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Recovery of US Economy Continues

The sharp drop in the dollar exchange rate had hardly any effect on the development of the US economy last year. In particular, there was only a slight increase in exports; domestic demand, on the other hand, continued to expand rapidly. Real GNP increased by 2.5 % in 1986. There was also a considerable increase in the number of employed persons. The 6.7 % rate of unemployment at the end of the year, however, was only marginally lower than one year previously. There was a marked decrease in the rate of inflation in 1986, primarily as a result of the drop in energy prices. The annual average rate of inflation for the private cost of living fell by almost half to 1.9 %. During the second six months of the year, however, the current rate had once more risen above that level.

It was above all the private households that accounted for the expansion of domestic demand. At a good 4 % private consumption in real terms increased at a faster rate than disposable incomes in 1986. Up until last autumn there was also a substantial increase in housing investments. The number of building permits and new building projects declined, however, after the drop in interest rates in spring had virtually come to a standstill. The volume of business investment was reduced at the beginning of the year and more or less stagnated after this period; it also increased only slightly in branches outside of the oil industry. Contractionary influences emanated during the second half of 1986 from the stockbuilding activity in the business sector; in comparison with the sales volume stock levels were finally very low.

The external value of the dollar vis-à-vis the currencies of the other major industrialised countries was only slightly higher at the beginning of this year than it had been in the early 1980s. Nevertheless, there has only been a slow expansion in the volume of exports so far – by roughly 2 % during 1986. This contrasts with a marked tailing-off of the increase in imports during the course of the year, even though due to the overhang there was still an increase of almost 10 % for 1986 as a

whole. Due to the decrease in the price of oil imports the terms of trade improved up until the late summer, especially since the increase in the price of imported industrial products was much less pronounced than might have been expected in view of the dollar depreciation. A deterioration seems to have occurred, however, after this period. The balance of trade deficit remained at a high level throughout the whole year. Altogether, the deficit of US \$ 153 billion (imports f.o.b.) was approximately US \$ 20 billion higher than in 1985.

The central bank has already been trying to support demand and production since the end of 1984 via lower interest rates and a weaker dollar. It was hoped that this would at the same time reduce the considerable protectionist pressure. Reservations regarding stability policy were subordinated to these goals. When last year there were no indications of either an accelerated economic recovery or an improvement in the foreign trade situation, the expansionary policy was intensified even further. In the fourth quarter of 1986 the money supply M1 was 15 % higher than one year previously after the corresponding increase in 1985 had already been 12 %. A target range of 3 to 8 % had originally been announced for both years. The long-term interest rates, which had fallen by four percentage points within a year up until spring 1986, have remained at 7½ % ever since despite further discount rate cuts.

In terms of the development of the budget deficit, fiscal policy retained its expansionary course until well into 1986. In fact, the deficit of US \$ 220.7 billion in the financial year 1985/86 was even somewhat higher than in the previous year. Then, however, a trend reversal apparently occurred. The government currently expects the deficit for the current financial year (since October) to be roughly US \$ 175 billion. This means that the deficit envisaged in the Gramm-Rudman law would be surpassed by a good US \$ 30 billion. Nevertheless, the draft for the financial year 1987/88 sticks to the projected reduction of the deficit to US \$ 108 billion. In order to achieve this goal spending cuts are planned in the

civilian sector and revenue is to be raised via higher government charges and the sale of federally owned property. The proposed budget, however, which envisages a marked real increase in defence spending, is rejected by Congress as a basis for negotiations.

The tailing-off of the increase in costs and prices together with the marked decline in interest rates led to an improvement in important growth conditions in the USA last year. Furthermore, the international competitive position of American suppliers has been substantially strengthened by the depreciation of the dollar vis-à-vis the currencies of most other industrialised countries. Against this background it is all the more remarkable that the continuous expansionary monetary and fiscal policies did not result in an accelerated increase in demand, but that the associated risks have tended, rather, to worsen the business climate. The key problem is the high government financing deficit. The budget deficit is now so high that its speedy reduction is no longer possible without causing other economic problems. In this respect, lagging behind the target figure envisaged in the Gramm-Rudman law does not in itself run contrary to a strategy aimed at reducing the overall economic "costs" of consolidation. A problematic aspect, however, is the obstruction of fiscal policy measures by the inability of the Government and Congress to agree on revenue-raising and spending priorities. Nevertheless, a gradual further reduction of the budget deficit can be expected.

The more pronounced trends towards consolidation become and the less the state therefore turns to financial markets, the greater the possibility that monetary expansion in the USA can be slowed down without triggering noticeable interest rate increases. Such a development is all the more important in view of the fact that, as energy prices do not fall any more, the risk that the price climate will become less favourable

and that the growing scope for price increases will be utilised will increase. Also with the aim of stabilising the dollar exchange rate the central bank will probably set out to limit monetary expansion during 1987. The tax reform which came into force at the beginning of 1987 is an additional factor of uncertainty for the forecast of economic trends. In terms of the expected burden and relief balance the deprivation effects are likely still to predominate during the current year.

In view of the gradual adjustment of the expansionary economic policy course assumed here a slowing down of the increase in domestic demand is probable. Apart from the reduced expansion of government demand, there will probably above all be a less pronounced increase in private consumption despite the tax relief for households, especially since the savings ratio is hardly likely to fall any further. There will probably again be a slight increase in business investment. Exploration and development activities in the oil industry are unlikely to be reduced any further, and the propensity to invest would seem to have been positively influenced in the other branches by the increase in profits. Whereas, on the whole, domestic demand will probably increase more slowly, exports are likely to increase at an accelerated pace and imports will stagnate or even decline. All in all, there will probably be a slight increase in demand and production; GNP in real terms in 1987 is likely to be once more roughly 2½ % higher than in the previous year. Prices will increase at a faster pace; the effects of cheaper energy prices will die down, and imports will become appreciably more expensive. Consumer prices will increase by approximately 3½ % on an annual average. There will probably be a gradual reduction in the current account deficit.

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	1986				1987			
	AA ²	October	November	December	January	February	27. 2.	13. 3.
Total index	143.2 ^P	129.7 ^P	121.1 ^P	130.2 ^P	145.1 ^P	146.4 ^P	148.8 ^P	146.6 ^P
Total, excl. energy raw materials	116.1	114.9	113.7	112.7	114.0	116.1	117.3	117.0
Food, tropical beverages	107.1	101.2	98.9	93.8	91.9	91.2	92.1	89.4
Industrial raw materials	122.9	125.4	125.0	127.0	130.8	135.1	136.5	138.0
Agricultural raw materials	131.0	137.4	137.6	140.3	146.9	152.3	153.7	155.4
Non-ferrous metals	124.3	122.1	120.9	123.0	124.1	126.9	129.0	131.4
Energy raw materials	159.1 ^P	138.3 ^P	138.2 ^P	140.4 ^P	163.3 ^P	164.1 ^P	164.1 ^P	164.0 ^P

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