	2.8	4.6	8.9	7.7
Finland	2.9	2.8	1.5	2.5	10.1	5.9	3.5	3.0	5.5	0.0 <sup>d</sup>	6.3	7.0
France	2.3	1.1	2.5	2.5	10.5	5.8	2.5	3.5	5.5	-0.3	10.3	10.5
FR Germany	2.2	2.5	2.5	2.5	4.2	2.2	-0.2	1.0	5.4	9.0	8.2	7.9
Great Britain	1.5	3.5	2.5	2.5	11.2	6.1	3.5	4.5	5.0	-15.3	11.4	11.7
Ireland	3.4	2.0	2.5	3.0	14.1	5.4	4.0	3.0	3.1	2.4	18.0	18.3
Italy	2.3	2.3	2.5	3.0	15.7	9.2	6.0	5.5	-6.3	6.5	10.7	11.1
Netherlands	1.5	2.0	1.5	2.0	5.4	2.3	0.2	1.0	4.3	7.2	13.3	12.4
Norway	3.7	4.2	3.5	3.0	9.0	5.7	7.0	7.5	-0.7	-12.0	2.5	2.1
Spain	1.7	2.1	3.0	3.5	16.1	8.8	8.5	6.0	-1.9	4.6 <sup>d</sup>	21.9	21.0
Sweden	1.4	2.3	2.0	2.5	10.0	7.4	4.2	4.0	-2.3	-3.7	2.8	2.7
Switzerland	1.3	4.0	2.5	2.5	3.3	3.4	0.7	1.5	3.0	7.9	1.0	0.8
OECD Countries Total <sup>3</sup>	2.8	2.9	2.5	2.7	8.0	4.1	2.2	3.0	.	.	8.1	8.0

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

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

in the terms of trade of developing countries. The world market prices of raw materials are hardly likely to increase in 1987 in the face of continuing excess supply; as regards oil, it will probably prove impossible to maintain the price increases recently negotiated by OPEC members over a longer period. In the case of many oil-exporting countries further adjustments of demand and imports to lower export earnings will be inevitable.

Due primarily to the continuingly serious debt problems, the scope for growth in the rest of the developing countries will remain limited, although there will be widely differing trends in individual countries depending on their respective economic and foreign trade structures. Given these factors, the economic authorities will find it increasingly difficult to reduce public and private consumption in connection with the necessary processes of adjustment, in view of the already low standard of living.

### Imbalances in World Trade

The basic trend in world trade in 1987 will be determined by the still moderate increase in economic activity worldwide; as in the previous two years, its volume is expected to increase at between 3 and 4 %. Continuing adjustments to the altered exchange rate and price relationships will characterise the development here for some time to come. Expansionary stimuli will primarily emanate from the Western European economies and Japan, since the increase in overall demand here as a result of the appreciation of their currencies will increasingly benefit suppliers from the dollar area; in the USA, on the other hand, the increase in imports will be curbed by the low external value of the dollar. On the whole, developing countries are once more hardly likely to contribute towards an expansion in world trade in 1987, even though at least the contractive influences emanating from the oil-exporting countries will probably die down during the

course of the year. The shifts in imports and exports in real terms will gradually come to be reflected in the development of the balances on current accounts. However, for the year 1987 as a whole, the deficit of the USA, on the one hand, and the surpluses of Japan and Western Europe, on the other, are still unlikely to be much lower than they were in 1986.

Despite the somewhat advanced "normalisation" of exchange rate relations, the serious imbalances in the flows of goods and services between the USA and the remaining industrialised countries can only be slowly rectified due to the fact that this involves reversing processes which have only just got under way during an over four-year period of dollar appreciation. Above all, however, the USA's current account deficit is connected with the vast inflow of capital into this country, which is caused by the high budget deficit accompanied by a low level of domestic saving. Failure to consolidate public finance, therefore, tends to sustain the USA's external economic disequilibrium and thus also to indirectly foster protectionist efforts.

The outlook for 1987 still leaves the question unanswered whether the slump in the price of oil and the adjustment of the dollar exchange rate will eventually provide the expected improvement of growth conditions able to release additional expansionary forces for the world economy. Discernible trends at any rate again indicate only a restrained upward trend – marked by considerable risks – this year. Impatience inevitably grows in such a situation, as demonstrated by the insistence by the USA on a stimulation of the demand expansion in the surplus countries. There is hardly any indication, however, that the application of this therapy in other countries would lead to the success it is currently unable to achieve in the USA itself. Such an approach is more likely to endanger the stabilisation successes achieved so far and thus to jeopardise an important condition for more worldwide economic growth.

**HWWA Index of World Market Prices of Raw Materials<sup>1</sup>**  
(1975=100)

Raw Materials and Groups of Materials	1985		1986				1987	
	AA <sup>2</sup>	December	AA <sup>2</sup>	October	November	December	2. 1.	16. 1
Total index . . . . .	197.3	198.5	143.2 <sup>P</sup>	129.7 <sup>P</sup>	129.1 <sup>P</sup>	130.2 <sup>P</sup>	137.1 <sup>P</sup>	145.4 <sup>P</sup>
Total, excl. energy raw materials . . . .	112.5	116.6	116.1	114.9	113.7	112.7	113.1	113.6
Food, tropical beverages . . . . .	106.9	114.2	107.1	101.2	98.9	93.8	91.0	91.0
Industrial raw materials . . . . .	116.8	118.4	122.9	125.4	125.0	127.0	129.9	130.8
Agricultural raw materials . . . . .	112.4	117.8	131.0	137.4	137.6	140.3	145.2	146.9
Non-ferrous metals . . . . .	131.5	128.4	124.3	122.1	120.9	123.0	125.2	123.7
Energy raw materials . . . . .	246.7	246.4	159.1 <sup>P</sup>	138.3 <sup>P</sup>	138.2 <sup>P</sup>	140.4 <sup>P</sup>	151.0 <sup>P</sup>	164.0 <sup>P</sup>

<sup>1</sup> On dollar basis. - <sup>2</sup> Annual Average. <sup>P</sup> Provisional (due to incomplete data on oil prices).